Central Banks

Banxico remains overly hawkish

In our view, the start of the easing cycle is likely to come later than warranted

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- **The little changed (overly hawkish) tone continues to signal an excessively cautious approach**
- **A delay of the start of the easing cycle seems increasingly likely**

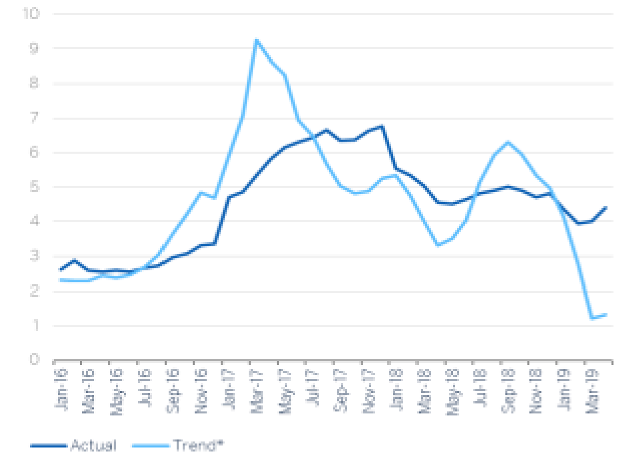
Banxico remained overly hawkish in its quarterly inflation report (yesterday) and in the minutes of the last meeting (16 May) released today

The little changed (overly hawkish) tone continues to signal an excessively cautious approach. The hawkishness of the minutes is reflected in the following statement: "Some [members] pointed out [...] that an easing of the monetary policy stance or a premature message in this direction would validate the inflation expectations, giving rise to questions regarding the commitment to the inflation target and affect the Central Bank's credibility". That is, some members think that even with a c. 4.5% real monetary policy rate (+ c. 2.5pp higher than neutral) in a context of a widening output gap, no signs of demand-side pressures on inflation, a stable exchange rate, and overly attractive risk-adjusted carry-trade and the Fed on the sidelines, Banxico will risk its credibility if they released a more neutral monetary policy statement. We disagree with such an overly restrictive message. Thus, we need to acknowledge that this excessive hawkishness gives signs that they are unwilling to shift to a neutral or easing bias any time soon. This regardless of Banxico's base case scenario of falling inflation in coming quarters and a stable core, of a declining economic activity (negative growth in 1Q2019) / widening output gap, with the Fed on the sidelines, with the exchange rate stable in spite of the risks and with a clearly very restrictive real exante monetary policy rate.

One member (Gerardo Esquivel) disagrees with the majority of the Board. We share his view. For the second meeting in a row he differed with the hawkish tone of the statement and he disagrees with the conclusion reached on the balance of risks (with a clear bias to the upside). We share his view on both and we agree that the current context "warrants a more neutral tone". Moreover, he pointed out that "it is not at all improbable that [inflation] expectations are being affected by the own communication from the central bank". We concur: even though year-to-date inflation is one of the lowest on record -2015 was lower but that was the year when the telecom reform resulted in a significant decline in prices (see chart 2)- the fact that the Central Bank is depicting a scenario of near stagflation, can be a factor inhibiting a decline in expectations. He also differed on the emphasis of the minimum wage increase as an upward risk to inflation. He pointed out that after five months of the increase "there is no convincing evidence that this is happening [...]". Again, we agree. In fact, the minimum wage increased significantly in 2018 and inflation is nowhere to be seen.

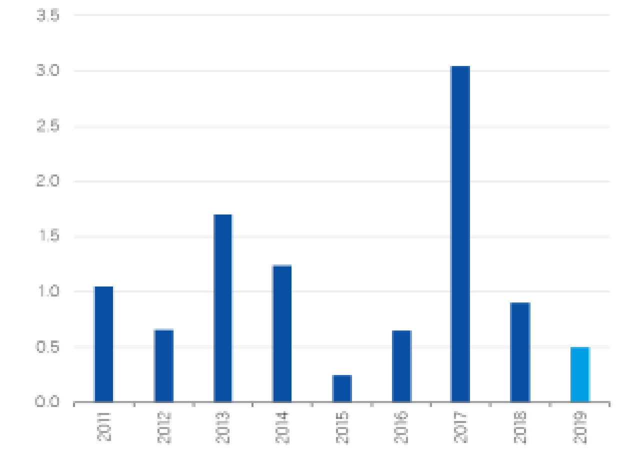
A delay of the start of the easing cycle seems increasingly likely. It seems that it is now likely to come later than we expected (3Q). Reality is likely to cause a shift in their bias sooner rather than later but the current hawkishness is of such degree that we now think that the easing cycle will not begin in 3Q and it is thus likely to come later than warranted in our view. Considering that monetary policy should be forward-looking, with inflation falling and the economy contracting, we think they should cut in the next meeting. It won't happen.

Chart 1. Headline inflation: actual & trend*
(YoY % change & 3Mo3M saar)



Source: BBVA Research / INEGI
* Based on the seasonally adjusted index, own calculations

Chart 2. Accumulated inflation in January-April
(Pp)



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