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Banxico is set to cut the policy rate by 50 bps on a divided vote

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The statement's forward guidance is likely to signal a shift to a more measured pace of easing

Last week, the Fed left its policy rate unchanged at a "well-positioned" 4.25–4.50% target range amid still-elevated uncertainty. The updated Summary of Economic Projections (SEP) for 2025 showed higher inflation—core PCE now at 3.1% (up from 2.8%)—weaker growth (1.4%, down from 1.7%), and a slightly higher unemployment rate (4.5%, up from 4.4%). These adjustments were not enough to shift the median fed funds rate projection for end-2025, which remains at 3.9%, implying two 25bp cuts (Figure 1). However, the dot plot revealed two almost evenly sized camps—those expecting two cuts and those expecting none—likely reflecting a divide between participants confident in continued economic resilience and those anticipating a material slowdown this year. Powell continued to stress that it is more likely than not that inflation will rise in the coming months, as "ultimately the cost of the tariffs has to be paid" by someone. His repeated emphasis on a forward-looking policy stance—despite recent softer-than-expected inflation figures—combined with the still-solid overall position of the economy and the stability of the labor market, supports our view that the Fed will take more time before resuming rate cuts. We remain confident that December is the most likely timing for the start of the easing cycle (see here and here for additional details on last week's FOMC meeting). The Fed's pause continues to contrast with Banxico's ongoing easing cycle, which still has room to better reflect both the progress on inflation over the past twelve months and Mexico's ongoing economic slowdown.

In Mexico, while early 2Q activity data show signs of resilience, the labor market has weakened sharply and persistent headwinds weigh on the growth outlook. While the unemployment rate remains near historically low levels—partly because the informal sector continues to act as a safety valve—formal job creation remains weak: just 134,000 positions were added between January and May, 64% below the 373,000 average from 2010 to 2019. Meanwhile, real wage growth has slowed further, now running at 3.1% year-on-year, down sharply from its 6% peak at end-2023. As a result, the expansion of the wage bill has also decelerated. Although still growing at 3.2% YoY, this is well below the decade-long average of 4.8%, casting a less favorable outlook for household consumption. In broader terms, the labor market is unlikely to be a source of inflationary pressure going forward. Meanwhile, high-frequency proxy GDP data surprised to the upside and indicated that 2Q was off to a good start. INEGI reported yesterday that the IGAE rose 0.54% MoM in April (compared to a 0.38% average pace in Q1), driven by a 0.9% increase in the services sector—particularly in entertainment, financial, and professional/business services—and by a marginal 0.1% gain in industrial production, which together more than offset a monthly contraction in the primary sector that had led growth in Q1. The IGAE figure is partly explained by a rebound and should not be overinterpreted based on a single data point. Moreover, the economy remains exposed to persistent headwinds. Uncertainty around Trump's tariffs and their impact on the U.S. economy continues to weigh on business sentiment. This, combined with the upcoming reshaping of the judiciary and no fiscal space amid the ongoing consolidation, will likely continue to weigh on investment, employment, and consumption. All in all, the output gap is not only expected to remain negative, but also to widen going forward. These factors—alongside a still restrictive monetary policy stance—will likely keep the Board confident that there is still room to continue withdrawing monetary restriction.

Headline inflation has surprised to the upside, but most of the increase reflects temporary factors affecting the non-core component. Headline inflation rose to 4.4% YoY in May, up from 3.9% in April, largely due to a sharp rise in fresh food prices (+3.2% MoM) and a smaller seasonal impact from electricity subsidies, following methodological changes in CPI weights last summer. Core inflation rose to 4.06% YoY (from 3.93% in April), as an acceleration in core goods prices (from 3.4% to 3.7%) more than offset the welcome, albeit modest, decline in core services inflation (from 4.6% to 4.5%). Core inflation came in stronger than expected in the first half of June (0.22% m/m), pushing the annual rate up to 4.2%. So far, the expected acceleration in goods inflation this year from previously low levels has been faster than the anticipated slowdown in services inflation. Looking ahead, we expect the remaining upward pressure on goods inflation to be limited, while there is still considerable room for services inflation to decline. Therefore, despite core inflation breaching Banxico's tolerance band, most Board members are likely to look through the noise and remain forward-looking, as weakening domestic demand—together with softening wage and employment dynamics—is expected to continue weighing on consumption and therefore support a downward trend in services inflation. We also expect the prevailing view to be that monetary policy should avoid reacting mechanically to temporary shocks in the non-core component, given its limited effectiveness in addressing them. In a backdrop of a widening negative output gap, core services inflation is likely to trend down ahead, helping to rebalance recent pressures from the still unsurprising uptick in core goods inflation. As such, a likely upward revision to Banxico's short-term inflation forecasts—likely bringing them closer to our 3.9% expectation for both headline and core by Q4—is unlikely to dissuade most Board members from proceeding with the well-telegraphed 50bp cut at this week's meeting.

With a strong peso providing room for further easing, we expect a majority of the Board to stand firm on delivering further monetary policy normalization. U.S. tariff-related developments have continued to position Mexico relatively favorably, with expectations persisting that the country will ultimately face a competitive weighted average tariff rate. The Mexican peso has outperformed its EM peers (Figure 2), and—even after the recent escalation of conflict in the Middle East—USDMXN volatility has remained below historical norms. Country risk premia have declined modestly by some measures, such as USD CDS spreads, which had spiked amid rising institutional concerns following the mid-2024 elections and the approval of the judicial reform. However, other indicators—such as spreads on USD-denominated sovereign debt—suggest that elevated risk perceptions persist. The need for "efficient convergence," cited in the May minutes, reaffirmed the dominant dovish tone among most Board members who will likely support a fourth consecutive 50 bp cut this week: one noted that further similar cuts remain on the table, another said they are consistent with recent macro trends, and a third supported signaling another cut of the same size but also warned that a narrowing rate gap will require more gradualism ahead.

We expect Banxico to deliver the well-telegraphed fourth consecutive 50bp rate cut, while beginning to signal a slower pace of easing going forward. A 4-1 split vote appears the most likely outcome, with Deputy Governor Jonathan Heath dissenting, having publicly argued that it is time to pause the current 50bp pace. Still, Governor Rodríguez's comments during the recent Financial Stability Report suggests that most Board members are comfortable with delivering one final large cut. Yet, we think the statement is very likely to shift toward a less dovish tone, as both the recent inflation rebound (Figure 3)—though likely driven by temporary factors—and stronger-than-expected early 2Q activity data are expected to prompt a more measured approach, compared to what we view as Banxico's delayed but forceful response earlier this year. This would pave the way for Banxico's transition to smaller 25bp steps in the second half of the year. The ex-ante real rate remains in restrictive territory (Figure 4), but the 200bp in nominal easing since March will lower it to around 4.4% this week—just 80bp above the upper bound of Banxico's estimated short-term neutral range. This will likely lead the Board to conclude that the remaining distance toward neutrality can be covered at a slower pace. That said, there is a small risk that the recent inflation and activity data could prompt Banxico to adopt a much less dovish tone, deciding against a 50bp cut this week or signaling a pause later this year. However, we believe this is just a remote possibility, as Board members are unlikely to attribute the recent inflation rebound to their policy decisions—first, because available evidence indicates that the monetary stance remains restrictive; and second, because inflation expectations have not deteriorated, but have actually declined further.

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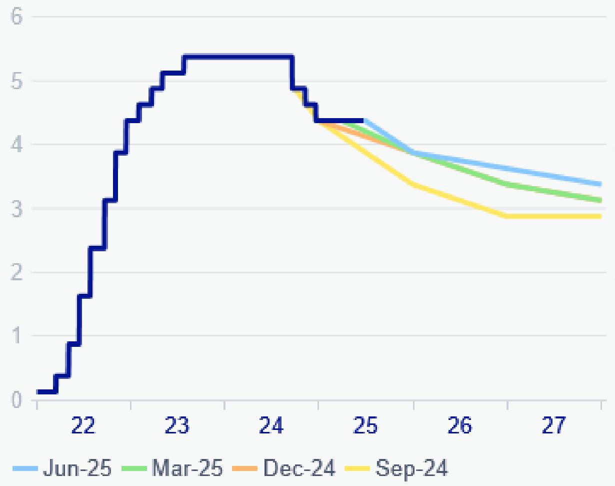
The Fed's pause continues to contrast with Banxico's ongoing easing cycle, which still has room to better align with the economic slowdown—especially amid a peso that has outperformed its EM peers

FIGURE 1. FOMC PROJECTED FED FUNDS RATE (%)



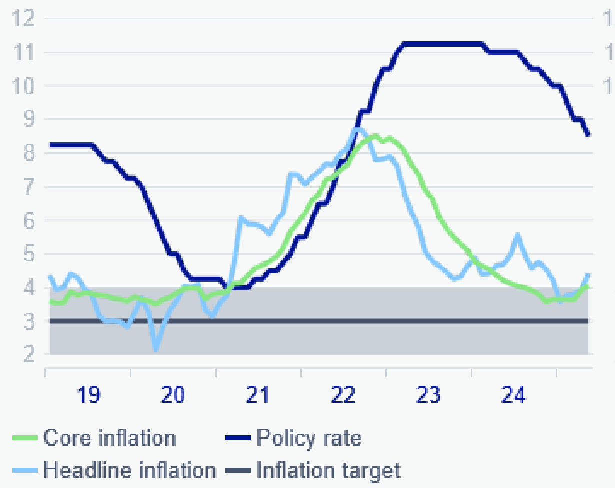
Source: BBVA Research / Fed

FIGURE 2. USDMXN RELATIVE PERFORMANCE (01-JAN-25=100)

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

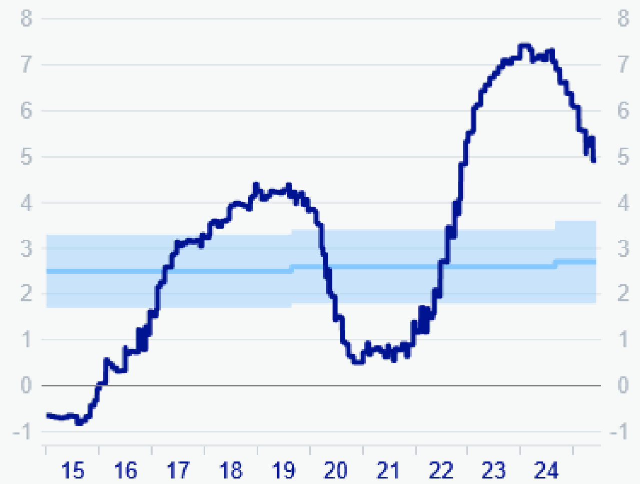
The inflation rebound—though likely driven by transitory shocks—could prompt a more measured forward guidance. This week's rate cut will lower the ex-ante real rate to around 4.4%—still above neutral

FIGURE 3. INFLATION AND BANXICO POLICY RATE (%)



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

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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