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Banxico Watch

Will the recent peso depreciation prevent Banxico from delivering a rate cut?

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In our view, any exchange rate inflationary effect will likely be more than offset by the greater weakness of economic activity

- **Last week, the Fed kept unchanged its policy rate at 5.25-5.50%, but shifted its policy bias to neutral by hinting that it is increasingly focused on its maximum employment goal.** The changes to the statement gave a clear indication that tackling inflation is no longer a top priority: the FOMC is now "attentive to the risks to both sides of its dual mandate," rather than "highly attentive to inflation risks." The dovish tweaks of the statement were reinforced by Powell during the press conference, who said that a rate cut "could be on the table as soon as the next meeting in September," and he even added that "there was a real discussion" about cutting rates at last week's meeting. While he said that 2Q inflation data "have added to [their] confidence," he continued to stress that the FOMC is still looking for "more good [inflation] data [that] would further strengthen [their] confidence." But at the same time, Powell acknowledged that even in a scenario of "disappointing" inflation readings, the Fed would weigh those data against the state of the labor market. That is, were the labor market to show unexpected signs of weakness, the Fed would ease policy even in the absence of good inflation data. Last Friday's US jobs report (which showed a lower-than-expected 114,000 increase in non-farm payrolls as well as a 0.2 pp uptick to the unemployment rate to 4.3%) increased the chances of such a scenario. FOMC participants will likely use the upcoming Jackson Hole's forum to convey more definitive signals around the increased odds of a September rate cut (for more on the latest FOMC meeting, see here and here).

- **Headline inflation in Mexico continued to trend upwards in July, but core inflation is set to have decreased for eighteen consecutive months despite core services inflation stickiness.** Growing chances of an upcoming fed funds rate cut alongside easing core inflation and weakening demand should prompt Board members to drop their hawkish bias too, but two of them have signaled they still have that bias while there is a risk that some others remain broadly cautious amid the transitory big jump in headline inflation numbers in the intermeeting period. The eye-catching 5.6% YoY 14-month high headline inflation reading for the first fortnight of July (up from 4.8% in the first half of June) reflected a surge in fruit and vegetable prices as well as an increase in energy and regulated prices inflation, against which monetary policy should not react, particularly in a context of well-anchored inflation expectations. Headline inflation is set to remain at 5.6% YoY when July inflation numbers are released on Thursday morning. The jump, driven by a big supply shock, will drive Banxico to revise its short-term inflation forecasts sharply to the upside. We think that headline inflation forecasts for the next four quarters will be revised up by 0.8, 1.0, 1.0 and 0.7 pp, respectively. On the other hand, core inflation reached its lowest level since March 2021 in the first half of July: it rose 0.18% FoF and edged down to 4.0% YoY from 4.1% in the previous fortnight (Figure 1). It is true that the deceleration pace of core inflation has recently slowed as the contribution of core goods disinflation has moderated and core services inflation persists at a sticky 5.2% YoY. Yet, we still see room for improvement: our forecast is that core inflation will average 4.0% YoY in the third quarter, coming down to 3.8% by year-end as core services inflation should start to ease gradually in 2H24 on the back of weakening demand. Indeed, the annualized monthly variations show a gradual improvement in core services inflation: while the average of these variations in the last 12 months (up to June) is 5.17%, the corresponding average changes for the last six and three months is 4.87 and 2.71%, respectively (Figure 2). Thus, lower services inflation is already in the pipeline and a sharper economic deceleration with risks now clearly biased to the downside should further contribute to break the recent stickiness. We think that Banxico has room to fine-tune its core inflation forecasts 0.1 pp to the downside for the next two quarters.

- **Banxico's Board members will likely continue to have differing points of view in terms of the inflation outlook, leading to a split decision for the second consecutive meeting in a row.** Omar Mejía will most likely vote again for cutting the policy rate this week. June's meeting minutes showed that, in his opinion, "greater-than-expected economic weakness […] will play a more relevant role in inflation" going forward. We agree with his opinion. The weaker-than-expected 2Q24 real GDP 0.2% QoQ figure from last week INEGI's preliminary report (1.5% YoY in 1H24) means he is unlikely to change his view. Considering that "making additional adjustments to the reference rate does not imply abandoning a restrictive policy stance," he called his colleagues to carry out a responsible and deep reflection "about the appropriate level of monetary restriction in the current context […] given the highly restrictive policy stance and the progress in disinflation." Neither Governor Victoria Rodríguez nor Deputy Governor Galia Borja supported Mejía in June, but the minutes showed they are not so far from sharing his view. One of them (likely Borja) considered "it would be appropriate to resume the downward adjustments" in light of a more favorable price dynamic driven by a "faster-than-anticipated pace" of deceleration of the Mexican economy. Another (likely Rodriguez) noted that the discussion around "possible reference rate cuts […] will be undertaken in upcoming monetary policy meetings […] in view of prospects of a weaker-than-anticipated economic activity."

- **Our base case is a split 3-2 vote in favor of a 25bp rate cut to 10.75% with a majority of members acknowledging a weakening economy and increased confidence about the inflation outlook.** The June minutes also suggested that the more hawkish members of the Board will continue to stand up for an overly restrictive policy stance. One of them (likely Deputy Governor Irene Espinosa) said that both "idiosyncratic and external shocks […] coupled with a balance of risks for inflation biased to the upside, [indicate] that monetary policy should continue being conducted cautiously," adding that there is a "risk that the monetary restriction might be insufficient to achieve [the convergence of inflation to the target] if the reference rate is reduced." This member seems to be the most sensitive to exchange rate developments and financial volatility, which in his/her view "[represent] an additional obstacle" to achieving the inflation target. The most recent c. 5% peso depreciation so far this month driven by global developments related to the expectation of higher interest rates in Japan as well as a global risk-off mood following weak US employment data, has likely reinforced his/her view (Figure 3). Another member (likely Deputy Governor Jonathan Heath) seems to have set a very strict test before considering a rate cut cycle: "the anchoring of inflation expectations at 3% must be ensured, and […], since they remain above the central bank forecasts, changes in slack conditions or the tightening of financial conditions should continue to be of secondary consideration." Neither of them are likely to change their mind this week.

- **But the sudden peso depreciation following the weekend's global volatility bout represents a risk to our call.** We think that a rate cut is warranted given the continued deceleration of core inflation and increased downside risks to economic activity, but given Banxico's price-stability single mandate and considering the handful of arguments within easy reach of Board members in relation to a potential deterioration of the balance of risks (the lack of progress of headline disinflation, core services inflation stickiness, potential exchange rate price pressures from recent global financial developments), there is a chance that any of both potential swing voters (Rodríguez and Borja) prompt a 3-2 or 4-1 vote in favor of extending the pause at 11.00% despite continued signs of economic activity weakness and an improving core inflation outlook. We think that the exchange rate volatility observed in recent days is explained by a global risk-aversion episode (that is being partially reversed as we write this note) and not by idiosyncratic movements. In this sense, monetary policy should not react to these global movements, against which it is largely ineffective. Extending the pause would drive the policy stance to 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 (Figure 4). We think that would be a policy mistake and a communication blunder, and would risk the need for a larger 50bp rate cut at the next meeting in September. Much of the increased global financial volatility can be attributable to the perception that the Fed is behind the curve. Banxico with a much tighter stance is already behind the curve. August's headline inflation is set to be much more modest and thus, the disinflationary headline inflation trend will resume in the next fortnight. In addition, economic activity will most likely be weaker in the second half of the year. Global financial stress should ease in the coming weeks as Powell strongly signals that the Fed is set to start easing monetary policy next month. Banxico should be forward looking and avoid policy and communication errors. We think that the big peso depreciation makes this week's move a closer call than it would otherwise be, but conditions for cutting rates while keeping a very restrictive stance remain.

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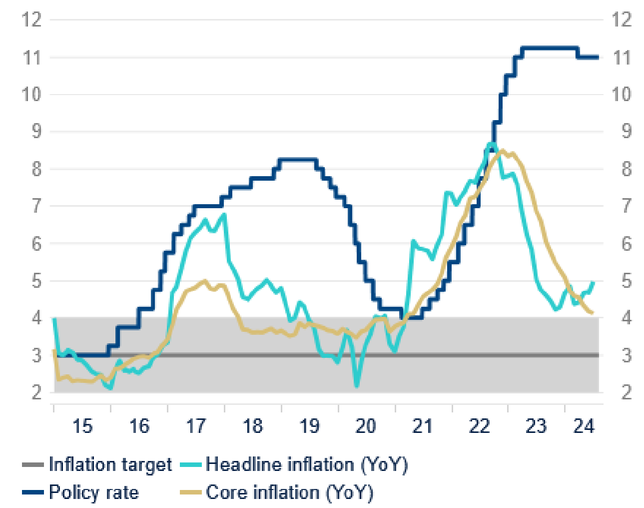
Core inflation reached its lowest since March 2021 in the first half of July (0.18% FoF, 4.0% YoY)

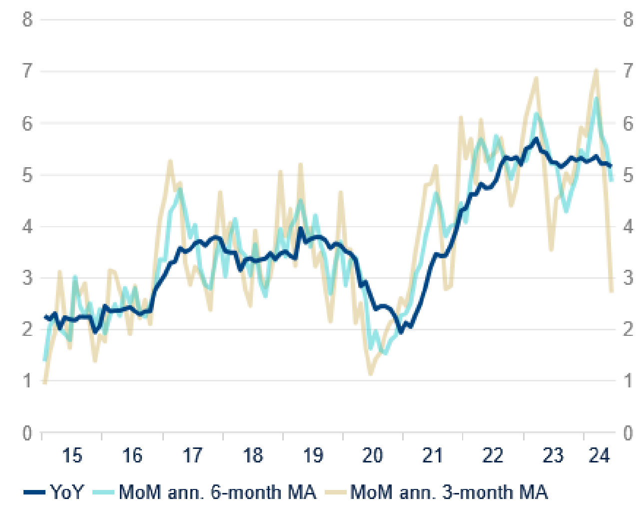
Figure 1. **INFLATION AND BANXICO POLICY RATE**
(%)



The gray area indicates the inflation target range
Source: BBVA Research / Banxico / INEGI

Core services inflation should start to ease in 2H24 on the back of weakening demand

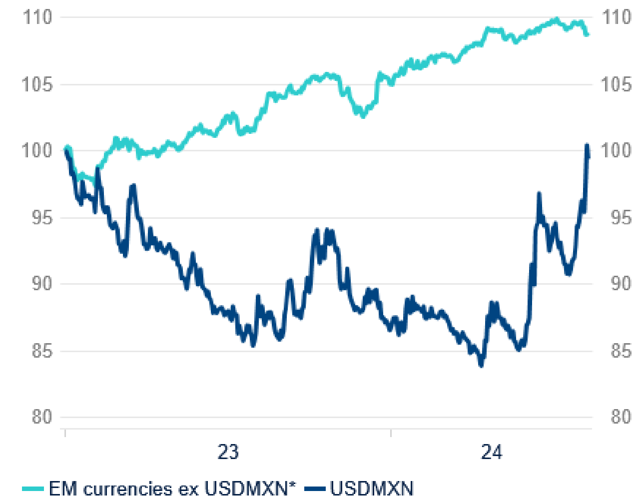
Figure 2. **CORE SERVICES INFLATION**
(%)



Source: BBVA Research / INEGI

The recent sudden peso depreciation represents a risk to our call for a 25bp rate cut this week

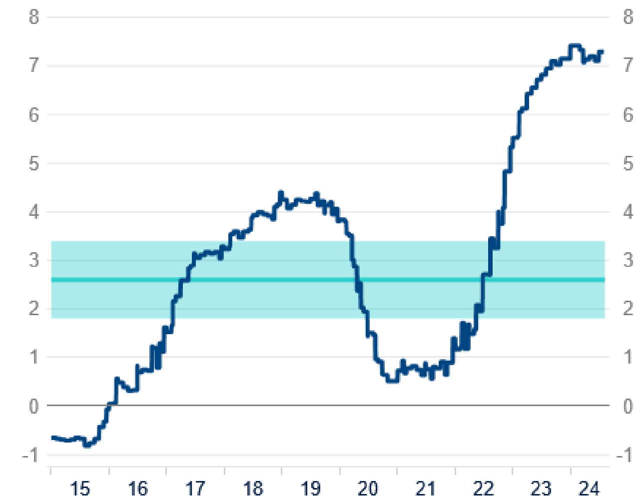
Figure 3. **USDMXN RELATIVE PERFORMANCE**
(01-JAN-23=100)



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

Conditions for cutting rates while keeping a very restrictive stance remain

Figure 4. **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 / Banxico / INEGI

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