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Banxico reduces its reference rate, while unanimity closes the door to more aggressive rate cuts.

- Banco de México announced a 50 basis points (bps) reduction to its reference rate, from 6.00% to 5.50%. As the adjustment was widely anticipated, the focus of attention was on the configuration of votes, which ended up in a unanimous decision, thus closing the door to more aggressive rate cuts in the future.
- Since mid-March, the Central Bank has reduced its reference rate by 150 bps, taking the ex-ante short-term real interest rate slightly below its neutral range, and the MX-US short-term spread to pre-COVID-19 levels.
- A few new dove arguments were offset by (also new) hawk statements that left the policy communiqué with a neutral tone.
    - The Bank added to the list of inflationary risks "the possible disruptions to the production and distribution chains of some goods and services", suggesting the resurface of discussions regarding the dominance of demand- vs. supply-side effects of the current shocks on inflation.
    - The former and the inclusion of a sentence referring to "the room for maneuver that expected economic disruptions provide, *on balance*, to monetary policy" gave us reason to consider the Central Bank's message as hawk one. The piece of information that redressed the balance was the mention of the severe contraction in economic activity and the shadow of a possible credit crunch as determinants for monetary policy developments.
- The announcement reinforced our view that prudence will remain as the distinctive feature of Banxico's approach. Therefore, we continue anticipating additional rate cuts, for a total of 100 bps, taking the reference rate to 4.50% in a front-loaded, yet gradual easing cycle.

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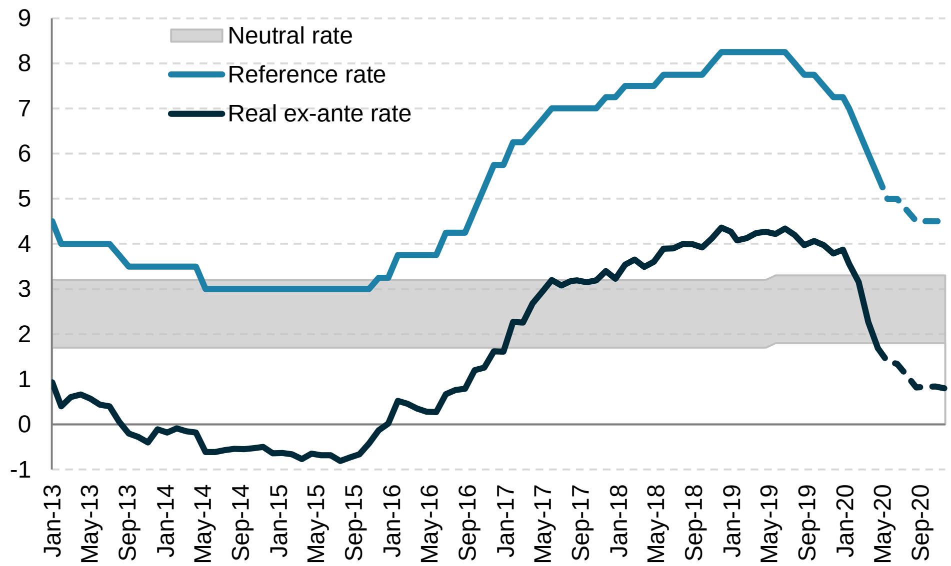
Yesterday afternoon, Banco de México announced a 50 bps reduction to its reference rate –from 6.00% to 5.50%–, in line with our expectation and market consensus. Underlying the decision were "the expected economic disruptions [derived from COVID-19 pandemic] and the room for maneuver that the former provide, *on balance*, to monetary policy", the accompanying communiqué stated.

Since mid-March, the Central Bank has reduced its reference rate by 150 bps, thus taking the short-term real interest rate slightly below what is considered its neutral range or r* zone (Figure 1), on the one hand, and the MX-US short-term spread to pre-COVID-19 levels, on the other hand.

Figure 1. Reference and real ex-ante rates: Observed and Finamex forecast
(%)



Source: Finamex Economic Research with data from Banco de México. Dotted lines correspond to Finamex forecasts.

Both the direction and magnitude of the adjustment were widely anticipated. The real focus of attention though, was the configuration of votes, which ended up in a unanimous decision (Table 1). While a substantial share of market participants/analysts was expecting it, there was also a considerable amount of them –including us– that foresaw a 4-1 vote as a more likely scenario. Although we believe that having an unanimous vs. 4-1 decision does not materially change the path of the reference rate going forward, since we continue seeing the majority of Board members on the prudent side, the outcome did trigger some adjustments in market's pricing, which suggests that this element of the decision was interpreted by some as Banxico's closing the door to more aggressive rate cuts.

Table 1. 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
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, 2020 *	7.00%	6.50%	-50	5	No	1 (-25 bp)	-
Apr 21, 2020 *	6.50%	6.00%	-50	5	Yes	-	-
May 14, 2020	**6.00%**	**5.50%**	**-50**	**5**	**Yes**	**-**	**-**

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

A few new dove arguments in the policy communiqué were offset by (also new) hawk statements, leaving it, on balance, with a neutral tone.

1) On the dovish side, Banxico qualified revisions to expectations for global economic growth in 2020 as unprecedented. On the local economic activity front, it argued that while most timely data showing the important contraction in Q1-2020 already incorporated considerable effects of COVID-19 in March, the effects of the pandemic on Q2-2020 would deepen, hence triggering sizeable disruptions in employment and widening slack conditions even further. The former, amid a continued context in which the balance of risks for growth is significantly tilted to the downside.

2) Importantly, the Central Bank did not oversell the recent decrease in annual inflation, from 3.25% in March to 2.15% in April, nor the reduction of short-run inflation expectations –although it could have had a free pass in doing so. On the contrary, it emphasized that energy and, in particular, gasoline

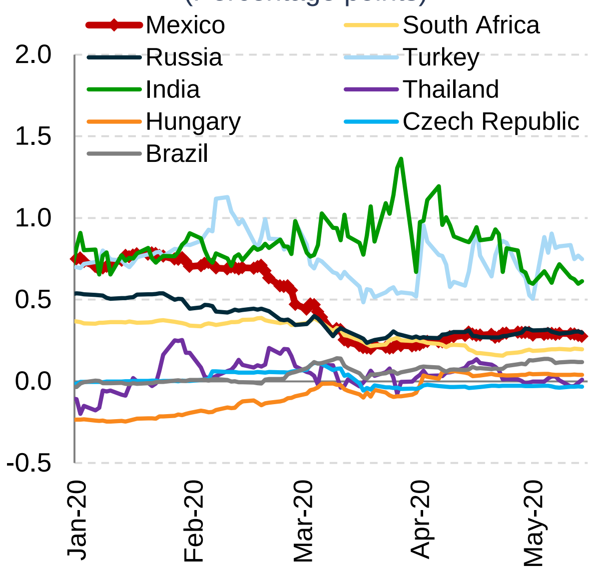
prices were the [temporary] driving force of this dynamic and, perhaps in an even more revealingly way, it added to the list of inflationary risks "the possible disruptions to the production and distribution chains of some goods and services", suggesting the resurface of discussions regarding the dominance of demand- vs. supply-side effects of the current shocks on inflation among Board members. No more distinction between short- and medium-term forces exerting opposing pressure on inflation, only continuing uncertainty surrounding its balance of risks.

3) The combination of the assessment for inflation and the inclusion of the sentence referring to "the room for maneuver that expected economic disruptions provide, *on balance*, to monetary policy" gave us enough reason to consider the Central Bank's message as tilting to the hawkish side. The last piece of information that redressed the balance for us was the mention of the severe contraction in economic activity and the shadow of a possible credit crunch as determinants for future monetary policy developments in the last paragraph.

Although we will have to wait for upcoming events, including the Minutes of the discussion corresponding to this decision, to be released on May 28th, to gather more information on the current positioning of Board members, **yesterday's announcement reinforced our view that prudence will remain as the distinctive feature of Banco de México's approach to its easing cycle.** It also allows us to emphasize our belief that a key driver of this approach is given by the recent evolution of vol. adjusted carry measures in Mexico vis-à-vis other emerging market economies (EMEs), which have decreased more rapidly even if country risk premium has not increased as much as in other countries (Figure 2A and 2B), hence, portraying a contrasting picture to those where only nominal or real rate levels are considered to evaluate the country's relative monetary stance.

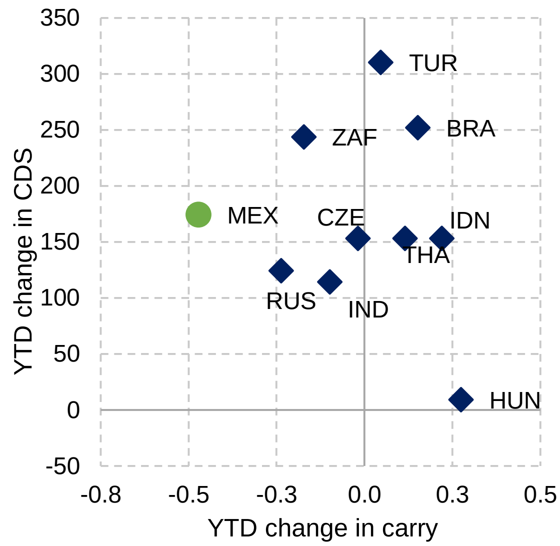
For the moment, and until significant changes in the economic landscape do not materialize, we anticipate additional rate cuts for a total of 100 bps, taking the reference rate to 4.50% in a front-loaded, yet gradual easing cycle (Figure 1). Provided our 2021 inflation expectations (currently at 3.7%) remain unchanged, this terminal rate would imply a real ex-ante rate of around 0.80%, 100 basis points into monetary expansionary territory. If either inflation expectations or long-run r* were to increase, the accommodative stance would be even greater. Needless to say, extraordinary times make estimations related to r* less useful, however, they provide a much-needed benchmark to anchor our discussion.

Figure 2A. Volatility adjusted carries: Selected EMEs
(Percentage points)



Source: Finamex Economic Research with data from Bloomberg

Figure 2B. CDS vs. Volatility adjusted carries: Selected EMEs
(Basis points and percentage points)



Source: Finamex Economic Research with data from Bloomberg

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