Banxico Watch

Banxico pauses a likely very gradual rate-cut cycle

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We expect rate cuts to resume in June amid easing core inflation and an overly restrictive monetary policy stance

- **Board members opted for caution and unanimously decided to leave the policy rate unchanged at 11.00% amid core services inflation stickiness and a patient Fed.** While the decision was widely expected, some doubts had arisen ahead of the meeting on whether the decision to skip a rate cut after Banxico embarked on a normalization cycle last month would be supported by all members. Yesterday's decision suggests that even the dovish-titled members decided to postpone the inevitable debate on the risks of keeping an excessively tight monetary policy stance and stuck to their last month's meeting-minutes suggestion that the first cut delivered seven weeks ago did not mean that consecutive cuts were likely. Board members also likely factored in previous week's Fed's message around the "lack of further progress" towards 2% inflation, which means that it will likely take longer than previously expected to gain the needed confidence to consider rate cuts (we pushed back the first rate cut from the Fed to September).

- **The balance of risks remains biased to the upside in Banxico's view, but recent developments seem to have reinforced our view of more balanced risks in the months ahead.** The subdued 0.2% QoQ preliminary estimation for 1Q24 real GDP released last week drove Board members to downgrade their assessment around the outlook for economic activity. We think the overly tight monetary policy is one of the factors that explain the deceleration of the economy. While the March meeting statement noted that "the Mexican economy [was] expected to show greater dynamism during the first quarter of 2024 as compared to the weakness of the previous quarter," yesterday's statement conveyed that "the weak behavior of economic activity during the last quarter of 2023 is anticipated to have extended into the first quarter of 2024." While this points to a likely significant downward revision of the staff's latest 2.8% YoY GDP growth rate projection for this year, Banxico is likely still attentive to inflationary risks arising from a labor market that has "remained strong," which nonetheless has also given signals of moderation since the end of last year. With market-based measures of sovereign risk at notably low levels, Board members seemed not to be too concerned about last month's bouts of global risk-off mood among investors due to which "medium and long-term government bond yields [...] increased" and "the Mexican peso underwent episodes of volatility." In fact, the risk that "Mexico's exchange rate levels mitigate certain pressures on inflation" remains on the list of downside risks to inflation.

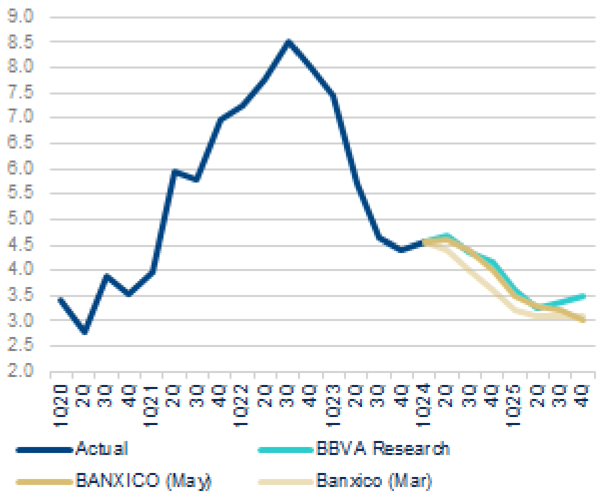
- **Banxico revised its inflation forecasts to the upside, bringing both its expected headline and core inflation paths closer to ours as "services inflation is foreseen to show more persistence."** Yesterday's inflation report early in the morning showed that headline inflation rose 0.2% MoM in April (to 4.7% YoY up from 4.4% in March) amid a 3.9% MoM surge in fruit and vegetable prices that more than offset a seasonal decline of electricity prices (-13% MoM). Core inflation rose a modest 0.21% MoM which brought the 12-month reading to a three-year 4.4% low. Both core goods and services inflation softened to 3.7% and 5.2% (from 3.9% and 5.4% in March). While members continued to state that "the disinflation process is expected to continue," the stickiness of core services inflation (which has hovered around a narrow 5.2-5.4% range since June 2023) drove Banxico to revise up its inflation forecasts after considering that "inflationary shocks [most likely those arising from a strong labor market] are foreseen to take longer to dissipate." Particularly, Banxico now expects both headline and core inflation to fall below 4% a quarter later than their previous expectation, thus moving closer to our expected path (Figures 1 and 2). We now have an upward bias to our year-end 3.9% YoY headline inflation forecast but are increasingly confident that core inflation will drop to our 3.8% YoY forecast by year-end.

- **The vote for a second rate cut will probably become 3-2 at the next meeting in June, once upcoming data convince some members that core inflation is set to cool further.** The usual ambiguity of Banxico's forward guidance in its policy statements somewhat complicates the task of inferring whether the majority of Board members will vote in favor of resuming rate cuts at the next meeting in late June. Aside from reiterating that "challenges and risks prevail, which requires monetary policy to continue being managed prudently" and stressing a data-dependent approach by stating that the Board "will assess the inflationary environment in order to discuss reference rate adjustments," there was no hint in the statement around the likely mechanics of what one member has called a "fine-tuning" strategy that would keep the real ex-ante rate excessively high (at 7.0%). Despite a disappointing 1Q24 for headline inflation driven by the non-core component, the core inflation annual rate has eased 0.7 pp year to date and is likely set to continue to ease ahead amid a likely further cooling of core goods inflation, a gradual easing of core services inflation with demand softening somewhat, and well-anchored inflation expectations. Core services inflation is likely set to start easing ahead amid our expectation of softer economic growth and a gradual but continued moderation of the labor market. Thus, core services disinflation will likely begin to support the overall decline of core inflation that has been mainly driven by lower core goods inflation up to now, leaving the door wide open to lower the excessively high real ex-ante rate.

- **We now think Banxico will bring down the policy rate to 9.75% by year end (up from the previous 9.25% forecast).** This responds to our renewed expectations following both local developments (headline inflation hitting a bump in the road) and changes in fed funds rate expectations. The hawkish minutes following the first cut in March suggested an ample consensus around the view that consecutive cuts through this cycle were unlikely. Yesterday's unanimous decision adds to the view that Banxico could take its time before feeling confident to formally signal that an easing cycle is underway. Albeit we expect core inflation to keep easing, headline inflation did not decrease further through the first four months of the year and is not likely to ease through June due to base effects, which will likely feed into the view of the more hawkish Board members. The increases in headline inflation observed so far are explained by increases in food items. We believe that monetary policy should not react to supply shocks that temporarily affect volatile prices such as perishable food prices or to base effects such as the ones we anticipate for the remainder of the second quarter. Nonetheless, a further delay of the Fed's rate cut cycle adds to the view that Banxico will proceed cautiously despite the wide margin at its disposal to continue cutting the policy rate in both absolute and relative terms. Further out, we project an additional 200 bp worth of rate cuts in 2025 to 7.75%.

Banxico brought closer its headline inflation expected path to ours…

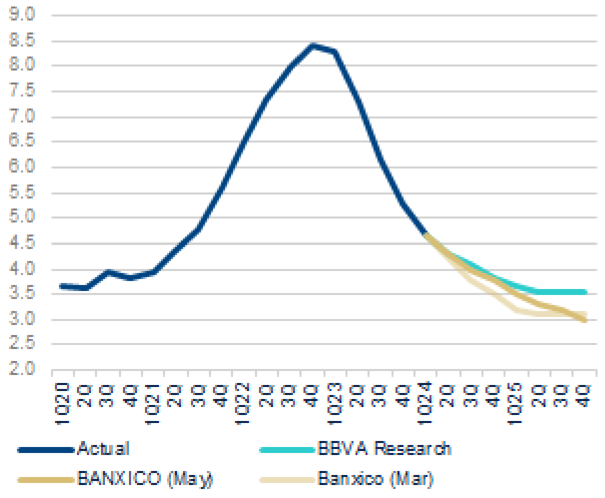
Figure 1. **HEADLINE INFLATION OUTLOOK**
(YOY % CHANGE, QUARTERLY AVERAGE)



Source: BBVA Research / Banxico / INEGI

… and revised up its core inflation forecasts, also bringing them closer to ours

Figure 2. **CORE INFLATION OUTLOOK**
(YOY % CHANGE, QUARTERLY AVERAGE)



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