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Banxico Watch

Banxico set to deliver another 50bp cut despite signs of slower disinflation

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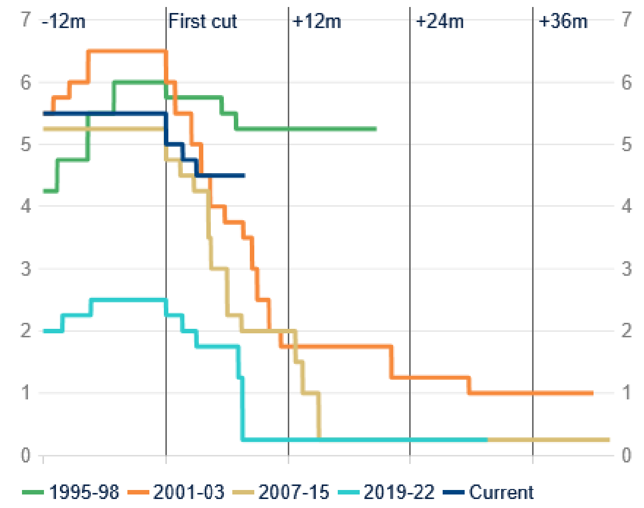
The Board may temper its dovish tone when signaling the pace of future rate adjustments, following April's inflation readings

- **Last week, the Fed held rates steady at 4.25-4.50% and appeared set to extend the pause at its next meeting in June.** The policy statement reaffirmed that "economic activity has continued to expand at a solid pace," suggesting the Fed remains confident in the strength of underlying domestic demand despite ongoing uncertainty. It continued to describe labor market conditions as "solid" and maintained a cautious tone on inflation, which "remains somewhat elevated." While "the risks of higher unemployment and higher inflation have risen," the statement emphasized that the Fed remains in wait-and-see mode. Powell noted that the data portray "a healthy economy albeit one that is shrouded in some very downbeat sentiment," with no evidence to justify near-term rate cuts. He reiterated that the Fed is not "in a hurry" to adjust policy and that the monetary policy stance is well-positioned to respond to either persistent inflation or slowing growth (Figure 1). The announcement reinforced our view that the Fed is unlikely to deviate from its wait-and-see approach in the near term and is likely to keep rates steady in June. Looking further ahead, we believe rate cuts are also unlikely shortly thereafter, especially given our expectation that tariff-related inflation will feed into upcoming data. As the outlook evolves, we'll be watching whether this cautious pause extends into the second half of the year (see here and here for additional details on last week's FOMC meeting). In contrast to the Fed, Banxico has room to continue cutting rates amid Mexico's ongoing economic slowdown. A low exchange rate pass-through and deeper domestic capital markets—now less vulnerable to foreign capital outflows—grant Banxico greater policy independence than in the past.
- **The Mexican economy avoided a technical recession in 1Q25, but underlying economic weakness continues to justify further monetary easing.** Following a 0.6% QoQ contraction in 4Q24, real GDP grew by just 0.2% in 1Q25, driven by an 8.1% rebound in the primary (agricultural) sector that more than offset both a 0.3% contraction in the secondary (industrial) sector and the stagnation in the tertiary (services) sector—a segment that had indeed consistently supported growth throughout 2024. Although the unemployment rate remains near historic lows (2.62% in March), weak momentum in both public and private investment is reflected in the sluggish pace of formal job creation. In April, the loss of 48,807 seasonal jobs far outweighed the modest gain of 1,365 permanent positions, according to IMSS data. Year-to-date, about 180,000 formal jobs have been created—well below the nearly 400,000 average over the same period in the past three years, resulting in an annual growth rate of just 0.2%. In addition, our big-data indicators confirm the deceleration of consumption in April. These developments point to a weak start of 2Q25. This reinforces our view that demand-driven price pressures are unlikely to be a concern for Banxico. With two consecutive quarters of weak activity data, the economy appears to be operating near a cyclical low—one that clearly does not warrant the current degree of very tight monetary policy restriction and will therefore lead most Board members to maintain their view that further policy rate cuts are appropriate.

- **Following April's inflation data and three straight 50bp rate cuts, the Board may adopt a less dovish tone in its forward guidance on the pace of future rate moves.** Core inflation rose to 3.93% YoY in April from 3.64% in March (Figure 2), driven primarily by core goods (up to 3.38% from 2.98%) and, to a lesser extent, core services (up to 4.56% from 4.35%). Within the latter, the “other services” category was particularly disappointing, rebounding to 5.31% from March’s 42-month low of 4.92%. Despite this, core services inflation has made a better start to 2025 than in previous years, and we remain confident it will continue to moderate in the coming months, supported by a slowing economy and subdued labor market conditions. As noted in earlier reports, we believe core inflation has entered the “last mile” of the disinflation process—where continued moderation in services offsets a gradual reacceleration in core goods, which was the main disinflation driver over the past two years and remained below historical averages for much of 2024. We now forecast year-end core inflation at 3.8% and expect Banxico to revise up its short-term inflation forecasts as well.
- **With no inflation risks stemming from exchange rate developments, Banxico has room to further unwind its still excessively restrictive policy stance.** The Mexican peso has stabilized despite global volatility triggered by tariff-related uncertainty. The spike in global volatility following Trump’s “Liberation Day” announcement in early April has almost fully reversed, as the implementation of the most disruptive reciprocal tariffs—including those targeting China—has been delayed. In recent weeks, the peso has even outperformed other EM currencies. This improvement follows a period of significant underperformance after last year’s Mexican elections and the approval of controversial constitutional reforms—particularly the judiciary reform—which had weighed heavily on investor sentiment (Figure 3). The peso’s stability likely reflects a reassessment of Mexico’s position within global trade dynamics. So far, the country has emerged relatively unscathed from US tariffs compared to other trading partners, and we believe that the weighted average tariff that Mexico faces on its exports to the US will continue to decline in the coming weeks as more goods are channeled through USMCA. reinforcing confidence in the peso’s outlook. This likely outweighs, at least for now, lingering concerns over institutional risks, as reflected by still elevated country risk premia relative to EM peers.
- **The ex-ante real policy rate remains at 5.25%, well above Banxico’s estimated neutral range (1.8-3.6%), justifying another 50bp cut this week** (Figure 4)**.** Minutes from the March meeting revealed that at least three Board members leaned toward another 50bp cut: one “deemed that, looking ahead, adjustments of a similar magnitude […] could be made;” another said “given the expected macroeconomic conditions, it is possible that a cut of the same magnitude could be implemented at the next meeting;” and a third noted that “adjustments of the same magnitude in the reference rate could continue.” Barring a sharp inflation reversal or peso depreciation—both unlikely in the near term—Banxico is expected to continue easing until it eventually reaches a neutral stance early next year. That said, forward guidance may become slightly less dovish, reflecting both stronger-than-expected inflation and the likely upward revisions to Banxico’s inflation forecasts. Nevertheless, we believe that one or two of the most dovish Board members could still raise the possibility of an additional 50bp cut in June, and thus, the statement will likely avoid ruling out a fourth outsized rate cut next month. At the very least, Banxico is likely to clearly signal that the easing cycle will continue, though probably at a slower 25bp pace, as we project for the months ahead.

The Fed is not “in a hurry” to adjust monetary policy

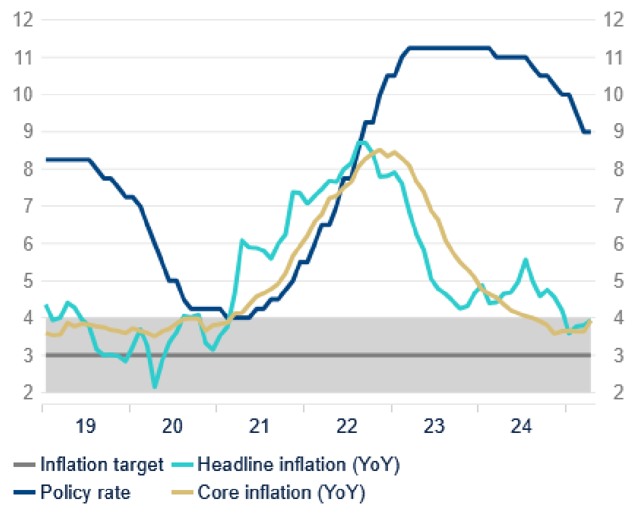
Figure 1. **FED FUNDS RATE IN EASING CYCLES**
(%)



Target rate for the 1995-98, 2001-03, and 2007-15 (before 16-Dec-08) cycles; upper limit of the target rate range for the 2007-15 (after 16-Dec-08), 2019-22, and current cycles. Source: BBVA Research / Fed

Following April's inflation readings, Banxico’s Board may tone down its dovishness

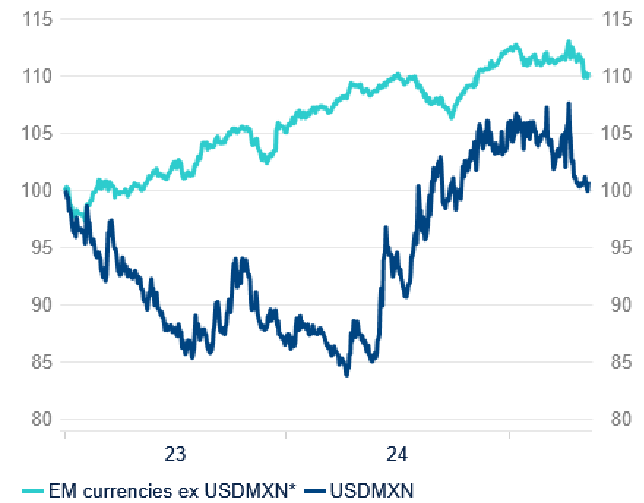
Figure 2. **INFLATION AND BANXICO POLICY RATE**
(%)



The shaded area indicates the inflation target range
Source: BBVA Research / INEGI / Banxico

The peso has outperformed other EM currencies in recent months

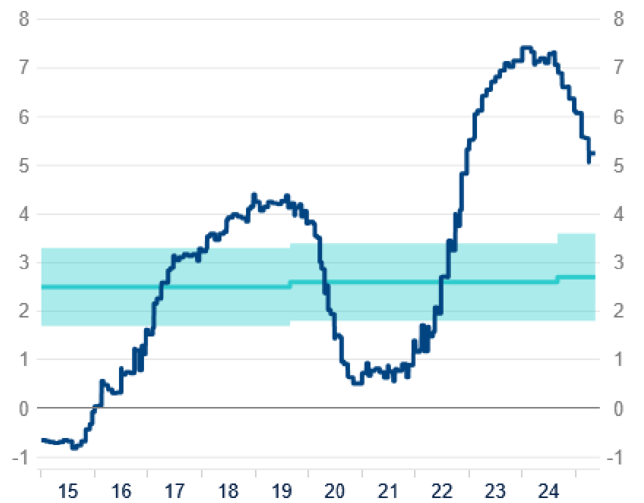
Figure 3. **USDMXN RELATIVE PERFORMANCE**
(01-JAN-23=100)



* Reweighted version of the Fed's Emerging Market Economies (EME) Dollar Index. Source: BBVA Research / Fed / Macrobond

The ex-ante real policy rate remains at 5.25%, supporting the case for another 50bp cut

Figure 4. **EX-ANTE REAL POLICY RATE**
(%)



The shaded area indicates Banxico's estimated interval for the short-term neutral rate in the long term; the solid aqua line indicates the midpoint estimation. Source: BBVA Research / Banxico / INEGI

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