Central Banks

Banxico will cut 25bp their policy rate on Thursday and on each of the remaining meetings in 2019

Given softer inflation and easing inflation risks an easing cycle has further to run

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- **All members are likely to vote for a rate cut, a 50bp might be discussed**
- **The wording of the statement will likely reveal a dovish shift on the Board with a very weak economy, falling inflation and the need of better forward guidance**
- **We now expect an additional 75bp worth of rate cuts this year (to 7.25%) and 100bp more in 2020 (to 6.25%), more than what markets are currently pricing in and consensus is expecting (7.50% and 6.75%, respectively)**
- **Larger cuts and a faster easing pace at the moment are, in our opinion, warranted, but Banxico will likely remain cautious as it continues to assess 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**

We think that faster easing pace is warranted but we expect Banxico to remain cautious

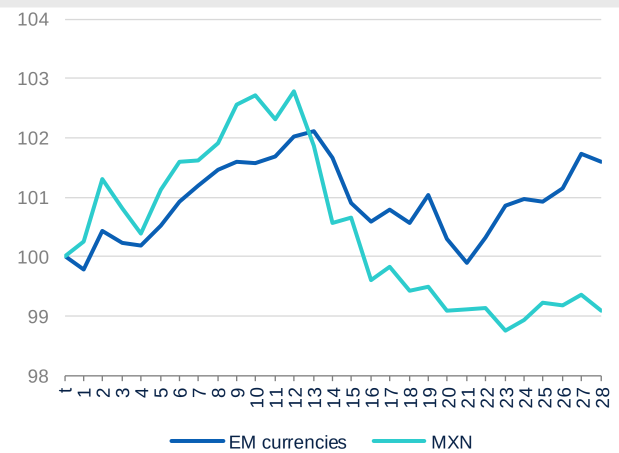
Easing inflation and inflation risks support our view that Banxico will cut the policy rate from 8.00% to 7.75% on Thursday. We expect all members of the board to vote for a rate cut. The current inflation backdrop calls for a bolder easing cycle considering the lagging effects of monetary policy and the current excessively tight stance. It would not be surprising if in the discussion within the Board at least one member argues for the need to speed up the easing cycle and votes for a 50bp rate cut. Yet, we believe that Banxico will cut rates by only 25bp but we now expect an additional easing of 75bp (to 7.25%) in the remaining of the year (25bp in each of the three remaining monetary policy meetings). We continue to expect an additional 100bp worth of cuts (to 6.75%) by year-end 2020. This is (for both years) a bit more than the market is currently pricing in.

We recently revised down our then below-consensus year-end headline forecast from 3.4% (consensus: 3.7%) to 2.9% (consensus: 3.2%). We argued that inflation performance in 2019 has been remarkable (see) and that inflation was set to fall below 3.0% by year-end. We now even have a downward bias to our new forecast as inflation continues performing remarkably well. Annual headline inflation in the first half of September slowed to 2.99% (from 3.04% in the previous fortnight). We expect it to stay at that level in September. Thus, cumulative inflation to September during this year will most likely be only 0.9%. The most likely scenario is now that inflation ends below 3.0% this year and thus, inflation expectations will likely continue to drop.

Since the last meeting, all factors point to an improvement in the balance of risks to inflation. Annual headline inflation has slowed (-)0.7pp to 3.0%, core inflation (-)0.05% to 3.78%, 12-month analysts' inflation expectations declined (-)0.1pp to 3.9% and long-term market-based inflation expectations (-)0.2pp to 3.6% (see chart 2). In addition,. The negative output gap has been growing, which will result in lower demand pressures for inflation. We have also argued before, that an easing cycle would not had a significant effect on the MXN, as rate cuts were priced-in and as the risk-adjusted carry trade would comfortably remain among the highest. Since Banxico cut its policy rate in August 15, the MXN has outperformed emerging market (EM) currencies almost 3pp as it appreciated 1% while EM currencies have depreciated on average 2pp (see chart 1). With the Fed and most central banks easing their policy stance, there is still plenty of room for Banxico to cut rates with no need to worry about a possible negative differentiation of the MXN. Especially considering that the interest rate differential with the US will not begin to decrease from historically high spreads until the likely third rate cut from Banxico in November as this expected cut coupled with August's cut will only match the (-)50 bp cuts in the fed funds rate.

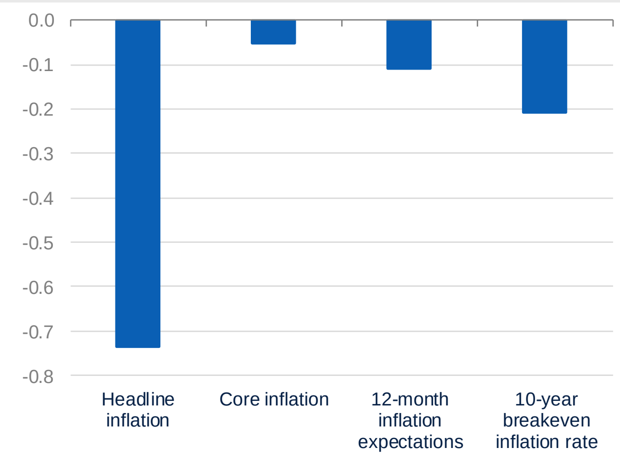
In the most recent meeting, the Board now seemed to be finally open to change its (still) very restrictive stance. That requires several rate cuts. We continue to think that many more are on the way and that August's cut marked the start of a long overdue and needed easing cycle. With inflation set to fall further, a relatively stable MXN, a weak economy, a widening negative output gap and with easing concerns in the fiscal front following the well-received 2020 economic package, Banxico should feel comfortable embarking in an easing cycle. A more dovish tone is warranted; A better forward guidance will be welcomed.

Chart 1. **MXN vs other EM currencies*** (Index 15 Aug 2019 = 100)



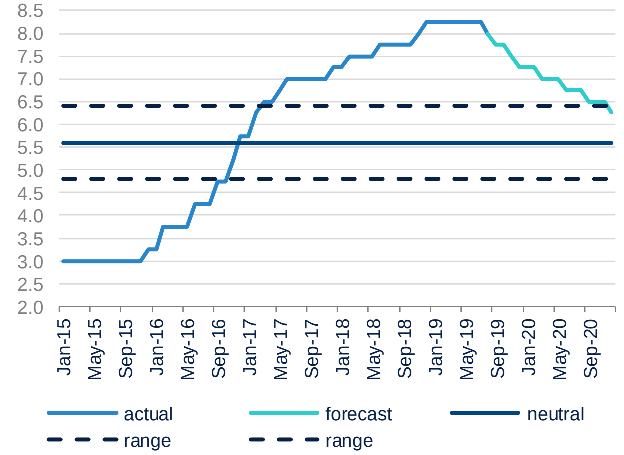
*Based on a reweighting of the JP Morgan after taking out the MXN; own calculations
Source: BBVA Research / Bloomberg

Chart 2. **Change since last monetary policy meeting for selected inflation and inflation expectations measures** (Pp)



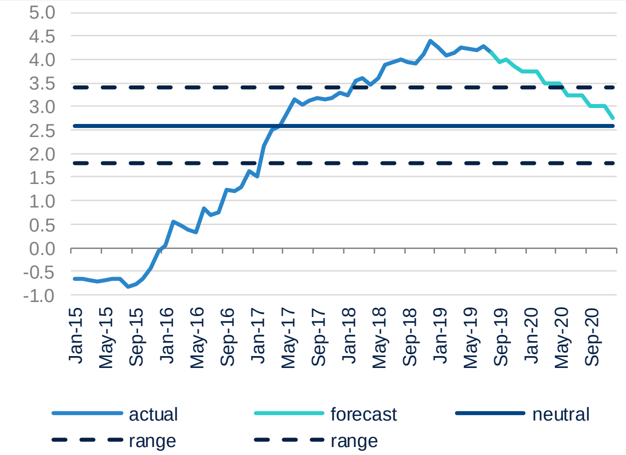
Source: BBVA Research / Banxico / INEGI / Bloomberg

Chart 3. **Nominal monetary policy rate (%)**



* The neutral rate (5.6%) and range (min, max: 4.8%-6.4%) are Banxico's estimates
Source: BBVA Research / Banxico

Chart 4. **Real ex-ante monetary policy rate (%)**



* Calculated with12-month inflation expecations using Banxico's Analyst Surveys for observed data and our projected inflation path for forecasted rate. The neutral rate (2.6%) and range (min, max: 1.8%-3.4%) are Banxico's estimates
Source: BBVA Research / Banxico / INEGI

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