Banxico's Minutes (Jun-20): Board members begin to prepare for terminal rate discussion

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- Banco de México released the Minutes corresponding to its last monetary policy decision. Our eyes were fixed on finding elements that provide information regarding how further the current easing cycle would go.
- The main elements of the discussion can be summarized as follows:
  1. A pessimistic outlook for economic activity both globally and domestically.
  2. An improvement in the performance of domestic financial markets but with latent risks of reversals.
  3. The lingering of domestic risks associated with the country's fiscal position and Pemex-related worries.
  4. The comeback of some old claims supporting contrasting members' views regarding future inflation dynamics.
- Going forward, the focus of attention will continue to be the tension between the contrasting effects of the recession in economic activity and a further tightening of domestic financial conditions on inflation and capital flows.
- Our reading of the Minutes make us reinforce the view that all Board members are still on easing mode. However, as the time to discuss the end of the easing cycle approaches, we perceived that, by resorting to more extreme arguments, Board members have begun to reinforce each one's preference regarding the terminal rate. We anticipate the final balance will preserve the prudent approach that characterizes Banxico's actions.
- We reduce our expectation for the terminal rate by 50 bps, from 4.50% to 4.00% by year-end. We also adjust our expectation for August's monetary policy decision from a 25 bps rate cut to a 50 bps reduction.

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Yesterday morning, Banco de México released the Minutes corresponding to its monetary policy decision of June 25th. After a unanimous 50 basis points (bps) interest rate cut, our eyes were fixed on finding elements that provide information regarding how further the current easing cycle would go. Since the emergence of the COVID-19 pandemic, Banxico has implemented a 200 bps decrease in its policy rate, which has entailed a reduction of more than 250 bps in the ex-ante short-term real interest rate that, in turn, has taken the monetary policy stance from restrictive territory to accommodative domain. Despite expecting a severe deterioration of domestic economic activity, and against most of its emerging markets' peers, the Central Bank, loyal to its prudent approach, favored a gradual-paced easing of monetary policy, amid a relatively deteriorated outlook for inflation and the build-up of idiosyncratic risks which, if combined with episodes of renewed global risk aversion, could generate problems for the country's macro-financial landscape.

The neutral tone of the communiqué accompanying the last policy decision draws from the balanced discussion within the Governing Board revealed in the Minutes. The main elements of the discussion can be summarized as follows:

1. A pessimistic outlook for economic activity in both, global and domestic fronts. Although glimpses of improved economic data here and there as a result of the gradual reopening of economic activity, especially in the external context, were mentioned, the continued heightened uncertainty and downside risks for economic prospects, particularly related to the upsurge of new waves of COVID-19 contagion, stood out. On the local front, all Board members acknowledged the severe damage to domestic economic activity registered in the past few months, while the majority of them underscored the deterioration of labor market indicators. The majority of Board members also highlighted the fact that even as the reopening of some sectors and regions in May and June could foster some improvement, the effects of the crisis on the real economy has been substantial, slack conditions have widened significantly, and the pace of the recovery remains uncertain.

2. On assessing the macro-financial environment, the majority noted an improvement in the performance of domestic financial markets. Still, shifts in FX and the front-end of the curve where qualified as moderate, as the risk of a possible reversal remains latent against the backdrop of continued capital outflows –albeit at a more reduced pace than in previous weeks.

3. The consideration of domestic risks associated with the country's fiscal position and Pemex-related worries lingered. Most members emphasized that perseverance in strengthening the macroeconomic fundamentals and adopting the necessary actions, regarding both monetary and fiscal policies, would contribute to a better adjustment of domestic financial markets. Interestingly,

we perceived a more strong positioning by some Board members regarding the limited fiscal support that the government has provided in the past few months. Specifically, "the lack of a balanced policy approach, particularly on the fiscal front, to foster the economic recovery" was noted. Furthermore, within this context, a Board member argued that "without decisive fiscal supports, firms and households' situation could rapidly deteriorate regardless of the availability of resources and the level of interest rates." In line with this, another member claimed that it is important to take into account the limits of monetary policy and the room for maneuver that it has in order to respond to the uncertain environment in a sensible fashion.

4. With regard to inflation, the Governing Board debated about the factors underlying its recent performance and the sustainability of relatively low prevailing levels –keep in mind that although the decision was made before the latest high inflation figures were realized, some upside surprises had already materialized at the time of the discussion. The stickiness of core inflation, the risk of the de-anchoring of its long-term expectations, the probability of observing new price shocks, like a possible additional depreciation of the currency, were among the arguments of some of those who showed more reservation regarding inflation's future performance. Remarkably, a counter-argument) regarding the importance that the Bank's communication strategy do not validate a pessimistic outlook on the economy which, in turn, could affect private agents' perceptions (which we attribute to Deputy Governor Esquivel, resurfaced. In sum, we identified the comeback of some old claims supporting contrasting members' views, especially regarding future inflation dynamics, amid its everlasting uncertain balance of risks.

Going forward, it is evident that the focus of attention will continue to be the tension between the contrasting effects of the recession in economic activity and a further tightening of domestic financial conditions on inflation and capital flows. An important determinant of its evolution will be the unfolding of global vis-à-vis idiosyncratic risks. The discussion on the subject was rich:

Hawkish arguments emphasized:

i) The immediateness of the financial shock and the need to ensure the orderly function of financial markets first, in order to gain more room for maneuver to cope with the shock to economic activity later on.

ii) The fact that, as global risks gradually reduce, idiosyncratic risks will gain more relevance, which would make domestic vs external interest rate spreads more relevant to help compensate the latter, while also preventing net capital outflows.

iii) The medium-term effects of a further monetary policy easing on the macro-financial framework, particularly, the fact that if the reference rate ends up being excessively low, it could negatively impact savings and exchange rate dynamics, and distort asset prices.

iv) The notion that the best way in which monetary policy can contribute to overcome the crisis is by sticking to its mandate, which will also favor a sustained decrease in interest rate levels across the yield curve.

v) The challenge to properly manage the room for maneuver that monetary policy has left, thus favoring a gradual, data-driven approach. One that allows the continuous assessment of the balance of risks and that can be fully anticipated by financial markets.

On the contrary, dovish arguments highlighted:

i) The positive effects that a lower reference rate could entail for economic activity and growth prospects which, in turn, would prompt a better performance of financial markets and capital inflows.

ii) The greater scope that current credit granting measures could have if they were accompanied by lower interest rate, and the risk of offsetting the effectiveness of the former if the latter remains at relatively high levels.

Our reading of the Minutes make us reinforce the view that all Board members are still on easing mode. The facts that the last decision was still unanimous and that the discussion about the convenience of bringing the easing cycle to its end was basically absent in the discussion revealed by the Minutes, suggest that more interest rate reductions are in the pipeline, as we have already anticipated. However, as the time to discuss the end of the easing cycle approaches –we believe it is actually pretty close–, we perceived that, by resorting to more extreme arguments, Board members have begun to reinforce each one’s preference regarding the terminal rate. In our view, although the reconfiguration of arguments will further sharpen in the next policy discussions, the final balance will preserve the prudent approach that has characterized Banco de México’s Governing Board actions.

Putting all the above pieces together, recalibrating our expectations regarding the evolution of both, economic activity and inflation, and adding the effects of excess liquidity prompted by über-accommodative monetary policy in advanced economies (that could trigger downward shifts in global r*, thus increasing risk appetite and search-for-yield strategies that favor domestic assets, at least in relative terms and for some period) into the picture, we reduce our expectation for the terminal rate by 50 bps, from 4.50% to 4.00% by year-end. This update entails that the ex-ante short-term real interest rate could be close to zero by the end of the easing cycle.

Down the road, several elements will be key for Banco de México to weigh on in order to determine the magnitude of future rate cuts. At the macro front, the Q2-2020 GDP figure due for the end of July and the inflation prints up to August's first fortnight, would influence the Bank’s update for economic growth and inflation projections. On fiscal matters, Q2-2020 quarterly reports on public finances and Pemex, and the deadline for fiscal authorities to present the 2021 Budget before Congress, which from our perspective will likely include the request to increase 2020 debt ceilings, would be decisive to monitor the build-up of domestic risks. In this regard, we also adjust our expectation for August’s monetary policy decision from a 25 bps rate cut to a 50 bps reduction. However, we acknowledge that now, more than ever, the pace of monetary policy will be data-driven.

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.

May 2020 Minutes	June 2020 Minutes
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 highlighted that numerous central banks have eased their monetary policy stances, and that **different monetary authorities have expanded their asset purchasing programs and their financing schemes.** Likewise, they stated that **some central banks have expressed their readiness to maintain easing measures for as long as necessary or even to strengthen them.** All members highlighted that, **global financial markets have exhibited a positive behavior**, reflecting the effects of the fiscal, monetary and financial stimulus measures adopted by the advanced economies and the gradual reopening of their productive activities. Most members highlighted the lower risk aversion, the increase in stock market indexes, the appreciation of currencies against the US dollar, a certain reduction in government bond yields, and an increase in commodity prices.
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. Most members mentioned that **the labor market has been affected by the effects of the health crisis.**	All members made reference to the **severe deterioration of economic activity in Mexico.** Most members pointed out that it contracted significantly during the first quarter of the year and that, according to available information, **the impact of the pandemic intensified in April.** Most members stated that, although the reopening of certain economic sectors and regions in May and June will foster a slight recovery of economic activity, the impact has been considerable and uncertainty persists.
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.	Most members pointed out that the lockdown measures have affected aggregate demand. One member stated that, **at the end of the first quarter, consumption and investment contracted 1.2 and 9.5%, respectively.** He/she added that **these are estimated to have continued declining as a result of uncertainty and the large loss of employment.**
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.	All members underlined that the growth outlook has deteriorated. Most members indicated that for 2020 there are even projections of a two-digit contraction. Most members agreed that **the balance of risks for growth remains significantly biased to the downside.** One member stated that a very deep recession is currently being observed, with a slow and complex "U"-shaped recovery, due to the severe deterioration of investment and consumption. The majority of members stressed the risk of a new COVID-19 outbreak.
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.**	Most members agreed that **economic slack has widened significantly.** Some members added that the recent decline in growth forecasts allows to anticipate that **the negative output gap will continue widening.** One member emphasized t**hat the output gap is at levels unseen since the 2008-2009 financial crisis.**

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

May 2020 Minutes	June 2020 Minutes
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 that **headline inflation increased between April and the first half of June** as a result of increases in both the core and non-core components, which in turn, are associated with the **demand and supply shocks derived from the current pandemic.** Especifically, **most members noted the high prices of Fruits and Vegetables and Food Merchandise**. **Some members highlighted the high and persistent levels of the core inflation**, while one mentioned that the low Energy prices still dominate the non-core component over the recent spike in Fruits and Vegetables.
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 mentioned the **supply and demand shocks derived from the current pandemic as possible upward pressures**, however, some highlighted that these shocks are transmitted through various channels that generate both upward and downward pressure, so the net effect is uncertain.
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.**	**Some members mentioned as an downside risk** that, while the ultimate outcome is very uncertain, as long as the financial shock remains contained, in a longer term horizon **the effects of the widening of the negtive output gap** should predominate. In this context, most members agree that the balance of risks for inflation remains uncertain.
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.	Most members noted that, since the latest monetary policy decision, there has been an improvement in the performance of domestic financial markets. Nevertheless, most members noted that **risks persist and capital outflows have continued**, although at a slower pace vis-à-vis what was observed some weeks ago. **Most members expressed concern on Pemex's situation.** One member mentioned the **rising delinquency rates of consumption and corporate portfolios of SMEs**. Another member stated that the **outlook for investment**, which is fundamental for the potential growth of the economy, is worrisome.

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.