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Economic Research
Monetary policy at a glance
August 14th, 2020

Banxico's last 50-basis-points-reduction and some forward guidance

- Just as we anticipated, yesterday afternoon Banco de México reduced its reference rate by 50 basis points (bps), from 5.00% to 4.50%, with a majority (4-to-1) decision and a slightly hawkish accompanying communiqué.
- The key message of the policy statement: "Looking ahead, the available room for maneuver will depend on the evolution of the factors that have an incidence on the outlook for inflation and its expectations (…)." This new element is relevant because i) forward guidance is not a recent common practice; ii) it suggests the notion of a floor for the reference rate, and iii) it signals that the focus of attention is the outlook for inflation and inflation expectations.
- The above, together with the end of unanimity, supports our expectations that the Governing Board has begun to prepare the public for the end of the easing cycle, on the one hand, and reinforces our interest on the new inflation trajectories that Banxico will reveal in its upcoming Inflation Report (due for release on August 26th), on the other hand.
- The end of the easing cycle is around the corner. Although we all know it, it is difficult to calibrate how much more of it remains on the pipeline. For the moment, and until more information regarding the positioning of each member is revealed in the Minutes, two weeks from now, we stick to our expectation of two additional rate cuts of 25 bps each (on September 26th and November 12th) that would take the reference to 4.00%.
- Worth saying, even when the end comes, we believe that, given the prevailing uncertain environment, the Central Bank will remain flexible and avoid tying its hands for future adjustments.

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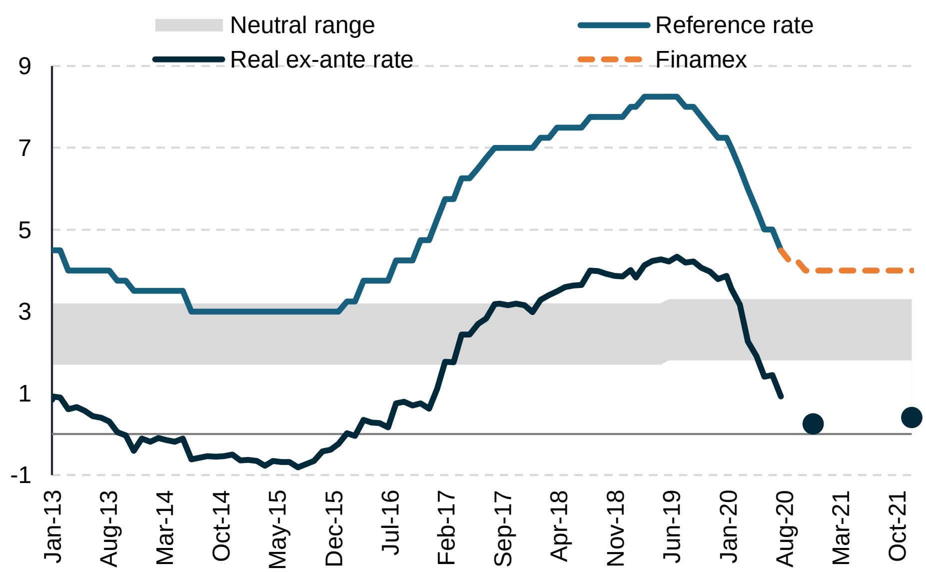
A winning trifecta. Just as we anticipated, yesterday afternoon Banco de México reduced its reference rate by 50 basis points (bps), from 5.00% to 4.50%, with a majority (4-to-1) decision and a slightly hawkish accompanying communiqué.

With this action, the Central Bank has not only deepened the country's accommodative monetary stance by driving the ex-ante short-term real interest rate from around 1.40% in late June to 0.90% (see Figure 1), but it has also accumulated 375 bps of interest rate cuts in the past year, 250 of which have been implemented post-COVID-19. Worth noting, the latter nominal adjustment already falls in the ballpark of the interest rate reductions that other central banks in emerging market economies –namely, Russia, Colombia, Brazil, and South Africa– have implemented during the same period (see Figure 2).

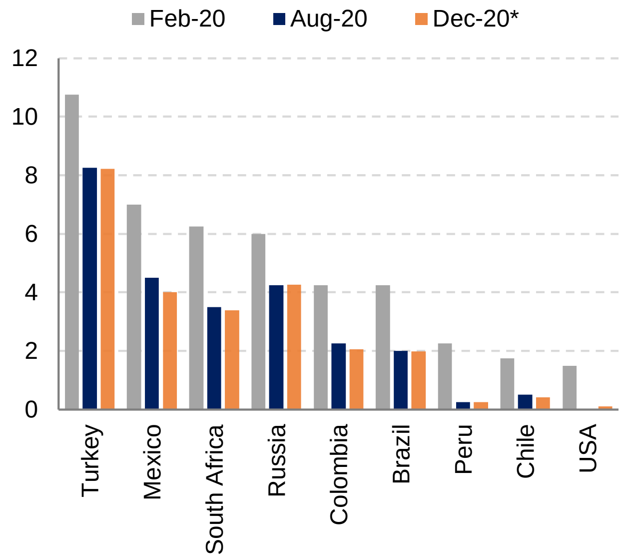
Figure 1. Reference and real ex-ante rates: Observed and expected
(%)



Note: The shadowed area corresponds to Banco de México's latest estimated ranges for r* in the long-term. The end-point of the real ex-ante rate is calculated based on Finamex's projections.
Source: Finamex Economic Research with data from Banco de México and Bloomberg.

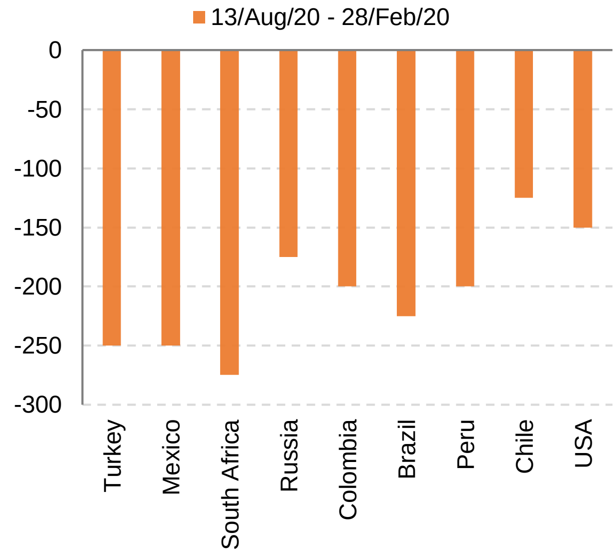
The fact that yesterday's was a majority decision also marks the end of a brief lapse of unanimous monetary policy actions that we observed in April, May, and June (see Table 1). In this regard, just as in last February's voting configuration, we see Deputy Governor Guzmán as the likely dissenter, in favor of a smaller 25 bps rate cut.

Figure 2A. Reference rates in selected major EMEs and the US (%)



Source: Finamex Economic Research with data from Bloomberg.

Figure 2B. Change in reference rates in selected major EMEs and the US (%)



Source: Finamex Economic Research with data from Bloomberg.

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	Comuniqué's tone
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	-	-
Jun 25, 2020	5.50%	5.00%	-50	5	Yes	-	-
Aug 13, 2020	**5.00%**	**4.50%**	**-50**	**5**	**No**	**1 (-25 bp)**	**-**

Note: (*) March 20th decision was advanced from its original date (March 26th) and April 21st decision was an out-of-calendar one.
Source: Finamex Economic Research with data from Banco de México.

The key message of the policy statement was given by a new phrase providing forward guidance: "Looking ahead, the available room for maneuver will depend on the evolution of the factors that have an incidence on the outlook for inflation and its expectations, including the effects that the pandemic might have on both factors." In our view, this element is relevant for three reasons. First, because forward guidance is not a recent common practice –we can even go further and say that, in general, in the past couple of years the Bank has shown reluctance to provide a specific guideline about the future path of monetary policy. Second, because of the choice of words matters. The fact that the communiqué refers to "the available room for maneuver" suggests the notion of a floor for the reference rate, which, in turn, indicates that the discussion among Board members about when to end the ongoing accommodative cycle has started. And third, because it signals that the focus of attention is the outlook for inflation and inflation expectations (has it ever been not the case?).

The above, together with the end of unanimity, supports our expectations that the Governing Board has begun to prepare the public for the end of the easing cycle, on the one hand, and reinforces our interest on the new inflation trajectories that Banxico will reveal in its upcoming Inflation Report (due for release on August 26th), on the other hand. Importantly, in the last regard, it advanced that "(a)lthough the recent increases in headline and core inflation affect their foreseen trajectories in the short term, both are expected to lay around 3% within the 12-24 month forecast horizon," further adding that "these forecasts are subject to considerable risks." As a result, we could see further delays in inflation convergence, currently expected in Q4-2021, in new inflation projections.

Other elements of the policy statement worth highlighting are the following:

1. The Bank emphasizes the uncertainty surrounding economic activity both globally and locally. Admittedly, it acknowledges some recent improvements in the data. However, it also qualifies the latter by saying that these come after sharp contractions or from low levels.

2. Despite mentioning that financial markets have shown a good performance, it also underscores that current conditions are still worse off relative to those prevailing before the pandemic, and repeats that its future behavior will be mainly determined by the latter's effects, thus transmitting a sense of fragility around the current environment.

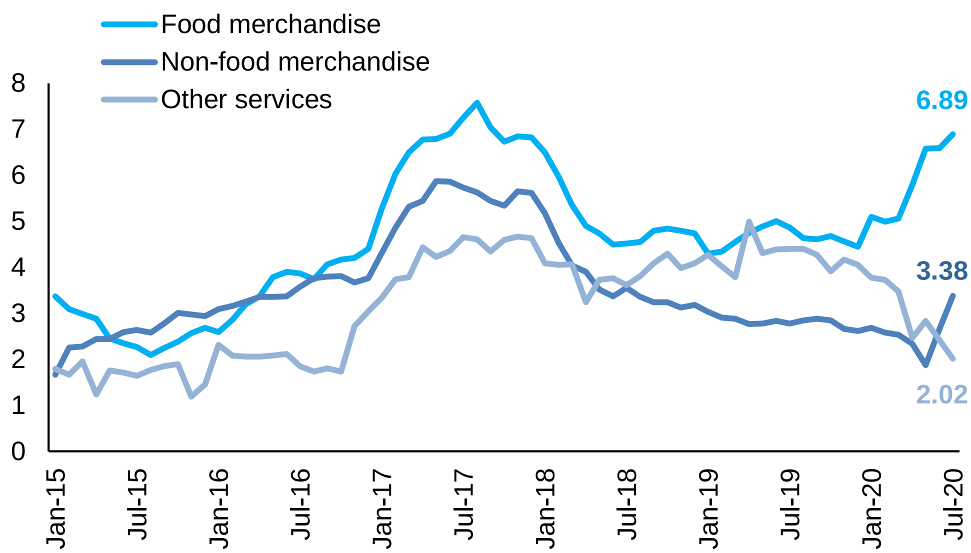
3. On inflation, beyond describing its recent increase and the uptick in short-term inflation expectations, and qualifying its balance of risk as uncertain –once again–, three elements stand out:

a. The mention of the change in relative prices of merchandises vis-à-vis services within core inflation (see Figure 3).

b. Again, an effort to shift focus to inflation's expected trajectory.

c. The addition of one risk to the upside (the good-old argument of a greater persistence of core inflation) and one to the downside (social distancing measures reducing the demand for certain services) for its outlook, such that the balance remains unchanged. We interpret this as a signal that, on the one hand, some of the Board member's arguments have shifted from pandemic-mode to more-regular-times mode and, on the other hand, there is a lot of discrepancy going on around this topic.

Figure 3. Selected Core inflation components (%)



Source: Finamex Economic Research with data from INEGI.

The end of the easing cycle is around the corner. Although we all know it, it is difficult to calibrate how much more of it remains on the pipeline. For the moment, and until more information regarding the positioning of each member is revealed in the Minutes, two weeks from now, we stick to our expectation of two additional rate cuts of 25 bps each (on September 26th and November 12th) that would take the reference to 4.00%. Worth saying, even when the end comes, we believe that, given the prevailing uncertain environment, the Central Bank will remain flexible and avoid tying its hands for future adjustments.

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