Central Banks

A rate cut is not off the table, but we expect Banxico to hold rates steady one more meeting

Banxico will likely strike a dovish tone to signal that an easing cycle is about to start

Javier Amador / Carlos Serrano

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- **It will likely be a close call, but we think Banxico will hold rates at 8.25% on Thursday**
- **The wording of the statement will reveal a dovish shift on the Board with a very weak economy and falling inflation**
- **We continue to expect Banxico to cut its policy rate by 25pb in September and again in December; we have penciled in 100 additional bp of cuts in 2020**
- **Larger cuts and a faster easing pace at the start of the upcoming cycle are arguably warranted, but Banxico will likely remain cautious as it gauges the effect of a less restrictive stance on the MXN and as some Board members were not, until very recently, convinced about the need to start an easing cycle**

A dovish shift will signal that an easing cycle will start in September

It will be a close call, but we think Banxico will hold its policy interest rate unchanged at 8.25% on Thursday. Our scenario since the beginning of the year has been that Banxico will ultimately cut rates before and by more than what markets had been pricing in[1]. We have been expecting an easing cycle to begin in the summer with inflation falling below 4.0%. Inflation is now at 3.8% and should fall further (to 3.6%) in August, just before the following monetary policy meeting in September. Headline inflation performance in 2019 has been remarkable (see chart 1) while core inflation has increased broadly in line with the average of recent years (see chart 2). Inflation will most likely end the year below 3.5% as we expect. Inflation expectations have been trending lower with falling inflation. That trend is likely to continue. The economy remains very weak (growing by a meager 0.1% in 2Q19 and by only 0.3% in 1H19), barely escaped recession and will likely remain weak in 2H19 on moderate consumption, weaker-than-expected investment and a slower pace of export growth.

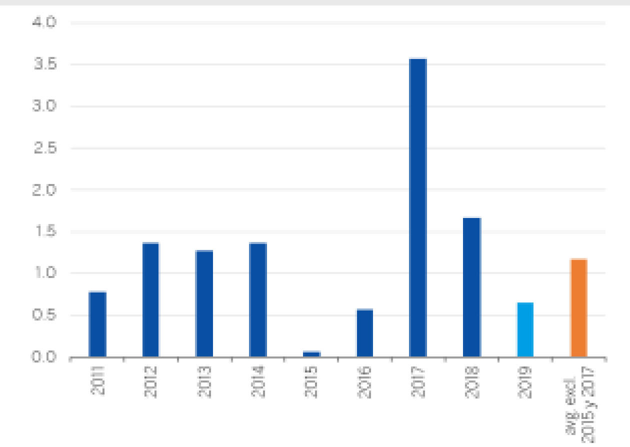
We have been arguing that Banxico has been overly cautious and its tone more hawkish than warranted. After each of the four meetings that have taken place this year we have acknowledged that Banxico was not ready to change its stance and not even to ease its (overly hawkish) wording. That started to change the last meeting in June in which Banxico remained cautious but finally (somewhat) eased its tone. In our note commenting that meeting, we concluded that considering that monetary policy should be forward-looking, Banxico should start cutting rates but that it wouldn't happen (see). Banxico held rates steady and in the accompanying statement, the less (but still) hawkish tone inched closer to resembling weak growth, slowing inflation and easing inflation risks. We argued that in this week's meeting

1 See: 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.

they were going pave the way for rate cuts and the start of an easing cycle. We continue to expect more decisive changes to the tone of the statement to be released this Thursday and a rate cut in the following meeting (Sep 26).

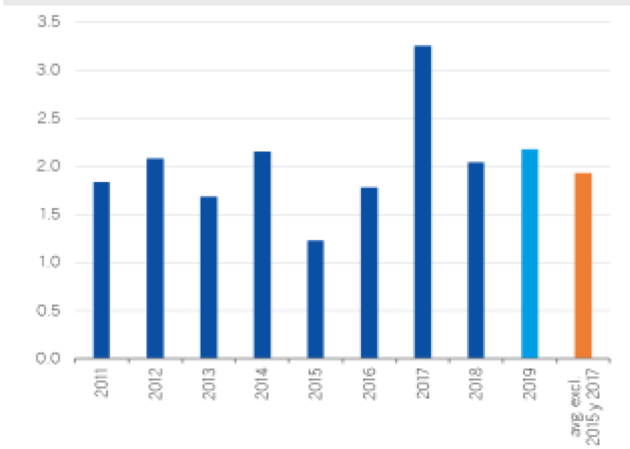
A rate cut this Thursday is not off the table and would not be a great surprise as the policy rate is overly restrictive, markets and analysts are expecting an easing cycle to start soon, and inflation is clearly converging towards the objective. Yet, we think that Banxico is likely to wait one more meeting for three reasons: 1) Communication-wise it makes more sense for Banxico to first strike a conclusive dovish tone as it has remained overly cautious and hawkish. We think that the Board cornered into holding rates this Thursday with a neutral/hawkish tone in June. Forward-guidance is important and even if it would not be a big surprise, most are expecting no rate movement at this meeting for only one reason: Banxico's communication. Monetary policy should be forward-looking but it would not be this year (in any case Banxico will start cutting rates late) and one month makes little difference in terms of monetary policy but a sudden change in Banxico's communication could have more long-last effects. 2) By striking a dovish tone at this meeting Banxico would have six weeks to assess the effect of the expectation of lower rates on the MXN and on capital flows. Banxico has been very cautious and has showed concerns for peso's performance. The peso has not underperformed during the recent spike in global risk-aversion (see chart 3) and that would most likely continue to be the case even if Banxico starts lowering rates as the relative risk-adjusted carry trade (see chart 4) will remain high in both absolute and relative terms with central banks easing policy all around the world. But still it will be important for the Board to test the waters. 3) The government is going to release the 2020 public budget on September 8, a couple of weeks before the following monetary policy meeting. Waiting one more meeting gives Banxico time to assess its effect, if any, on the MXN and on the overall stance of fiscal policy. All said, we expect Banxico to hold rates one more meeting and a 25bp rate cut on Sep 26 that would mark the beginning of an easing cycle.

Chart 1. **Cumulative headline inflation to July (Pp)**



Source: BBVA Research / INEGI

Chart 2. **Cumulative core inflation to July (Pp)**



Source: BBVA Research / INEGI

Chart 3. **MXN vs other EM currencies***
(Index 1 Oct 2018 = 100)

*Based on a reweighting of the JP Morgan after taking out the MXN; own calculations
Source: BBVA Research / Bloomberg

Chart 4. **Risk-adjusted carry trade**
(Pp, adjusted with 1-month ER implicit volatility)

Source: BBVA Research / Bloomberg

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