

# Banxico Flash

## Unexpectedly, Banxico cuts fondeo rate in 50bp to 3.0% as economic slack increases

- Since last statement there were two relevant events related to the monetary policy decision. First, Banxico reduced its growth forecast from 3.0 to 4.0% to 2.3 to 3.3%, based on their own first quarter GDP growth estimate of 0.60% q/q seasonally adjusted. Second, two days afterwards, the observed first quarter GDP growth surprised the central bank and the markets by growing only 0.28%.
- As a result, in today's statement Banxico stressed that the economic slack has increased and that the second quarter GDP growth will be more moderate than expected. Given the latter it is possible that Banxico will cut again its 2014 GDP growth forecast in its next inflation report.
- The central bank expects that inflation will slump to close to 3.0% from January 2015 supported by the economic slack and the lower adjustment in gasoline prices next year. This implies that real interest rates will continue being negative until December and will return close to zero in January. The latter might suggest that Banxico is more tolerant to negative real interest rates than in the past.
- The surprise regarding the timing and magnitude of the decision could be explained by the expectation that inflation will begin to accelerate next month given the unfavorable annual base effects.
- The exchange rate depreciated 0.37% and the Mexican stock market increased by 1.0% immediately after the announcement.
- This move could also contribute to mitigate short term portfolio inflows, thus reducing macroprudential risks that have been a source of concern for the central bank.
- Bottom line: The surprising rate cut suggests that the central bank considers that the economic slack will prevail for longer and that inflation will remain under control.

**Highlights from recent statements**

	25-Apr-14	06-Jun-14	Bottom line*
<b>Global context</b>	<ul style="list-style-type: none"> <li>• <b>Economic growth perspectives improve marginally</b> ;</li> <li>• <b>US economic activity picked-up</b> and is expected to improve in coming quarters;</li> <li>• <b>Some downside risks prevail</b></li> <li>• Low global inflation</li> </ul>	<ul style="list-style-type: none"> <li>• US economic activity was weaker than expected in the first quarter. <b>A weaker 2014 GDP growth is expected</b>;</li> <li>• <b>Downside risks prevail</b></li> <li>• Low global inflation</li> </ul>	<b>Pessimism on US economic activity</b>
<b>Economic activity</b>	<ul style="list-style-type: none"> <li>• <b>The balance of risks</b> of economic activity improved marginally.</li> <li>• There is an <b>early improvement of some components of aggregate demand</b></li> <li>• The economic slack remains</li> </ul>	<ul style="list-style-type: none"> <li>• <b>The weakness of domestic demand surpassed the improvement of exports</b></li> <li>• The <b>GDP growth for 2014</b> will be <b>lower</b> than expected two weeks ago</li> <li>• The economic slack has <b>increased</b></li> <li>• <b>Downside risks</b> are biased to the <b>downside</b></li> </ul>	<b>Dovish tone</b>
<b>Inflation</b>	<p>The balance of risks remains stable based on:</p> <ul style="list-style-type: none"> <li>• The <b>absence of second round effects</b> on prices.</li> <li>• The <b>inflation drop below 4.0%</b> and the <b>decrease of short term expectations</b>.</li> </ul>	<ul style="list-style-type: none"> <li>• The balance of risks <b>improved</b></li> <li>• There are high probabilities that <b>general inflation will be close to 3.0% since January 2015</b>.</li> </ul>	<b>Dovish tone</b>
<b>Policy decision</b>	0.00	-0.50	
<b>Rate</b>	3.50	3.00	

Source: BBVA Research and Banxico

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