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Monetary policy: From alert to emergency mode

- Banco de México's messages accompanying its last policy decision marked a clear change to an emergency tone from the alert mode we had previously perceived. The Minutes of the discussion, published yesterday, confirm the change.
- Specifically, we observe a one-way message around the importance of ensuring financial stability and using additional reductions in the reference rate as complementary actions towards the relaxing of financial conditions.
- Prudence in the conduction of monetary policy was used in numerous arguments. However, in some cases it meant a gradual approach to monetary easing given the building up of domestic risks, whereas in other it meant to substantially lower the real interest rate, "as soon as possible" and even to negative levels, thus highlighing the contrasting views that prevail among Board members.
- Although we continue anticipating a front-loaded yet gradual easing cycle, recent events made us reconsider its depth. We now expect the reference rate to go further down by 150 bps to stop at 4.50% (previous level: 5.50%).
    - Within this context, we could see two additional reductions of 50 bps each, in May 14th and June 25th (the next two scheduled policy meetings) and two consecutive 25 bps rate cuts afterwards.
- We do not discard that some of the coming decisions are non-unanimous, and that DG Heath is the one advocating for more aggressive rate cuts.

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Banxico performing a solo concert

All around the world, policymakers from both monetary and fiscal sides have gone above and beyond to implement measures that limit the economic effects of COVID-19 pandemic and a disrupted oil market. In Mexico, however, the picture is one in which the monetary authority is performing a solo concert, as its fiscal counterpart has dragged its feet. The severity of concurrent shocks, the lack of decisive fiscal policy intervention, and the expectation that whenever the latter comes it will be too little too late, have not only prompted continuous rounds of downward revisions to 2020 GDP growth forecasts (Finamex current estimate is at -7.0%) but also left Banco de México alone with the task of doing most of the heavy lifting to support the economy.

Indeed, since mid-March Banxico has decreased its reference rate by a total of 100 basis points and announced a set of wide-ranging measures aimed at strengthening the functioning of the financial system. Importantly, these actions were part of a stepwise process occurring at two different points in time, each one presenting distinctive landscapes. We divide the narrative into 3 stages.

Stage 1. Banco de México on alert mode

On March 20th the Central Bank cut its reference rate by 50 bps and presented some measures to improve the functioning of domestic financial markets. Although, from our perspective, the Bank was on alert mode, the policy discussion was still somewhat hawkish. According to the Minutes, Board members debated around the adequate policy response in light of the potential pass-through effects of the observed FX depreciation on prices, given both its severity and the uncertainty surrounding the duration of the adjustment. As the absolute monetary stance approached its neutral range, the relative one lost traction as a potential trigger of additional interest rate reductions against the backdrop of higher country risk premia. Furthermore, the majority of Board members believed that monetary policy had limited scope to effectively counter present shocks and that fiscal policy was better suited to address the situation. We interpreted the former argument as Banxico's call for fiscal authorities to do its part to mitigate the nascent crisis which, as a result, could boost economic confidence, thereby providing additional room for maneuver for monetary policy (see our Monetary Policy at a Glance note "Banxico's Minutes (Mar-20): More prudence in sight amid the buildup of domestic risks" of April 8th, 2020).

Stage 2. Appropriate fiscal response nowhere to be found

On April 5th, President Lopez Obrador addressed the nation to present its plan to reactivate the economy. The actions announced were disappointing, to say the least. The continuation of social programs focused on the most vulnerable; the extension of low-impact loans targeted to those with no access to formal credit; the reduction of gasoline prices; the continuation of hallmark infrastructure projects; the creation of 2 million jobs (whose source and quality remains unclear); and the unrelenting promises of no increase in the country's indebtedness level, less corruption and more fiscal austerity were the highlights. Although some additions have been made on the road here and there, the limited scope of the measures and the authorities' reluctance to swiftly shift course do nothing more but reveal an ill-defined response strategy.

Stage 3. Banco de México draws on heavy artillery

On April 21st –a month after its first emergency decision, and almost two weeks after the recovery plan fiasco–, the Central Bank announced an additional reduction of 50 bps to its reference rate (See Figure 1). Although the action was imminent, its timing was somewhat less clear given, on the one hand, the hawkish message of March's Minutes and the materialization of some local risks and, on the other hand, the implementation of more aggressive monetary actions across central banks. Together with the interest rate reduction, a broader set of measures with the aim of reducing the potential procyclicality of credit institutions were launched (Table 1). Remarkably, most measures –which accounted for resources of up to MXN 750 Bn, half of which will go to provide market facilities, as the other half goes to foster credit channels– were solely backed by the Central Bank and labeled as operations "of extraordinary nature" that it could carry out by law "to prevent disruptions in the payment systems".

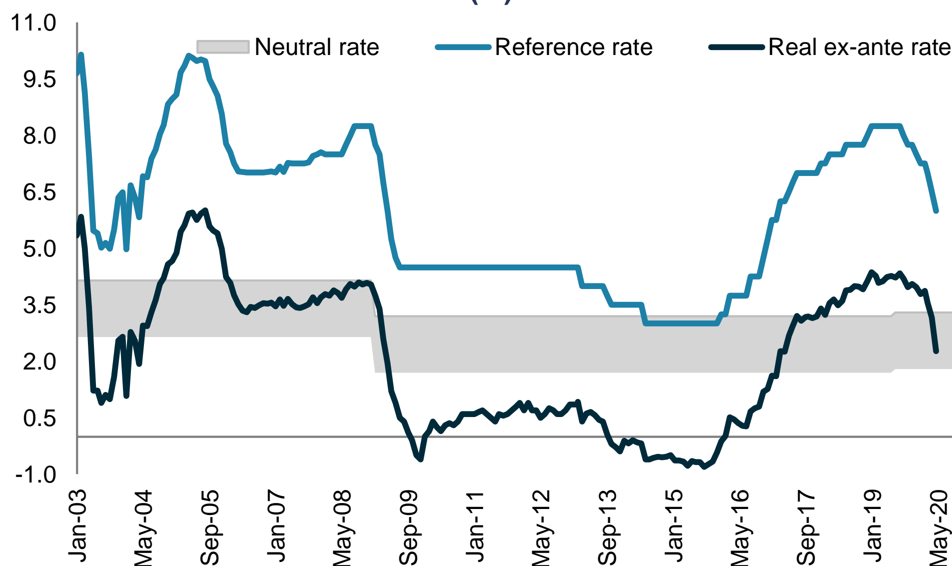
Banxico's messages accompanying its last decision marked a clear change to an emergency tone

The policy communiqué was dovish in three respects

First, Banxico anchored the discussion around a severe contraction of economic activity by pointing out that initial growth estimations could surpass a 5% contraction during the first half of the year, thus implying the prevalence of sizeable slack conditions in the economy. Second, it withdrew the expectation of a delay of inflation convergence to its 3% target. Furthermore, the Central Bank outlined the possibility that the contrasting forces effecting inflation could materialize at different points in time, which we interpreted as an acknowledgement that low inflation will prevail in the short run (Finamex current year-end inflation estimates

are at 3.1% for headline inflation and 3.2% for core inflation). Third, the decision was unanimous, which meant that Deputy Governor (DG) Guzman agreed to pursue a more aggressive move relative to its recent vote history.

Figure 1. Reference and real ex-ante rates
(%)



Note: Shadowed area corresponds to Banco de México's estimated ranges for r* in the long-term. For the period 2003-2008 we use the estimate of r* in the short and medium term (see Inflation Report Jul-Sep 2016).
Source: Finamex Economic Research with data from Banco de México.

The Minutes of the discussion, published yesterday, also confirmed the change

To begin with, a generalized concern for the severity of the economic contraction and the deterioration of the labor market was evident, as the idea that inflationary pressures would not be a short-term concern also dominated, though –admittedly– worries about its outlook prompted the majority of the Board to continue qualifying its balance of risk as increasingly uncertain, "particularly in the long-run", some members added. The majority of Board members also pointed that country risk had increased and continued emphasizing that monetary actions alone would not be able to resolve prevailing difficulties, as decisive and balanced fiscal measures were necessary.

Notwithstanding, we perceived a one-way message around the importance of ensuring financial stability and, remarkably, using additional reductions in the reference rate as complementary actions towards the relaxing of financial conditions. In our view, most Board members tried to come up with compelling arguments, under their respective mind frames, to accommodate the latter idea, either because i) some of them expect that the effects of the demand shock would dominate those coming from the supply shock; ii) a lower reference rate would help boost the recovery phase; or, interestingly, iii) the relevant neutral rate (r*) against which the reference rate should be compared is the one prevailing in the short-run rather than that prevailing in the long-run (as it has been the case in the past years).

Prudence in the conduction of monetary policy was used in numerous arguments. However, in some cases it meant a gradual approach to monetary easing given the building up of domestic risks, whereas in other it meant to substantially lower the real interest rate “as soon as possible”, and even to negative levels, thus highlighting the contrasting views that prevail among Board members.

Recent communications by Board members also signaled the emergency mode the Bank adopted.

Governor Díaz de León argued that the recent actions were aimed to avoid a credit crunch, while DG Heath mentioned that the main focus is to prevent a financial crisis.

What to expect next?

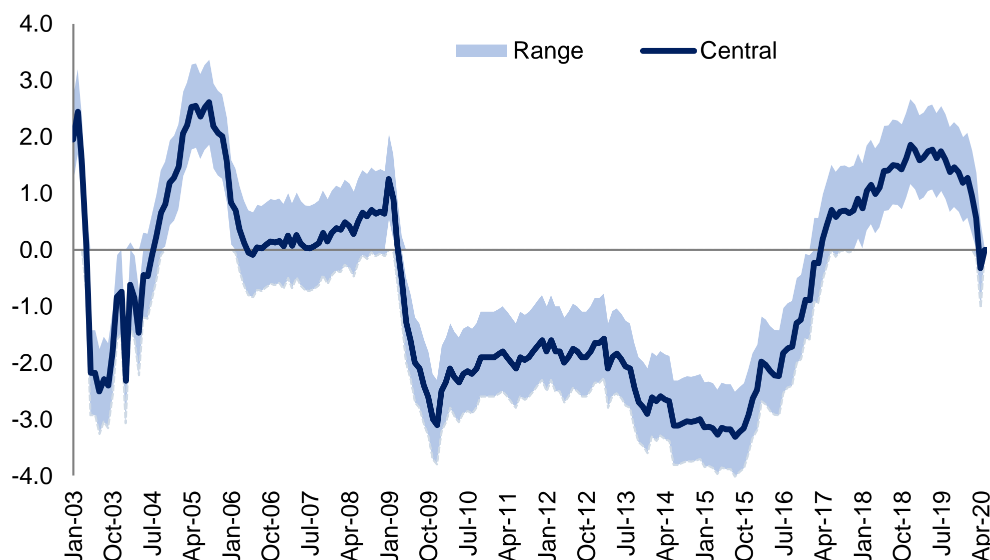
Although we continue anticipating a front-loaded yet gradual easing cycle, recent events made us reconsider its depth. We now expect the reference rate to go further down by 150 bps to stop at 4.50% (previous level: 5.50%).

The level

Provided 2021 inflation expectations remain unchanged, this terminal rate would imply a real ex-ante rate of around 0.85%, slightly higher than that prevailing after the 2008-09 global financial crisis (GFC), and 100 bps into easing territory (See Figure 2). If either inflation expectations or long-run r* were to increase, the accommodative stance would be even greater. Admittedly, the current crisis is unprecedented, and the Mexican economy is at a rather different place to that during the GFC. However, the line of argument goes both ways: the recession could be of greater proportions, yet the country’s financial integration with the rest of the world is greater. We anticipate that in its way to monetary accommodations the Central Bank’s stance

remains mindful of the risk that the economy carries as an EME and that of its own. The former calls for a somewhat less accommodative monetary stance.

Figure 2. Monetary stance (Percentage points)



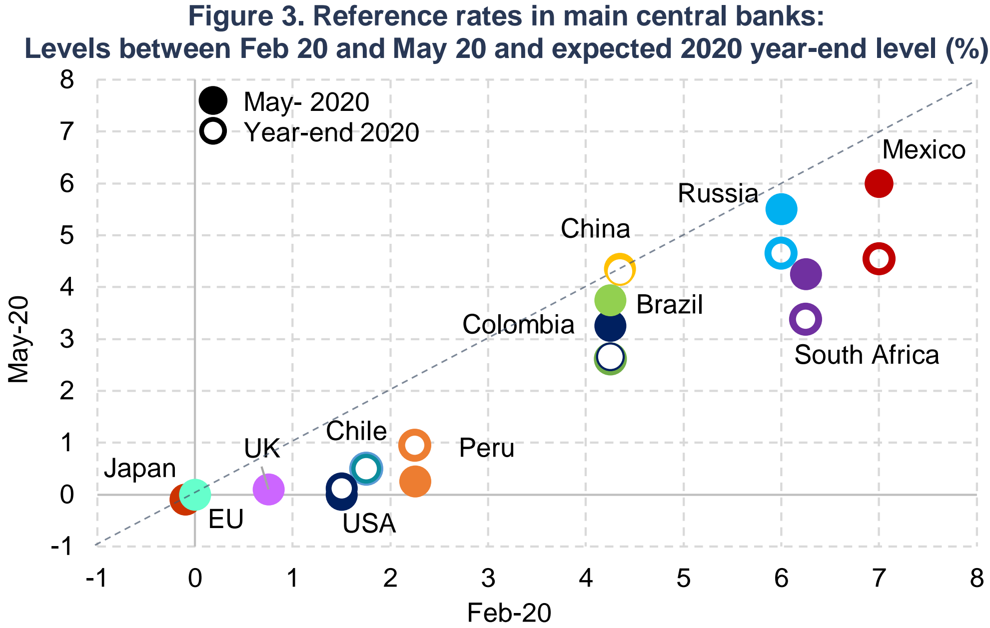
Note: Difference between ex-ante real interest rate and the neutral zone.
Source: Finamex Economic Research with data from Banco de México.

The move will still leave the reference rate at a relatively high level (See Figure 3). Although interest rate spreads may not be such a concern to determine capital flows right now, they will be in the future. In this sense, although MX-US spread will be wide in absolute and relative terms vis-à-vis other EMEs, 1M, 3M and 12M volatility adjusted carries are already at low levels and have reduced at a relatively faster pace (See Figures 4A and 4B). Further downward adjustments than the ones already priced-in could exert FX pressures given the depth and size of USD/MXN derivative markets.

The pace

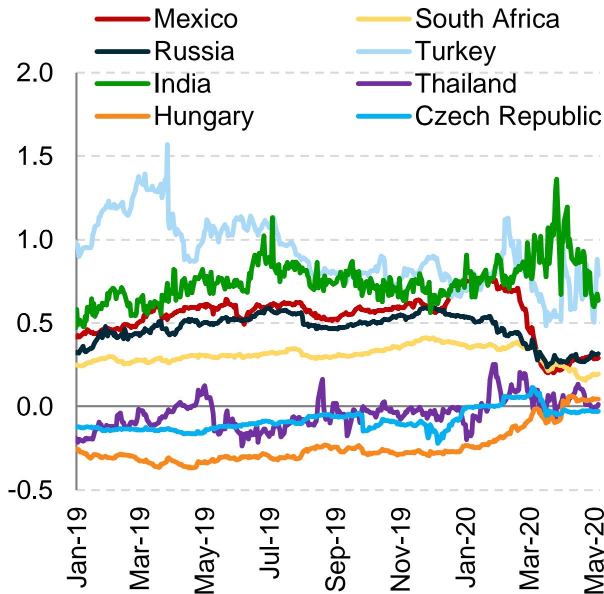
We expect the easing cycle to be front-loaded to take advantage of the current favorable levels of inflation and international momentum, and to reach the targeted accommodative stance before the recovery phase begins. Within this context, we could see two additional reductions of 50 bps each in May 14th and June 25th (the next two scheduled policy meetings) and two consecutive 25 bps rate cuts afterwards.

Figure 3. Reference rates in main central banks: Levels between Feb 20 and May 20 and expected 2020 year-end level (%)



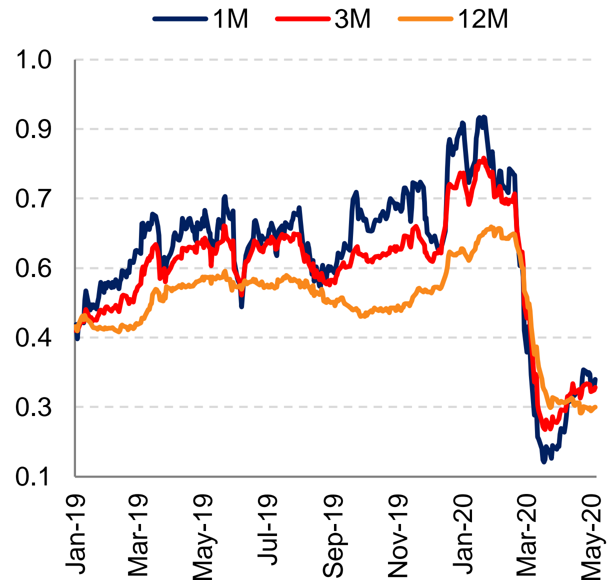
Source: Finamex Economic Research with data from Bloomberg.

Figure 4A. Volatility adjusted carry in selected EMEs (Percentage points)



Source: Finamex Economic Research with data from Bloomberg.

Figure 4B. Volatility adjusted carry in Mexico (Percentage points)



Source: Finamex Economic Research with data from Bloomberg.

Uncertainty is so high though, that unexpected events, such as more coordination between monetary and fiscal authorities –which we perceived as non-existent for the moment– or a more erratic message by the government that further deteriorates confidence, could easily modify this baseline trajectory for better or worse. In this sense, we do not discard that some of the coming decisions are non-unanimous, and that DG Heath is the one advocating for more aggressive rate cuts.

Table 1. Additional measures to strengthen credit channels, provide liquidity and help financial institutions' management of risk.

No.	Objective	Measure	Amount / Reach	Institution
1	Liquidity provision	Increase the level of liquidity during trading hours whenever deemed necessary.		Banco de México
2	Liquidity provision for securities with impaired trading conditions	Extend securities eligible for the Ordinary Additional Liquidity Facility (FLAO), foreign exchange hedging program operations, and USD credit operations.		Banco de México
3	Liquidity provision to development banks	Extend access to FLAO to development banks		Banco de México
4	Liquidity provision to financial institutions holding government debt	New facility to repurchase government securities at longer terms than those of regular open market operations	Up to MXN 100 Bn	Banco de México
5	Liquidity provision for instruments with lower liquidity and impaired trading conditions in secondary markets	Debt securities temporary swap facility. Eligible institutions may deliver debt securities to Banco de México in exchange for government securities.	Up to MXN 100 Bn	Banco de México
6	Liquidity provision for short-term corporate securities and long-term corporate debt	New Corporate Securities Repurchase Facility	Up to MXN 100 Bn	Banco de México
7	Strengthening of credit channels in the economy	New financing facility for commercial and development banks to allow them to channel credit to micro, small-, and medium-size enterprises and individuals affected by the COVID-19 pandemic.	Up to MXN 250 Bn	Banco de México
8	Strengthening of credit channels in the economy	New temporary collateralized financing facility for commercial banks with corporate loans, to finance micro, small- and medium-size enterprises.	Up to MXN 100 Bn	Banco de México
9	Promotion of the proper functioning of government debt market	Implement swaps of government securities, in which it will receive long-term securities (10Y and longer) and will deliver other with maturities of up to 3Y.	Up to MXN 100 Bn	Banco de México
10	Enhance of the orderly functioning of the FX market	Incorporate the possibility to conduct hedge transactions settled by differences in US dollars during hours when Mexican markets are closed		Exchange Comission

Source: Finamex Economic Research with data from Banco de México announcement on April 21st, 2020.

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

March 2020 Minutes	April 2020 Minutes
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.**	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 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 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.
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.	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 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.**	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.**
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.**	Most members agreed that **slack conditions are widening considerably and that the effects of the pandemic will significantly widen the negative output gap**.

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

March 2020 Minutes	April 2020 Minutes
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.	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**.
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**.	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.
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.	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 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.**	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.

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	Comuniqué's tone
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, 2020 *	7.00%	6.50%	-50	5	No	1 (-25 bp)	-
Apr 21, 2020 *	**6.50%**	**6.00%**	**-50**	**5**	**Yes**	**-**	**-**

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

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