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Banxico Watch

Banxico members will likely vote unanimously to pause amid political uncertainty

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June 26, 2024

Core services inflation stickiness has prevented the most hawkish members from moderating their view on inflationary risks

- **The big but expected shift in the Fed's dot-plot does not rule out a fed funds rate cut in September; we continue to think that two rate cuts this year are still more likely than not.** Two weeks ago, the Fed decided to hold the policy rate unchanged at its current 5.25-5.50% target range. The updated SEP showed that the median FOMC participant revised up his/her core PCE inflation projection from 2.6 to 2.8% for the end of this year, while the median projection for policy rate cuts this year was revised down to a single cut rather than three. Powell reiterated that they still want more positive inflation data "to gain further confidence" on the disinflation process. However, he also acknowledged that the new inflation forecast for year-end was "conservative," and suggested that either one or two rate cuts this year were a "plausible" outcome. With the fed funds rate at its peak, growing chances of disinflation resuming in 2Q24 and more balanced risks, we stick to our call that easing core inflation will open the door for the Fed to cut rates two times this year, in September and December (for more on the latest FOMC meeting, see here and here).
- **Regardless of the upcoming Fed's decisions later this year, we continue to think that Banxico has ample room to resume the rate cut cycle after the first cut back in March.** The real ex-ante rate at 7.2%, well-anchored long-term inflation expectations, and core inflation now close to 4.0% and set to ease for 17 months in a row in June are the main reasons behind this view. Yet, given that it is still unclear whether core services inflation has turned a corner, and bearing in mind that Banxico will most likely revise upwards its short-term headline inflation path, we think that the Board will vote to stay on the sidelines in the short term, even more so with the recent depreciation of the exchange rate. A further increase in the real ex-ante policy rate to its 7.4% cycle peak will likely reassure Banxico to match Fed movements ahead, which means the monetary policy stance will likely remain overly restrictive through the end of the year.
- **Banxico will likely revise up its headline inflation forecasts, but has no need to change its core inflation path as it has evolved as projected even with core services inflation stickiness.** Supply shocks so far this year have halted the decline in headline inflation. At 4.8% YoY in the first half of June, it has not eased since the end of 2023. On the other hand, core inflation has continued decelerating: it has slowed for 16 consecutive months, falling 0.9 pp so far this year to a 4.2% three-year low. Going forward, we anticipate that headline inflation will resume a downward trend starting in July, but we anticipate that it will remain above 4.0% for the rest of the year, ending at 4.2% in December. Banxico will likely revise up its inflation forecasts for this quarter and next two, but we see elements for core inflation to keep cooling down continuously for the rest of the year, although at a somewhat slower pace (to 3.8% in December), with goods inflation falling even further and services inflation finally breaking its stickiness in a context of less strong domestic demand. Our inflation

expectation represents a less optimistic trend than the one expected by Banxico for headline inflation and a similar one for core inflation.

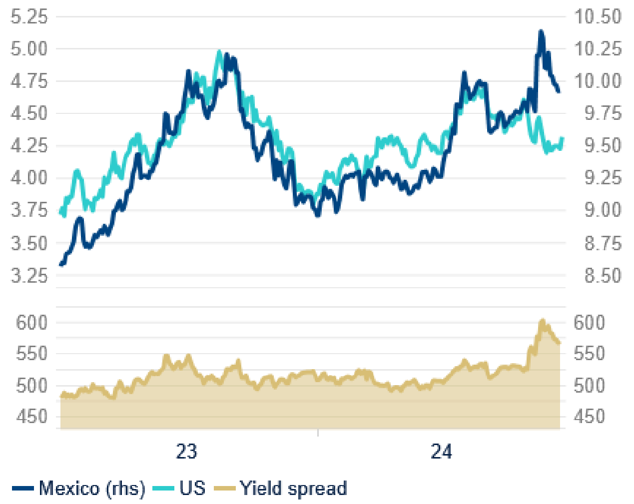
- **The two most hawkish Board members will likely stand firm and will continue to advocate for extreme caution before signaling that a second rate cut could be on the way anytime soon.** May's unanimous decision masked clearly differing views on monetary policy. On one hand, the minutes showed two members who fiercely defend the current policy restriction. One (probably Irene Espinosa) warned—without supporting it since core inflation has continue to ease—that the premature rate cut in March "incurred a social cost, as it required extending the monetary restriction for a longer period," and that "in view of the risks faced and the slowdown in the disinflationary process, the achieved monetary restriction should be firmly maintained." Another member (probably Jonathan Heath) noted that with stagnant inflation and a deteriorated balance of risks "no additional fine-tuning of the target rate can be made, either now or in the following months," but added that "in the second half of the year there would be greater clarity to make fine adjustments, even more gradual than anticipated." While long-term inflation expectations remain anchored at their historical average, he/she suggested that "advantage should be taken of the high monetary restriction to continuously, forcefully and unrestrictedly converge to 3%," and added that Banxico's communication "must assure that the bank is determined to attain the target at all costs." He/she even suggested that "this intention should be explicitly stated in the forward guidance," which would imply a significant change in the wording of the statement.

- **This time, doves will likely opt for delaying an uneasy debate with the ultra hawks and vote for a pause driven by the recent USDMXN volatility and uncertainty around the political outlook.** While they maintain a more balanced view regarding inflationary risks, they do not seem determined to promote a rate cut cycle yet (not a single member voted for a cut in May). The minutes showed that one member "considered that the current environment, while still challenging, is less adverse than in 2022 and early 2023," and while he/she noted that "the inflationary environment is such that it allows to consider potential reference rate cuts going forward," she considered that "subsequent reductions should be gradual given the higher-than-anticipated persistence in services inflation." A strongest opinion came from another member (probably Omar Mejía), who expressed that the continued persistence of services inflation "do not indicate new pressures, but rather [...] disturbances observed over the previous years [that] continue to dissipate, albeit at a slower pace." He/she added that "the current policy stance is highly restrictive and that, even with additional adjustments, it will remain robust." But even this member is unlikely to vote for a rate cut this week amid the recent political-related financial turbulence, which drove long-term bond yields to a 16-year high (Figure 1) and caused a depreciation of the peso of just over 10% (Figure 2).

- **Members are unlikely to be overly concerned about the exchange rate, but their forward guidance will likely continue to point to an overly restrictive stance for a longer period than warranted in our view.** The peso has even gained some ground over the past week, and remains at a level at which the pass-through is still likely very low and does not warrant in our view a change in our core inflation forecasts. But in the current backdrop of continued volatility amid the uncertainty around the potential economic effects of a judicial reform, the upshot is that Banxico will most likely suggest it will proceed with caution, at least until more information is available about the reform and the type of fiscal adjustment that will be implemented to fulfill the federal government's commitment to reduce the public deficit by 2.9 points of GDP next year. We expect a unanimous vote in favor of extending the pause, though. We now expect that Banxico will end up cutting the policy rate only twice this year by 25 bps each (in September and December) followed by cuts at each of next year's eight policy meetings (200bp worth of cuts). This means that in the absence of an acceleration in the expected rate cut cycle, the policy stance will remain very restrictive during 2024-25, with an ex-ante real rate well above 3.4%, the upper limit of the estimated range for the neutral rate in the long term (Figures 3 and 4).

M10 yields spiked with 10-year Treasury yields moving down, reflecting higher-perceived risk…

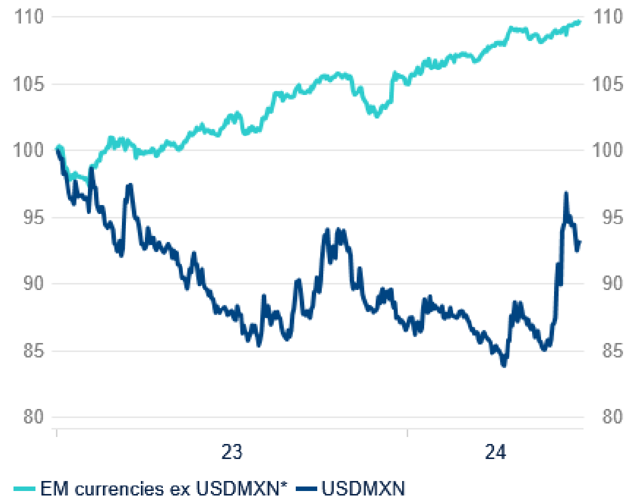
Figure 1. **10-YEAR GOVERNMENT YIELDS AND YIELD SPREAD** (% AND BPS)



Source: BBVA Research / Macrobond / Treasury

… while the peso weakened sharply. Both have partially reversed these moves, but risks remain

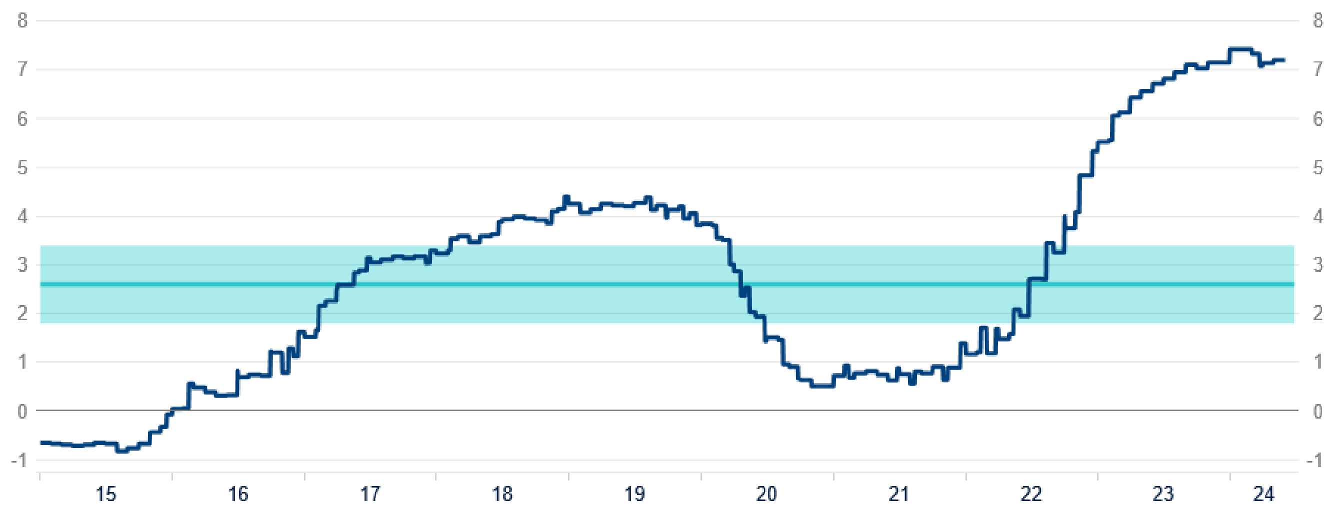
Figure 2. **USDMXN RELATIVE PERFORMANCE** (01-JAN-23=100)



* Reweighted version of the Fed's Emerging Market Economies (EME) Dollar Index. Source: BBVA Research / Fed / Macrobond

The real ex-ante rate is close to this cycle's 7.4% peak, and is likely to edge up in coming months if Banxico stays on the sidelines in the short term. Thus, the stance is set to stay very tight in 2H24-25

Figure 3. **EX-ANTE REAL POLICY RATE** (%)

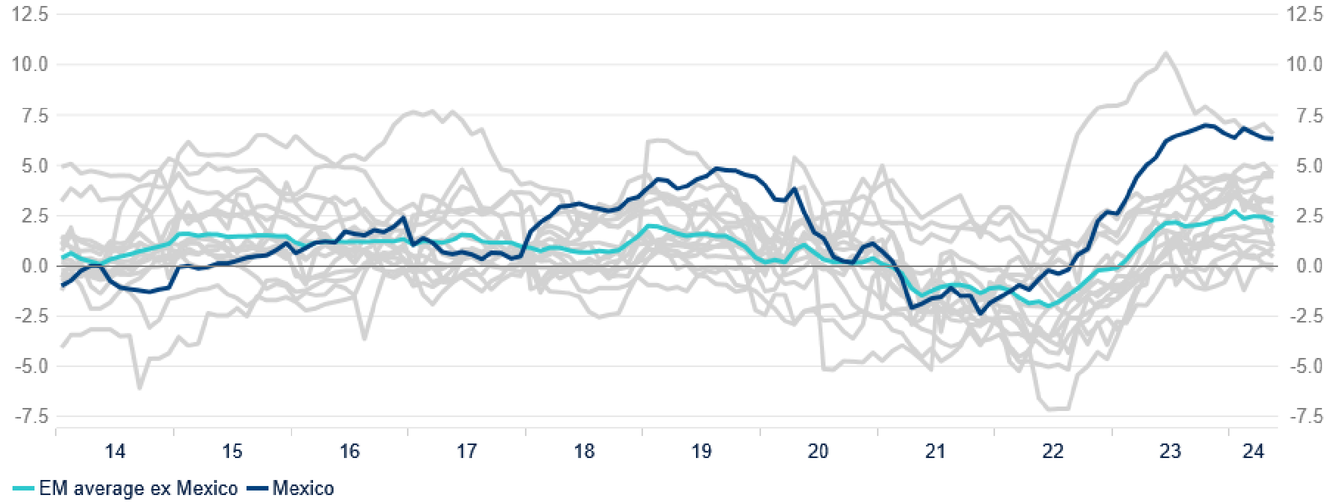


The shaded area indicates Banxico's estimated interval for the short-term neutral rate in the long term, which is between 1.8 and 3.4%; the solid aqua line indicates the midpoint 2.6% estimation. Source: BBVA Research / INEGI / Banxico

Hence, Banxico is likely set to keep the ex-post real policy rate among the highest compared to other emerging central banks through the end of 2025

Figure 4. **EX-POST REAL POLICY RATES**

(%)



Light-gray lines indicate real ex-post policy rates for Brazil, Chile, China, Colombia, Hong Kong, India, Indonesia, Israel, Korea, Malaysia, Mexico, Philippines, Saudi Arabia, Singapore, Taiwan, Thailand and Vietnam

Source: BBVA Research / National sources

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