# Banxico's Minutes (May-20): United against a shared enemy but with important differences regarding the implementation of a common strategy.

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- Yesterday morning, Banco de México released the Minutes corresponding to its last monetary policy decision. In line with our reading of the policy statement, we noticed a neutral tone in the discussion among Board members, with hawkish sparks spread across the document.
    - The Minutes confirmed the bear outlook regarding economic activity that dominates among Board members, as well as our perception that discussions regarding the dominance of demand- vs supply-side effects of the current shocks on inflation resurged.
    - Noticeably, macro-financial developments are a source of big and common concern.
    - We perceive that most Board members are ready to continue the easing of monetary conditions but that there are important differences regarding the most suitable approach.
- Worth noting, the document preceded the publication of the latest inflation figures, whose atypically high levels underscored the particular forces governing the setting of prices at the current juncture. We see the former as one of the main drivers of the renewed hawkish tone that we noticed on the Inflation Report, released on Wednesday –the other being the non-stop accumulation of idiosyncratic elements that contribute to the further loss of investor confidence.
- We continue expecting further reductions of the reference rate, of up to 100 bps, during this and next quarter. Specifically, we see a 50 bps rate cut in Banxico's next monetary policy meeting on June 25th and the possibility that the last 50-bps-mile is implemented in two consecutive rate cuts of 25 bps each.

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Yesterday morning, Banco de México released the Minutes corresponding to its last monetary policy decision of June 14th, in which unanimity with respect to the 50 bps reduction of the reference rate and a relatively neutral policy communiqué left those still anticipating more aggressive rate cuts without further arguments to fuel this expectation.

**In line with our reading of the policy statement, we noticed a neutral tone in the discussion among Board members, with hawkish sparks spread across the document.**

As we mentioned in our June 15th Monetary Policy at a Glance note "Banxico reduces its reference rate, while unanimity closes the door to more aggressive rate cuts", **the Minutes confirmed the bear outlook regarding economic activity that dominates among Board members.** In this respect, most members agreed that the balance of risks for growth is significantly biased to the downside and faces significantly uncertainty. Although the document revealed some discrepancies regarding the length and magnitude of economic disruptions –some members even pointed that the lack of the absence of a comprehensive support approach, particularly given the modest fiscal response, can lead to a slower recovery–, isolated comments showed multiple worries about the labor market, the uneven burden for those with lower wages, small and medium firms and the informal sector, and concerns about the permanent damage to production and employment and the worsening of the environment of legal uncertainty for private investment looking forward.

**The Minutes also confirmed our perception that discussions regarding the dominance of demand- vs. supply-side effects of the current shocks on inflation resurged among Board members, especially, with respect to the prices within the foods, beverages and tobacco sub-index**. A Board member emphasized that some inflation dynamics can be explained by a dramatic change in consumption patterns due to the lockdown measures, on the one hand, and to the disruption of value chains, which produce extreme variations within the INPC (CPI), on the other hand. Furthermore, **opposing arguments regarding inflation's current state and future dynamics prevail.** For example, in the latter's case, while a member considers that core inflationary pressures are generalized despite the fact that some of its components lie below the 3% annual mark, another suggests that core inflation has shown less persistence, that FX pass-through effects have been reduced and that the increase in some of its components should be transitory. In the former's case, some Board members believe that inflation will end up 2020 below its 3% target –one of them even thinks it will be below the target for the remaining of the year–, while another Board member thinks it will reach levels above the target by 2H-2020 and that it will converge until 2H-2021.

**While new upside risks for inflation were added to the discussion, its balance of risk continued being qualified as uncertain**. The sources of uncertainty vary across Board members, though. One of them mentioned a list a 5 key drivers to weigh in, including the drop in aggregate demand, and the persistence of adverse conditions for financial markets. Another member emphasized the same factors, nd highlighting the high level of risks on both up and down sides. Yet, other member assessed the balance of risks as tilted to the downside, while another one suggested that downward pressures are dominating over upward ones.

**Noticeably, macro-financial developments are a source of big and common concern.** The debate showed that the majority of Board members see the unprecedented capital outflows, prevailing deteriorated market conditions and FX dynamics as worrysome. The sovereign and Pemex debt ratings, and the small room for maneuver on fiscal matters are also recurrent topics. With respect to the latter, the majority agreed that efforts should be directed to a reallocation of the budget according to efficiency criteria: "One member specified that said reallocation should be directed towards spending with an effect on the labor market in the short term. Another member stated that there are some margins for maneuver, such as the reallocation of public spending from controversial large-scale projects to priorities arisen as a result of the pandemic." Finally, most members highlighted the need to generate public policies that provide certainty to private investment, and to keep solid macroeconomic fundamentals. In this regard, a member related this topic to an orderly adjustment of Mexican financial markets. In addition, some members revealed their concerns about the escalation of the uncertain environment for investment, specifically, about the latest changes in the rules for private generators of electricity. For one member, this decision has a direct impact on competition and free market participation. Another member showed concerns in the reduction of the potential growth amid the health crisis.

**Regarding monetary policy actions, we perceive that most Board members are ready to continue the easing of monetary conditions but that there are important differences regarding the most suitable approach, including the convenience of providing forward guidance**. Two Board members clearly advocated for prudence amid high (global and domestic) risks. Two other members mentioned that the current context provides room for continued and still significant reductions in the reference rate. Interestingly, another one argued that there are elements of stability in domestic financial markets, and for the financial system as a whole, that must be considered in order not to induce or worsen an adjustment of portfolios, hence the need "to identify the different challenges and dilemmas that monetary policy faces, assess the scenarios that materialize, and based on these elements define the most convenient adjustments to the monetary policy stance." Finally, most members mentioned the relevance of implementing the measures aimed at fostering an orderly behavior of financial markets, strengthening the credit channels, and providing liquidity in order to continue supporting the financial system. Still, one member claimed these measures need reinforcements on communication, implementation, and an assessment on their effects. For instance, this member considered of great importance to respond to the economic emergency within the powers of the Central Bank to its maximum capacity, i.e., a more accommodative stance. Also in this line, another member discussed the limits of the facilities announced by Banco de Mexico to foster credit, implying that is necessary to bring the reference rate below its neutral level, relatively soon.

**To sum up, in our view, the Minutes depict a Governing Board united against a shared enemy –the crisis generated by COVID-19– and hence willing to relax its monetary stance, but with important differences across members regarding the implementation of a common strategy.** We perceived that Board members are aligned in their views regarding economic activity, they even agree (to the greatest extent we have seen so far) on the fact that domestic risks are piling up. However, their assessments on inflation dynamics and the suitable depth of the easing cycle remain as the main points of discrepancy.

**Worth noting, the document and corresponding decision under discussion preceded the publication of the inflation figures for the first fortnight of May, whose atypically high level underscored the particular forces governing the setting of prices at the current juncture, thus provideing additional arguments to those on the hawkish side of the spectrum to continue on a prudent path. We see the former as one of the main drivers of the renewed hawkish tone that we noticed on the Inflation Report released on Wednesday –the other being the non-stop accumulation of idiosyncratic elements that contribute to the further loss of investor confidence.**

**We continue expecting further reductions of the reference rate, of up to 100 bps in our baseline case, during this and the next quarter.** Specifically, we see a 50 bps rate cut in Banxico's next monetary policy meeting on June 25th and the possibility that the last 50-bps-mile is implemented in two consecutive rate cuts of 25 bps each. However the fast changing landscape, specially, with respect to the evolution of inflation dynamics and the potential materialization of idiosyncratic risks, could easily change this expectation.

For details regarding the change in messages on different topics, and the Board composition and recent monetary policy voting behavior, see Tables 1 and 2, respectively.

**Table 1. Key takeaways from changes in Banxico's Minutes.**

| April 2020 Minutes | May 2020 Minutes |
|---|---|
| Most members stated that several central banks of advanced and emerging economies lowered their interest rates significantly, and are close to zero or even negative interest rates. Most members emphasized that **the adverse environment has generated an increase in risk aversion, worsening global financial conditions and leading to a recomposition of investors' portfolios towards lower-risk assets**. However, they acknowledged that during the last month there was a slight improvement following the announcement of monetary, fiscal and financial support measures. Most members stressed that **in this context emerging economies have registered significant capital outflows;** and mentioned that this has led to a **depreciation of their currencies and to volatility in their FX markets**, as well as to pressures on stock indices and interest rates. | Most members pointed out that numerous central banks have lowered their interest rates significantly and implemented extraordinary measures to foster the well-functioning of their financial systems, and that some countries have also implemented fiscal stimulus measures to mitigate the adverse effects of the pandemic. **This adverse environment has led to a greater risk aversion, a deterioration of global financial conditions, and to a recomposition of investors' portfolios towards lower-risk assets**. Most members acknowledged that the actions adopted by advanced economies to provide liquidity and restore financing, as well as the announcements about a possible gradual reopening in some countries, have contributed to **a more stable behavior of international financial markets in the last weeks.** |
| **Most members agreed that the pandemic is an unprecedented shock.** Another member pointed out that this is due to the **supply and demand shocks caused by social distancing and the economic lockdown**. Most members stated that supply has been affected by interruptions in the production of goods and services, as well as by the closure of businesses. With respect to the labor market, most members highlighted the **deterioration observed in the employment figures** reported by the IMSS. | All members pointed out that timely information shows that **during the first quarter of the year economic activity in Mexico contracted significantly, which already incorporates effects. associated with the pandemic.** Most members noted that the economy was already weak prior to the pandemic.<br>Most members mentioned that **the labor market has been affected by the effects of the health crisis.** |
| Demand has been affected by **lower consumption, as a result of a decline in individuals' incomes and of fewer spending opportunities,** as well as by lower investment and lower external demand, partly due to the deceleration of the US economy. | Most members noted that the **lockdown measures have affected aggregate demand** and that various indicators point to a **contraction of consumption and investment** in March and April. Most members added that **exports,** including the automotive ones, **decreased,** while imports maintained their negative trend. |
| All members pointed out that, in view of the impact of the pandemic, **Mexican economic activity is anticipated to contract significantly during the first half of the year,** while acknowledging that the magnitude and duration of the pandemic's effects are still unknown, and that available information is still limited. All members agreed that **the balance of risks to growth is significantly biased to the downside and is characterized by high uncertainty.** | The majority of members stated that, although the magnitude and duration of the **effects of the pandemic** are still unknown, these are **expected to intensify during the second quarter**. Most members pointed out that growth forecasts for 2020 continue to be revised downward. Most members agreed that the **balance of risks for growth is significantly biased to the downside** and considered that it is subject to uncertainty, given that the duration and depth of the effects of the pandemic are unknown. |
| Most members agreed that **slack conditions are widening considerably and that the effects of the pandemic will significantly widen the negative output gap**. | In this context, most members pointed out that **slack conditions widened considerably** and that they are expected to continue doing so. One member mentioned that **the negative output gap is expected to reach levels not recorded since the 2008-2009 crisis.** |

**Table 1. Key takeaways from changes in Banxico's Minutes.**

| April 2020 Minutes | May 2020 Minutes |
|---|---|
| Most members mentioned that **the recent decrease in headline inflation between Febreuary and March is mainly driven by the recent fall in energy prices**. Most members highlighted that core inflation decreased in March as well. Most members mentioned that **it is highly likley that inflation remains low in the short run**. | Most members mentioned **the continued decrease in headline inflation between March and April is mainly explained by the marked reduction that energy prices have presented**, which registered historically low annual variations in the referred months. Most members also highlighted that **Food Merchandise prices increased** while **Non-food merchandise and Services decreased**, most likley due to changes in demand associated with the current pandemic. |
| Most members mentioned **the exchange rate depreciation as an upward pressure to the foreseen trajectory for inflation**, which will depend on its magnitude and persistence. | Most members pointed out **a stronger or more persistent depreciation of the peso exchange rate** and **disruptions of supply-chains** as possible upward pressures. |
| Most members highlighted a **downward pressures due to the widening of the negative output gap and, in the short term, due to lower energy prices**. Most indicated that **uncertainty about the balance of risks for inflation has increased significantly**. Some pointed out that the **uncertain environment for inflation prevails particularly for the long term**. | Most members highlighted **the significant widening of the negative output gap and the low energy prices** as important downward pressures to the headline inflation. In this context, **the balance of risks for inflation remains uncertain.** |
| Most members highlighted the **deterioration of domestic financial markets** generated by the shocks associated with the pandemic. All members underlined **the depreciation of the peso** exchange rate. Most members warned that **the adverse environment the domestic economy is facing resulting from the pandemic and the lower oil prices is worsened by idiosyncratic factors**. In this context, most members highlighted **the recent downgrade of the sovereign and Pemex's credit rating by three agencies.** The majority of members highlighted the importance of fiscal measures under the current situation, although they pointed out that fiscal sustainability must not be jeopardized. | Most members highlighted that **unprecedented capital outflows** registered and that **foreign investors have reduced their government bond holdings** by over MXN 250 billion. Most members mentioned that in view of the anticipated deficit increase and the fall in GDP, **public debt is expected to increase as a fraction of GDP.** Some members expressed their **concerns about the uncertain environment for investment**. In particular, they mentioned the recent **modifications in the rules for private sector participation in electricity generation** using renewable sources. |

**Table 2. 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.

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