Central Banks

Banxico’s monetary policy pause will be short-lived

We expect Banxico to cut rates two times this year, we do not rule out three rate cuts

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- **Banxico has enough reasons to begin to soften its wording on inflation as soon as in next month’s statement**
- **We expect a dovish shift from Banxico on the growth picture deterioration, slowing inflation pressures and a more dovish Fed**
- **We anticipate that the easing cycle will begin in August, we do not rule out an earlier start**

We are on the brink of a dovish shift from Banxico

After hiking rates by 25pb at each meeting in November and December 2018, Banxico held the policy rate steady at 8.25% on February 7. Before the meeting, we argued that with easing inflation pressures, a more stable peso, and a more favorable external backdrop with pledges from the Fed to be patient with future hikes (see BanxicoWatch Feb 6), further hikes will be no longer be in play. We expected the next move in the monetary policy rate to be down, but not until later in the year. In the accompanying statement of the meeting, the wording tempered Banxico’s ready-to-hike disposition of the previous statement[1]; yet, there were no signs of a dovish shift as Banxico did not soften its tone on inflation. The Board acknowledged the recent decline in inflation, but minimized it noting that core inflation remains sticky, not mentioning the decline from 3.68% in December to 3.60% in January and instead highlighting that it barely moved “from 3.63% in November to 3.60% in January”. The statement acknowledged the recent decline in long-term breakeven inflation expectations, but stressed that these “remain at high levels”. The Board repeated that the balance of risks to inflation remains tilted to the upside. Overall, the statement signaled that further tightening was unlikely, but at the same time, that a cautious wait-and-see approach was the most likely scenario in the near-term. In our view, the statement supported our scenario that the next movement in rates was going to be down, but not until late in the year.

Is it still too soon for a dovish shift? We think that there are enough reasons for Banxico to begin to soften its wording on inflation as soon as in next month’s statement (March 28). We expect the Board to acknowledge that even if inflation risks are still skewed to the upside, the balance of risks has markedly improved, and with a steeper economic deceleration than previously thought, risks to the upside and downside seem more balanced now.

Although driven mainly by the strong decline in fruits and vegetable prices, headline inflation is having the more positive start of a year since 2015 when it reached 2.1% by year-end, the lowest inflation on record. Headline inflation declined (-)0.10% HoH in the first half of February, bringing the annual rate below 4.0% for the first time since December 2016. Core inflation’s annual rate edged down from 3.55% in the previous fortnight to 3.51%, breaking to the downside the narrow 3.6%-3.7% range in which it fluctuated since March 2018. If our monthly headline inflation current projection for February (0.03% MoM) is accurate, accumulated inflation in the first two months of the year will only be 0.1pp, compared to 0.9pp last year, and the exact same pace of 2015, when inflation reached an all-time low.

To point out how positive the beginning of the year has been in terms of inflation, it is important to remember that at the start of 2015, lower telecom prices –recall that the telecom reform dropped long distance and roaming chargers in

1: Banxico’s Board eliminated the reference of its readiness to “strengthening the monetary policy position” where appropriate.

January–, strongly drove inflation to the downside. Typically, accumulated inflation in the first two months of the year is 0.9pp, just as last year. Since 2011, it has increased at a slower pace inly once (2015) and at a faster pace only twice, in 2014 following the tax reform that implied a one-off increase in some core goods and in 2017 following the pass-through arising from a weaker MXN after the US election. In the other five years during that span, the pace has averaged 0.88pp and has been very consistent (with a minimum of 0.82pp and a maximum of 0.91pp). Following the positive surprises of inflation to start the year, we are revising downwards our year-end 3.7% below-consensus forecast to 3.4%. We continue to expect core inflation to end the year at 3.3%.

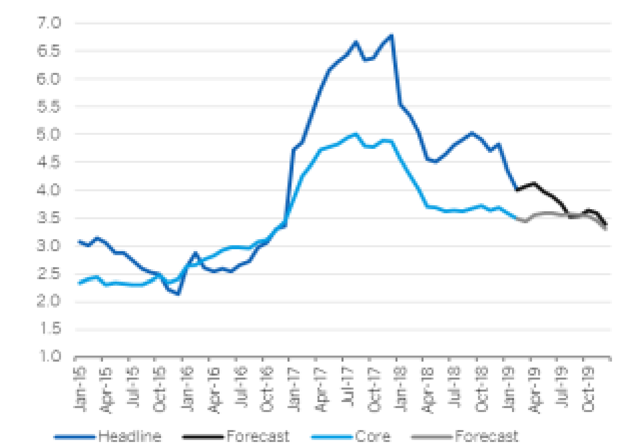
Why do we think that we are on the brink of a dovish shift? The strong decline in headline inflation over the first three fortnights of 2019 (-0.8pp) along with the marginal decline in core inflation should convince Banxico that inflation is on a clear downward trajectory and risks have eased significantly. Several developments are behind easing inflation risks: (1) The (negative) output gap has widened on weaker economic activity (see chart 2), and will likely widen further in the first half of the year. (2) Lower observed inflation is bringing down inflation expectations. Long-term market based inflation expectations have been falling back following peso's rally. Analysts' consensus expectations have decreased and will likely decrease further. Consensus expectations, which started the year at 4.0%, fell to 3.9% following inflation data in the first half of January, and fell further to 3.8% following January's inflation print. (3) Monetary policy has been an important anchor of stability for local financial variables but concerns on Mexico have eased. There is still lingering uncertainty mainly associated with PEMEX-related risks and the pending ratification of the USMCA by the US Congress, but risk-premia in Mexican financial variables has faded significantly even if MXN negative differentiation recently resurfaced following Fitch downgrade of PEMEX debt and concerns on PEMEX's need to show rating agencies a sustainable model to save its investment grade. (4) The external backdrop is more favorable with recent Fed's dovishness and more appetite for risk.

We now expect the easing cycle to begin in August, we do not rule out an earlier start

Why do we think that the easing cycle will start before (in 3Q) than we previously expected (4Q)? (1) We now estimate that headline inflation will permanently stay below 4.0% from July onwards (see chart 1). (2) Inflation expectations should fall more rapidly, keeping in check both inflation expectations and risks to inflation. (3) Following the downward revisions to GDP growth in all quarters of 2018, the output gap turned more negative (see chart 2). Besides, the gap is likely to turned more negative in the near-term before recovering taking into account that the growth deceleration will be more pronounced in 1Q19 (our GDP growth tracker points to quarterly growth of 0.1-0.2%). (4) The real ex-ante interest rate, which is already very restrictive (it is currently at 4.25% while the r* is 2%), would further increase once inflation expectations fall back if Banxico delays the easing cycle (see chart 3). Last, March will be the second meeting for deputy governors Gerardo Esquivel and Jonathan Heath and we expect the statement will begin to reflect their views. The new members are more likely to want the statement to reflect the growth picture deterioration, slowing inflation pressures and a more dovish Fed. We expect a somewhat less hawkish Board going forward. We think that the restrictive stance is no longer appropriate.

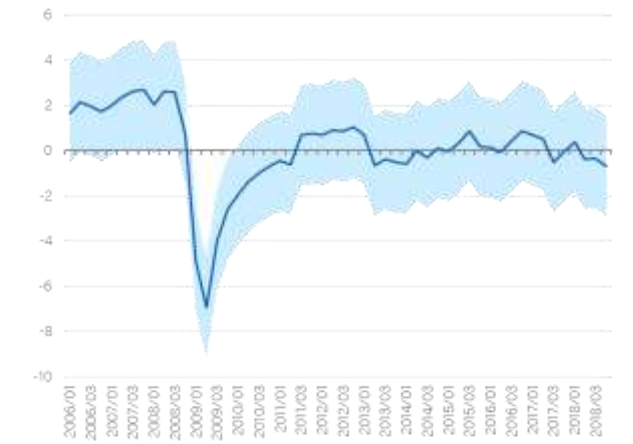
Bottom-line. We now think Banxico will start easing its policy rate in August and we now anticipate two 25bp rate cuts this year (in August and November). We continue to expect 100bp of rate cuts next year, i.e 6.75% by December 2020 (see chart 4). We think that Banxico has enough reasons to acknowledge that inflation is on a downward trend and risks have eased. In a context of a negative output gap, demand-side pressures will remain absent. With pledges from the Fed to be patient with its hiking cycle, the probable need to keep a wide interest rate spread is no longer there. In our view, the current stance of monetary policy has become more restrictive than appropriate. Therefore, we now expect the easing cycle to begin in August and we do not rule out that it could even begin earlier, in June. Thus, we do not rule out three rate cuts this year.

Chart 1. 2019 inflation outlook
(YoY % change)



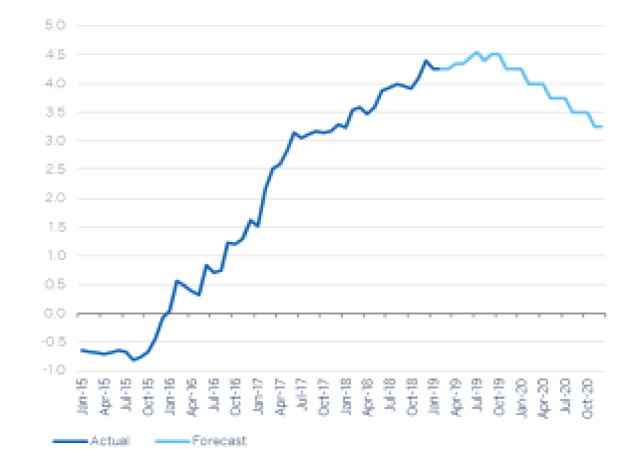
Source: BBVA Research / INEGI

Chart 2. Output gap*
(% of potential GDP)



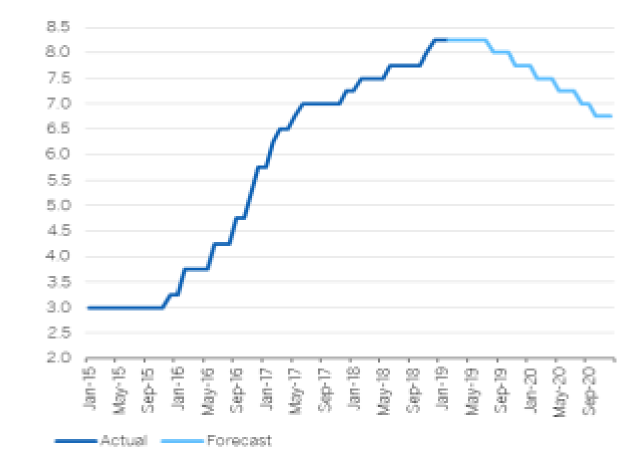
* Elaborated using seasonally adjusted GDP figures; estimated with the Hodrick-Prescott filter. Confidence interval calculated with +/-2 standard deviations.
Source: BBVA Research / INEGI

Chart 3. Real ex-ante monetary policy rate*
(%)



* Calculated as the difference between the nominal rate and 12-month inflation expectations from the Banxico survey for actual data and using our inflation projections for the expected path.
Source: BBVA Research / Banxico / INEGI

Chart 4. Nominal monetary policy rate outlook
(%)



Source: BBVA Research / Banxico

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