Banxico's Minutes (Mar-20): More prudence in sight amid the buildup of domestic risks

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- Friday morning Banco de México published the Minutes corresponding to its last monetary policy decision, which was moved forward from March 26 to March 20. The document reflects a rich interaction within the Governing Board.
  - Regarding domestic economic activity, the majority pointed out its continued weakness and agreed on the fact that current shocks will contract the economy in 2020.
  - With respect to inflation, although most of Board members agreed on the existence of contrasting forces affecting its future path, there was less consensus on the net effect of these shocks, which turned into contrasting views for its balance of risks.
- In our view, three key element will determine future monetary policy actions: i) the nature of FX adjustments; ii) country risk premium and its implications for the relative monetary stance; and iii) the speed and effectiveness of fiscal measures implemented to satisfy health needs and to support the most affected economic agents.
- All in all, we perceived the message of the Minutes a bit more hawkish than the communiqué, and believe that the buildup of local risks pinpointed by Board member's, which in the two weeks after the decision have either materialized or reinforced, add to this vision.
- What's up ahead? More prudence. While sticking to our expectation of observing additional rate cuts summing up to a reduction of 100 bps total in the reference rate during the following months, we lowered the likelihood that we had assigned immediately after the decision to see some action before the next scheduled meeting. This is, we now expect Banxico to cut the reference rate by 50 bps in May 14.

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Friday morning, Banco de México published the Minutes corresponding to its last monetary policy decision.

Let us recall that, in an unexpected move, and amid extraordinary actions by numerous central banks globally, the meeting in question, in which in addition to reduce the reference rate by 50 basis points (bps) –from 7 to 6.50%– the Central Bank decided to adopt certain measures to provide liquidity and improve the functioning of domestic financial markets (see Table 1), was moved forward from March 26 to March 20.

In the communiqué accompanying the decision, Banxico not only mentioned that it expects a further widening of slack conditions with a balance of risks for growth considerably tilted to the downside, but also reinforced the ideas of a slower convergence of inflation to its 3% arget and an uncertain outlook surrounding this expectation –as disinflationary pressures from lower economic activity and energy prices could be offset by the pass-through of FX depreciation. In line with the previous statement, the Bank indicated that it will take the necessary actions in order to maintain the reference rate in a level consistent with an orderly and sustained convergence of inflation to its target, based on the flow of new information. Finally, Banxico called for fiscal authorities to also take the necessary actions to contribute to an orderly adjustment of financial markets and the economy as a whole, while preserving macro fundamentals.

The document that summarizes the discussions underlying the decision reflects a rich interaction within the Governing Board.

Regarding **domestic economic activity,** the majority of Board members pointed out its continued weakness prior to COVID-19, and agreed on the fact that the latter will have significant effects on domestic demand –particularly on consumption and investment, with severe implications for tourism and services–, which makes it foresee an economic contraction in 2020.

With respect to **inflation,** the majority acknowledged the increase in headline inflation from January to February due to the rise in the non-core component, as some highlighted the continued persistence of core inflation. Although most of them agreed on the existence of contrasting forces affecting future inflation, there was no consensus on the assessment of the net effect of these shocks which, again, translated into contrasting views for its balance of risks. This is, a member believes the latter is skewed to the upside and another one thinks it is slightly tilted to the downside, while the rest of members characterized it as uncertain or highly uncertain.

Yet, the sections corresponding to discussions on the macro-financial environment and monetary policy were the most revealing and, in our view, provided key ingredients that will determine future monetary policy actions.

Specifically three elements stood out:

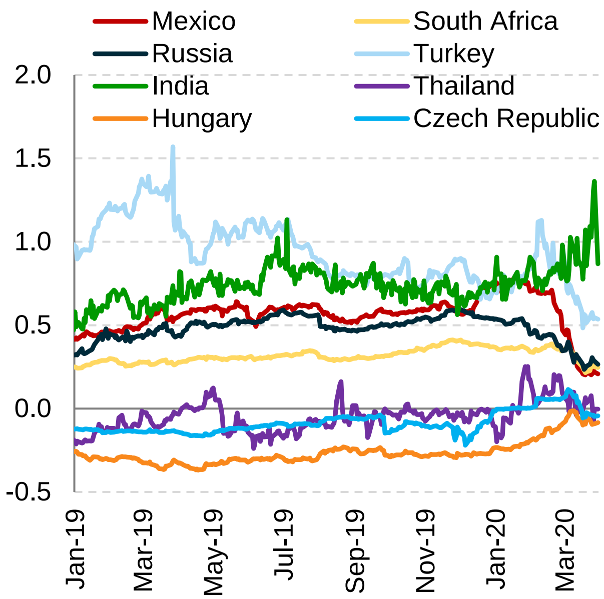
1) **The nature of FX adjustments.** Although all Board members drew attention to the depreciation of the currency, one of them sees the glass as half full. Inparticular, he/she believes FX dynamics were explained by risk aversion and the plunge in oil prices. Meanwhile, others argued that its adjustment was sharper relative to other emerging market economies (EMEs). Another member went further, saying that the exchange rate already reflects idiosyncratic factors, pricing in concerns over Pemex and public finances and their respective credit ratings.

   Understanding the different sources driving FX dynamics to assess the persistence of its adjustment and, in turn, the possible effects on the price formation process of the economy will shape member's opinions with respect to the adequate monetary policy response.

2) **Country risk premium and relative monetary stance.** The majority of Board members indicated that within the context of higher country risk premia, the margin for the relative monetary stance has reduced, as opposed to the common view. In line with this, it also mentioned that although interest rate spreads between Mexico and the U.S. widened, once controlling for FX volatility, they have actually narrowed (see Figure 1). Furthermore, some members highlighted that, given the peso's high level of sensitivity due to its use as a currency hedge, it should also be taken into account that lowering local short-term interest rates reduces the cost of embarking on this type of transactions.

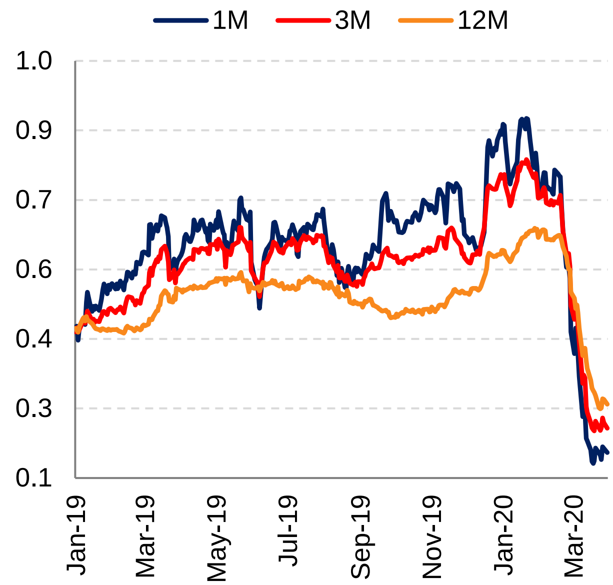
   In short, the story of Mexico's restrictive monetary stance vis-à-vis the U.S. and other EMEs seems to have lost some traction as a driver of additional interest rate reductions for the moment, as the absolute monetary stance also approaches the neutral range (see Figure 2).

Figure 1A. Volatility adjusted carry in selected EMEs (Percentage points



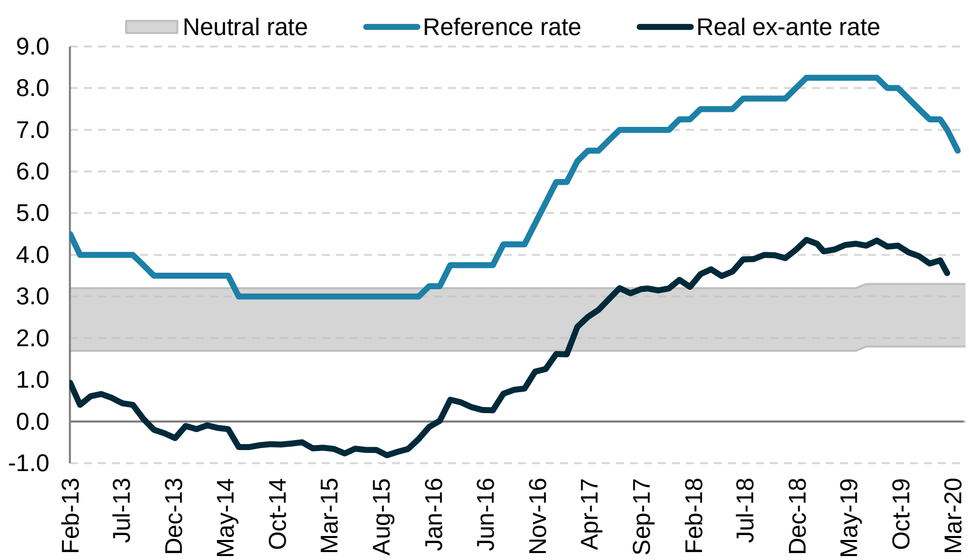
Source: Finamex Economic Research with data from Bloomberg

Figure 1B. Volatility adjusted carry in Mexico (Percentage points)



Source: Finamex Economic Research with data from Bloomberg

Figure 2. Reference and real ex-ante rates (Percentage points)



Note: Shadowed area corresponds to Banco de México's estimated ranges for r* in the long-term.
Source: Finamex Economic Research with data from Banco de México.

3) **Fiscal measures to satisfy health needs and to support most affected households, businesses and sectors.** Board members pointed out the difficult balance between more public spending needs and maintaining a sustainable path for public finances, mainly against the backdrop of the weakness of Pemex's credit profile –which has deteriorated severely due to the fall in international oil prices– and feedbacks into sovereign risk. However, a clear message was sent around the idea that monetary policy has limited scope to counter the current shocks to economic activity and that fiscal policy is better suited to effectively address the present situation and to target the most affected domains.

   Our interpretation: Banxico wants to see the implementation of fiscal measures aimed at mitigating the health and economic effects of concurrent shock, which could boost confidence about a faster economic recovery in the future, thus providing the Central Bank with more room for maneuver. Relatedly, the majority of Board members warned of the relevance of implementing public policies aimed at providing confidence to private investment, which would also improve economic sentiment going forward, thus contributing to foster long-term growth.

The decision was not a unanimous one. As greatly anticipated, the Minutes revealed that Deputy Governor Guzmán was the Board member who voted in favor of a 25 bps reduction in the reference rate. He argued that the current environment exerts pressures on inflation in opposite directions and increases uncertainty which, in combination with external and local challenges, calls for prudence in monetary policy actions, especially since the effects of interest rates on economic activity is modest, and even more limited in the face of the present shock's nature. He also emphasized that "in a rapidly changing environment, monetary policy must adjust at the time and in the magnitude required" and added that "in order to overcome the crisis, public health and fiscal actions need to be taken".

All in all, we perceived the message of the Minutes a bit more hawkish than the communiqué. The buildup of local risks pinpointed by Board member's add to this idea. In the two weeks after the decision have either materialized in the form of downgrades to the sovereign and Pemex, and with the USDMXN exchange rate reaching record highs. On the former front, see the one-notch downgrade to sovereign debt by S&P, as well as those to Pemex debt by S&P and Fitch (the latter deeper into non-investment grade). Moreover, other risks have reinforced with the announcement of a more than disappointing fiscal plan aimed to address current shocks.

So, what's up ahead? More prudence. While sticking to our expectation of observing additional rate cuts summing up to a reduction of 100 bps total in the reference rate during the following months, we lowered the likelihood that we had assigned immediately after the decision to see some action before the next scheduled meeting. This is, we now expect Banxico to cut the reference rate by 50 bps in May 14. After the reference rate reaches the level of 5.50%, thus recovering the interest rate differential with U.S. short-term rate of 550 bps, we believe that the Central Bank will make a pause, to compensate higher country risk premium coming from the fiscal side.

However, the fast changing environment could easily challenge our baseline scenario. A significant improvement in market sentiment as better news from Covid-19 or OPEC++ agreements unfold, on the external front, and more decisive actions on the government's side to at least somehow alleviate the effects of Covid-19 mitigation measures on the economy, on the local one, could trigger additional rate cuts throughout the year.

For details regarding the change in messages on different topics, the Board composition and recent monetary policy voting behavior, see Tables 2, 3 and 4, respectively.

Table 1. Liquidity measures in response to the COVID-19 pandemic and plunge in oil prices

No.	Objective	Measure	Executor
1	Promote credit supply	Reduction of the Monetary Regulation Deposit (DRM) by 50 Bn MXN.	Banco de México
2	Promote credit supply	Issuance of special accounting criteria that facilitates capital/interests payment deferrals for up to 6 months	CNBV
3	Mantain adequate liquidity conditions	The cost of referred credits and repos lowered to 1.1x Banco de México's target for the overnight interbank interest rate.	Banco de México
4	Mantain adequate liquidity conditions	US dollar auctions among credit institutions, financed by the swap line with the US Fed (60 Bn USD).	Exchange Comission
5	Ensure participion in debt market	Increase in the currency hedging program from 20 to 30 Bn USD.	Exchange Comission
6	Improve fixed income market operations	Implementation of swaps of government securities, amendments to the purchase option of government securities for market makers.	MoF, Banco de México
7	Guarantee attention to the insured	Authorized Insurance Institutions to extend premium payments.	CNSF

Source: Finamex Economic Research with data from Banco de México and CESF Reports.

Table 2. Key takeaways from changes in Banxico's Minutes.

February 2020 Minutes	March 2020 Minutes
Most members noted **the possibility of central banks adopting more accommodative monetary policy stances in view of the risks associated with the coronavirus outbreak**. In this context, most members emphasized that global financial conditions have continued to loosen. Most members indicated that **the good performance of global markets has favored capital flows to emerging economies**. However, they mentioned that **episodes of volatility associated to the coronavirus outbreak** have been observed. They also pointed out that there are factors that could contribute to episodes of risk aversion such as the US elections, conflicts in the Middle East and the reemergence of trade tensions.	All members mentioned that different **central banks in advanced and emerging economies lowered their interest rates**, in some cases ahead of schedule. They also pointed out that other **extraordinary monetary measures have also been implemented to mitigate the effects** of the expected fall in domestic and external demand, and to guarantee the well-functioning of financial markets. They highlighted **measures to provide liquidity and incentivize credit, as well as the purchase programs** of: i) government bonds; ii) mortgage-backed securities; iii) corporate bonds; iv) non-financial firms' commercial papers; v) equity funds, and vi) real estate investment funds. All members highlighted the **significant deterioration of international financial markets, underlining the greater volatility and risk aversion.**
All members agreed that **economic activity in Mexico has remained stagnant for several quarters.** Most members noted that **the latest information as of the Q4-19 suggests a slight contraction for the year as a whole.** One member added that this is accounted for by: i) an unfavorable global context; ii) the beginning of a new administration; iii) some controversial public policy decisions that contributed to generate uncertainty; and, iv) a tight monetary policy for a relatively long period.	Most members mentioned that timely information released prior to the pandemic-related events shows that **domestic economic activity has remained weak.** On the production side, one member noted that the **deceleration of industrial activity**, particularly of manufacturing, **as well as the weakness of services.** Most members mentioned that the disruption in global supply chains and the restriction of flows of individuals and international goods **will strongly affect tourism and services in general**.
Most members highlighted the **weakness in aggregate demand components, emphasizing investment's sluggishness.** Some members mentioned that **investment has been affected** by the public budget underspending and the lack of both legal certainty and domestic and external certainty. Most members stressed the **slowdown of manufacturing exports in late 2019.**	One member mentioned that all **demand components remain weak**. Most members pointed out that technical shutdowns began to be observed across different sectors in March due to the shortage of inputs. Such members also noted that **a significant impact on domestic demand is anticipated, in particular, on consumption and investment.** Some members underlined the impact on domestic demand of the social distancing measures and the fear of contagion among the population.
Most members mentioned that, based on the most recent information, **GDP growth in 2020 is expected to be lower than the figure released in the Q3-19 Quarterly Report.** Most members considered that **the balance of risks to growth remains biased to the downside.** Most members added that economic activity is subject to both external and domestic risks.	Most members noted that **the impact of the pandemic on economic activity, in a context of a greater weakness of the global economy, leads to a deterioration of the growth outlook**. Such members stated that, although it is not possible to accurately estimate the magnitude of the impact on economic activity, **an economic contraction is foreseen for 2020.** Most members considered that the **balance of risks for growth is strongly biased to the downside.**
Most members agreed that **stagnation of economic activity has implied that slack conditions have continued to widen.** One member noted that exogenous cost pressures, such as those related to wages, could hamper the recovery of production and the narrowing of the negative output gap.	Some members considered that **economic slack has increased**. In view of the deteriorated growth outlook, most members mentioned that **an even greaterthan-anticipated widening of slack conditions is foreseen.**

Table 2. Key takeaways from changes in Banxico's Minutes.

February 2020 Minutes	March 2020 Minutes
All members mentioned that **in early 2020 annual headline inflation increased,** although some of them highlighted that at the end of 2019 it stood below 3%. Most members underlined that the recent increase was mainly associated with the rise in the non core component. Most members stated that **core inflation was affected by the increase in the prices subject to the special tax on production and services** (IEPS, for its acronym in Spanish) **and that it continues to show resistance to decline.** The majority considered that **its behavior is also due to the evolution of wages.**	Most members mentioned that **annual headline inflation increased between January and February**, mainly due to a rise in the non-core component. Some members highlighted the **persistance of the core inflation**. Some indicated that **the trend of inflation towards the goal of 3% could be slower than expected** and present significant risks, both downward and upward.
Regarding upside risks to the foreseen trajectory for inflation, most members mentioned **core inflation's resistance to decline and the possibility that wage increases affect prices.** Another member highlighted the minimum wage increases accumulated in the last two years and the mean salaries for IMSS-contribution purposes in 2019. Most members added as upside risks **a possible exchange rate adjustment**, as well as **greater-than-expected increases in agricultural and livestock prices.** Some members mentioned the possibility of non-core inflation reversing to levels greater than anticipated due to the high variability of this subindex. In addition, the majority mentioned the risk of a **deterioration of public finances**.	Regarding upside risks to the foreseen trajectory for inflation, the majority mentioned **the effect that the exchange rate depreciation could have on prices**. Some members added as an upward risk to inflation the **pressures derived from the disruption of global supply chains and the shortage of some goods as a result of the suspension of activities**.
As for downside risks for inflation, most members mentioned: **i) a further appreciation of the peso exchange rate in response to greater risk appetite; ii) lower international prices of energy goods due to the coronavirus outbreak; and, iii) greater economic slack.** One member also added the benign behavior of producer prices. In this context, some members pointed out that uncertainty continues as to the balance of risks for the foreseen path of inflation.	As for the downside risks for inflation, the majority mentioned **the expansion of the negative output gap and the decrease in international energy prices**. One member also mentioned **the dissipation of the recent shock in the prices of agricultural products**, as they typically dissolve within a few months. In this context, some members pointed out that uncertainty as to the balance of risks for the foreseen path of inflation has increased.
Regarding Pemex's situation, one member said that, although a slight rebound in oil production has been observed, the target for 2020 appears optimistic given that investment is lagging behind. One member mentioned that this year **the challenges for public finances are exacerbated in the face of an outlook for economic growth and oil income being lower than previously foreseen.** One member pointed out that **the vulnerability of the public finances would increase in the coming years given the longterm challenges Pemex faces and the probable exhaustion of federal government reserve funds.**	Most members highlighted that **domestic financial markets exhibited a negative performance: the peso exchange rate depreciated significantly**, and risk premia increased sharply. The majority of members warned that both the **fall in oil prices and the lower economic growth increase fiscal accounts' vulnerability**. The majority emphasized that **Pemex's situation is a risk factor for public finances,** underlining the possibility of a downgrading of both the sovereign and the State-owned company's credit rating. Some members signaled **the risk of a greater contagion of COVID-19 and a more prolonged impact on world economic activity.**

Table 3. Banco de México's Board Members Profile

Position	Governor	Deputy Governor	Deputy Governor	Deputy Governor	Deputy Governor
Name	**Alejandro Díaz de León Carrillo**	Javier Eduardo Guzmán Calafell	Gerardo Esquivel Hernández	Irene Espinosa Cantellano	Jonathan Ernest Heath Constable
Former Position	CEO at Bancomext	Director General at Center for Latin America Monetary Studies (CEMLA)	Professor in the Department of Economics at El Colegio de México	Federal Government Treasurer	Independent Economic Consultant
Term	December 2017 - December 2021	February 2013 - December 2020	January 2019 - December 2022	January 2018 - December 2024	January 2019 - December 2026
Education	BA in Economics (ITAM), MBA (Yale)	BA in Economics (UNAM), MA in Economics (Yale & Leuven)	BA in Economics (UNAM), PhD in Economics (Harvard)	BA in Economics (ITAM), MPP (ITAM)	BA in Economics (Anáhuac University), PhD in Economics (UPenn)
Last 5 rate decisions*	Cut; Cut; Cut; Cut; Cut	Cut; Cut; Cut; Cut; Cut	Cut; Cut; Cut; Cut; Cut	Cut; Cut; Cut; Cut; Cut	Cut; Cut; Cut; Cut; Cut

* Monetary policy decisions follow a top-down order from the most recent to the oldest one.

Table 4. Banco de México's Board Members Decisions and Dissents

Decision's date	Previous reference rate	Current reference rate	Movement in the reference rate	Quorum	Unanimous decision?	No. of dissenting votes on: Decision	No. of dissenting votes on: Comuniqué's tone
Mar 28, 2019	8.25%	8.25%	0		Yes	-	1
May 16, 2019	8.25%	8.25%	0		Yes	-	1
Jun 27, 2019	8.25%	8.25%	0		No	1 (-25bp)	-
Aug 15, 2019	8.25%	8.00%	-25		No	1 (0 bp)	-
Sep 26, 2019	8.00%	7.75%	-25		No	2 (-50 bp)	-
Nov14, 2019	7.75%	7.50%	-25		No	2 (-50 bp)	-
Dec 19, 2019	7.50%	7.25%	-25		No	1 (-50 bp)	-
Feb 13, 2020	7.25%	7.00%	-25	5	Yes	-	-
Mar 20, 2019	**7.00%**	**6.50%**	**-50**	**5**	**No**	**1 (-25 bp)**	**-**

Source: Finamex Economic Research with data from Banco de México's Minutes.

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(*) Research analyst(s) primarily responsible for the preparation and content of this research report.