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Banxico Watch

With the tariff threat in pause, a 50bp rate cut now seems very likely

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Banxico has ample room to keep cutting rates this year amid an improving inflation outlook and worsening growth prospects

- **Last week, the Fed kept the policy rate unchanged at 4.25-4.50% amid continued uncertainty around Trump's policies, as well as in the face of a strong economy and sticky core inflation.** While all eyes were on any signals pointing to a more long-lasting pause amid the ongoing uncertainty around the potential effects of Trump's immigration and trade policies, neither the wording of the statement nor the Q&A gave a strong hint about the possible direction of the next policy decision in March. On one side, with core PCE inflation at a "somewhat elevated" sticky level, Powell said that the Fed does not need to "be in a hurry to make further adjustments" given the continued economic strength supported by solid consumption growth and a stabilized labor market, and emphasized that their primary focus remains on seeing real progress on inflation or, alternatively, any unwelcome employment weakness. On the other hand, he continued to acknowledge "some elevated uncertainty because of significant policy shifts," but stressed that it is too early to know what will happen with them. In this way, we think the Fed kept its options open: signs that core inflation is back on trend to 2% could open the door for another cut in the next meetings and up to 50bp worth of cuts in 2025, but the implementation of policies that could spark an upward trend in inflation, even if temporary, could imply a more extended pause. We continue to expect that the Fed will be able to cut rates by 25 bps in March amid further signs of less solid growth and better inflation readings, but additional cuts (particularly our baseline assumption of an additional 25bp rate cut in June) could increasingly be at risk amid tariff-related price pressures later this year (see here and here for additional details on last week's FOMC meeting).
- **Inflation dropped below 4.0% YoY for the first time in four years; core services inflation continues to ease.** Inflation readings in the intermeeting period likely reinforced the Board's majority (leaning) strategy to speed-up the easing cycle. Mexico's headline inflation rate dropped to 3.7% YoY in the first half of January (down from 4.2% in December), falling back within Banxico's target range for the first time since February 2021. Core inflation dropped to 3.7% YoY in 4Q24, the lowest since 2Q20, and stayed broadly unchanged in the first fortnight of the year amid a higher-than-expected increase in core goods prices but a slightly softer services inflation. Core services inflation rose 0.07% FoF and fell to 4.8%YoY, from 5.0% in the previous fortnight. The fall in services inflation excluding housing and tuition was larger (-0.3 pp to 5.6%). Core services inflation has stayed below 5.0% YoY since last October, a streak not seen in more than two years. Most of the components that put the most pressure on core services inflation and have the largest relative weight have decreased since reaching their peak in 1Q23, but they still have to make progress to converge to the steady-state average, which is key to consolidating the lower core inflation levels already achieved. Looking ahead, we expect the rebalancing between (lower) services inflation and (somewhat higher) core goods inflation to continue allowing core inflation to consolidate at the levels already reached and to edge down to around 3.5% by the end of the year.

- **December's Banxico meeting minutes strongly suggested that three members would favor a 50bp rate cut this week despite the increased uncertainty around Trump 2.0.** Some members seem to share the view that the effect of Trump's trade policies on Mexico's inflation is not straightforward, as they pointed out that price pressures stemming from "an exchange rate depreciation […] given the potential implementation of [trade] policies" would likely be offset by "a negative impact [of such policies] on economic activity." The most dovish stance probably comes from Deputy Governor Omar Mejía who we think is the member who said that "it is necessary to increase the magnitude of rate cuts in some of the upcoming monetary policy decisions." Both Governor Victoria Rodríguez and Deputy Governor Galia Borja seem to share a similar but slightly less-dovish view: one expressed the need for "discussing the possibility of larger downward adjustments […] at the next policy meetings," while the other stated that "the process of calibrating the monetary policy stance could imply downward adjustments of larger magnitude in some monetary policy decisions" this year. On the other side, Deputy Governor Jonathan Heath said that "accelerating the pace of monetary easing as well as admitting in advance that it can be done in future decisions should be avoided for the moment." With the threat of US tariffs looming on February 1st, the likelihood of Banxico cutting rates by 50 bps seemed to diminish as the meeting neared. The subsequent pause in tariff implementation that allowed the MXN to continue to hold up, though, offers a window for such a bigger rate cut this week.
- **Below 4.0% inflation, easing core services inflation, softer aggregate demand, a cooling labor market, a peso that continues to hold up, and an overly restrictive monetary policy stance, keep the door wide open for a larger 50bp cut.** Banxico opened the door to a 50bp rate cut at the last meeting and the minutes showed that up to three Board members (out of four since the fifth had not yet been appointed) hinted that they would likely lean to a 50bp cut. 2024's growth rate was around half of that recorded in 2023 and a vast majority of analysts (and Banxico itself) think that growth is set to slow down further in 2025. In this context, demand pressures on inflation are increasingly unlikely, in fact, what is foreseeable is that this weakness will lead to the pending rebalancing between inflation of goods and services, which will be key to consolidate the low levels of inflation already achieved. Under this backdrop, the monetary policy rate remains extremely restrictive. The estimate of the neutral real interest rate is just under 3%, but the current real rate is around 6%. Therefore, there is ample room to cut the policy rate throughout the year while still keeping a restrictive stance (now unwarranted in our view), but making it less restrictive. **We thus keep unchanged our call of a 50bp cut:** Banxico will likely step up the easing pace in a backdrop of an "improving" inflation outlook and worsening growth prospects.

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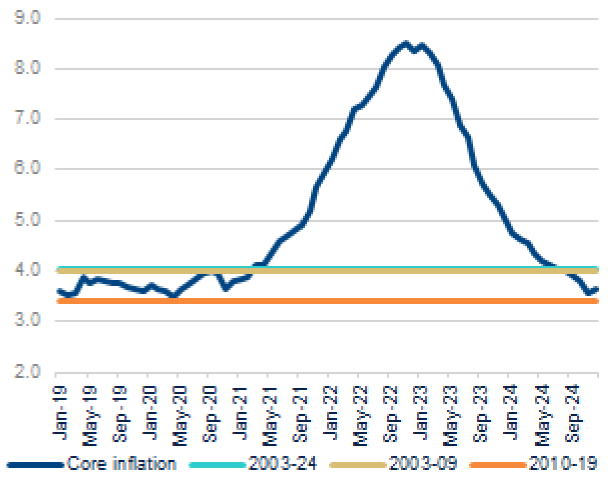
Core inflation is now close to its steady-state level

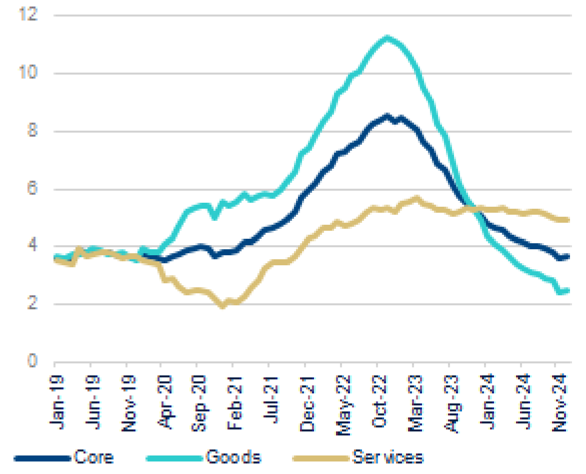
Figure 1. **CORE INFLATION**
(YOY % CHANGE)



Source: BBVA Research / INEGI

Somewhat higher core goods inflation but lower core services inflation is likely…

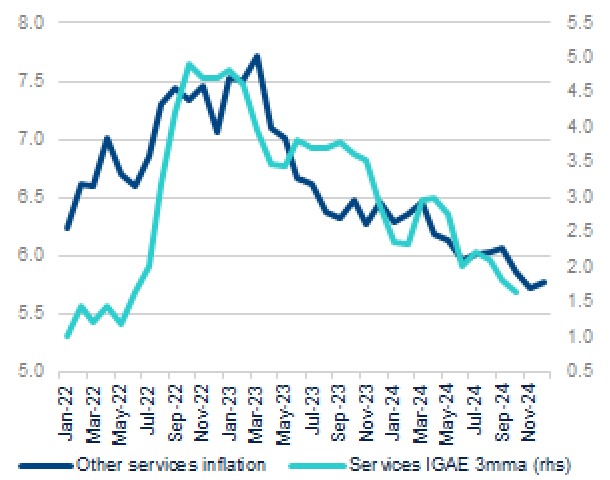
Figure 2. **CORE INFLATION BREAKDOWN**
(YOY % CHANGE)



Source: BBVA Research / INEGI

… in a backdrop of softer demand and a weakening labor market

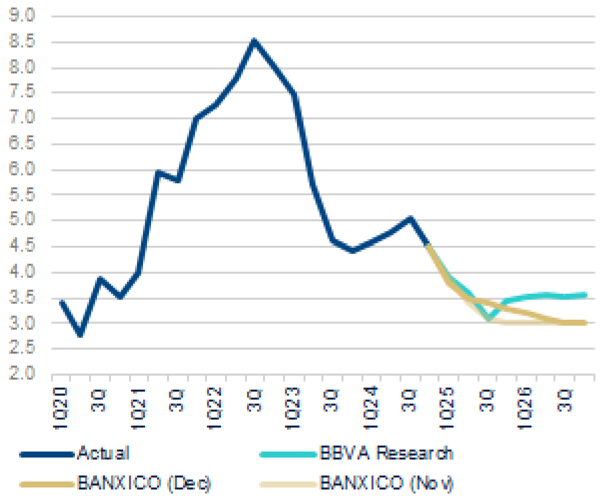
Figure 3. **CORE SERVICES INFLATION**
(%)



Source: BBVA Research / INEGI

Inflation could fall below 3.0% in the summer before bouncing back to 3.5% by year end

Figure 4. **HEADLINE INFLATION OUTLOOK**
(YOY % CHANGE)



Source: BBVA Research / BANXICO / INEGI

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