Central Banks

Banxico will keep rates at 8.25%. We still expect an unwarranted hawkish tone

We do not agree with Banxico's overly hawkish tone; we think they should cut rates but they will not. We estimate the next move to be a cut, in September

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- **In our view, the balance of risks to inflation is no longer tilted to the upside and, if not balanced, is tilted to the downside.**
- **However, Banxico will continue to strike an overly cautious tone on Trump´s tariff threat, even in a context of a stable MXN that has recovered fully from the threat**
- **We still firmly believe that with falling inflation and a sharp deceleration in economic activity policy easing is warranted. Yet, we don't expect it until 3Q19**

Hawkish statement will continue to signal cautious approach

Inflation is having a good performance in 2019. After yesterday´s reading corresponding to the first fortnight of June, the annual rate is already at 4.0%. It will most likely be below 4.0% in June, and should decrease sharply during the summer. We expect it to reach 3.5-3.6% by the end of the summer and to decline further in 4Q. Cumulative inflation in 2019 is one of the lowest on record.

Despite this, Banxico´s tone (overly cautious and more hawkish than warranted) conveyed in recent communication and confirmed in last meeting's minutes, as well as that expressed by a Board member in a recent media interview signals that Banxico will not ease this tone and will instead keep its 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 much more benign context that the one that made Banxico hike to 8.25%, the Central Bank would risk its credibility if they released a more neutral monetary policy statement. We do not agree. The current backdrop for inflation is much more favorable on several fronts: inflation now stands at 4.0% and will most likely fall below that threshold on a permanent basis from June onwards. Economic activity has weakened further and the output gap will continue to widen. The labor market has weakened sharply. There are no signs whatsoever of demand-side pressures and with growth most likely below 1.0% this year, those possible pressures will remain absent. The exchange rate (ER) has remained relatively stable, while the inflation component most affected by its dynamics (non-food core goods) has remained on a declining trend, and it now stands at 2.9% YoY. With rates so high and the ER stable, the risk-adjusted carry-trade will remain overly attractive even if the central bank starts easing rates as the Fed does not only remain on the sidelines but it recently signaled that it stands ready to cut rates later this year if warranted. Overall, we disagree with such an overly restrictive message. Yet, 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. Even if a central bank needs to be cautious and take into account risks, it also should be forward looking, particularly considering the lag with which monetary policy operates. Besides, risks to growth have further tilted to the downside in the intermeeting period and risks to inflation have eased throughout 2019 even if Banxico communication do not acknowledge it. Risks do not only have changed substantially over the last months, they now point to the need of lower rates, particularly considering the (overly) restrictive starting point.

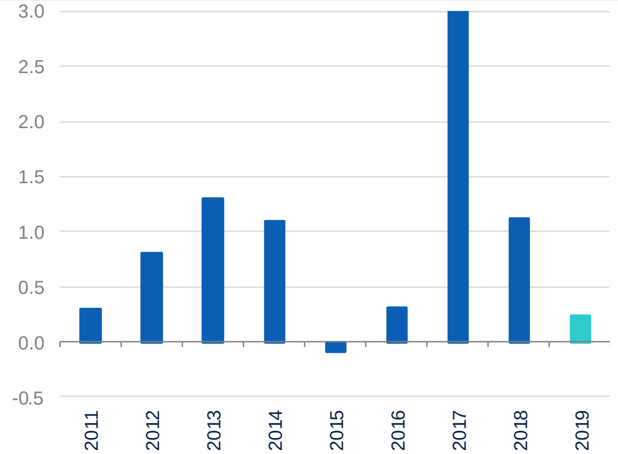
One member disagrees with the majority of the Board. We share his view. For the second meeting in a row he differed with the hawkish tone of the statement and he disagrees with the conclusion reached on the balance of risks (with a clear bias to the upside). We share his view on both and we agree that 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 effects are nowhere to be seen. Neither Banxico nor any analyst has come up with any evidence of such effects following the minimum wage increases of the past few years.

We do not think that even if Trumps´s tariff threat is still in the air monetary policy has to be more cautious for two reasons. The first one is that such menace main´s negative effect is higher uncertainty and, therefore, lower investment. Arguably, the best reaction from the Central Bank, in a context where inflation and inflationary expectations are under control, is to lower rates to foster credit to corporates and to nudge rates of return of investment projects to be higher. The second is that, in the case Trump ends up applying the tariffs, the best form in which the economy can absorb the shock is through a real exchange rate depreciation; the Central Bank should facilitate it not try to offset it or reduce it. Besides, the bank has an inflation target not an ER target.

We still expect to see the start of the easing cycle in the second half of the year, but now we think it will start in September rather than in August. By then, the situation will be of falling inflation, a growing output gap, weak labor markets, a stable MXN and, most likely, the Fed on an easing mode, already starting to cut rates. Reality will catch up with Banxico. In our view, Banxico risks making a sharp U turn it its communication in the next few months unless they start to acknowledge the improved backdrop for inflation and start to ease the tone and show more flexibility.

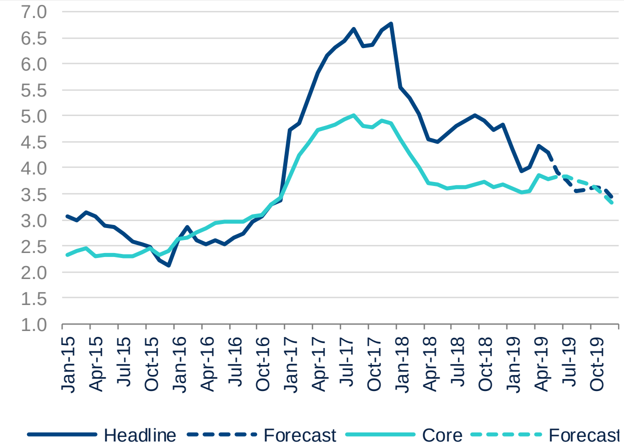
As we have mentioned, considering that monetary policy should be forward-looking, we think Banxico should start cutting rates at this meeting. It won't happen.

Chart 1. **Cumulative inflation to June***
(Pp)



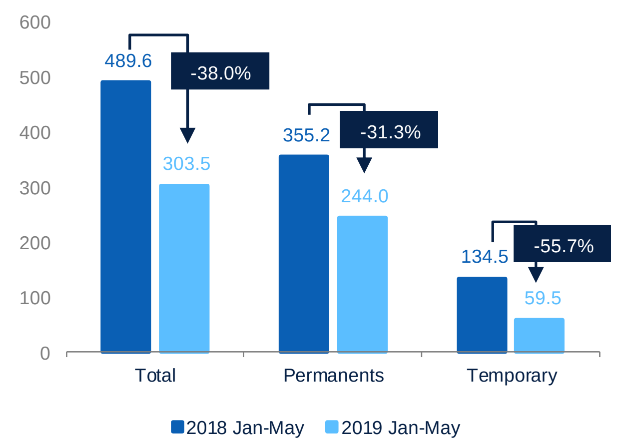
*June 2019 is forecast but it already incorporates the actual data in the first half of the month.
Source: BBVA Research / INEGI

Chart 2. **Inflation Outlook**
(YoY % change)



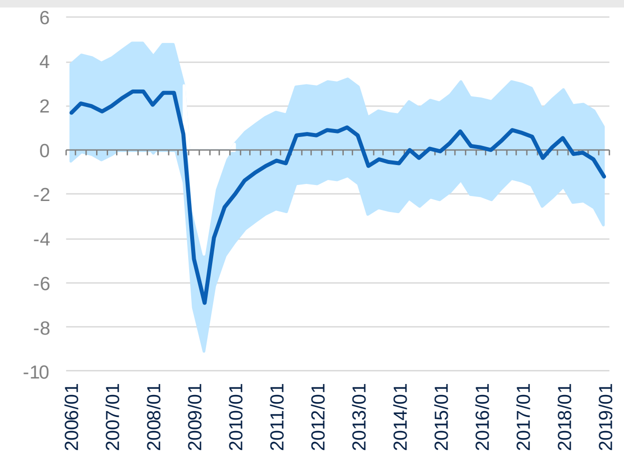
Source: BBVA Research / INEGI

Chart 3. **Job creation in the formal private sector**
(Thousands of net new jobs)



Source: BBVA Research / IMSS

Chart 4. **Output gap***
(Pp)



*Own calculations.
Source: BBVA Research / INEGI

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