March 11, 2021

Latam Daily: Change in Banxico Call to Only One -25 bps Cut in Q3

- **Mexico: We have revised our monetary-policy rate scenario from two -25 bps cuts this summer and now expect only one -25 bps cut in Q3 followed by a hold of the target rate at 3.75% through end-2021.**

MEXICO: LESS ROOM TO CUT IN 2021

On March 25, the Board of Mexico's central bank, Banxico, is scheduled to deliver its second monetary-policy rate decision of the year and we expect the Governors to hold the target rate at 4.00% at this meeting.

Looking forward, we had been expecting one -25 bps cut in each of Q2-2021 and Q3-2021 owing to ongoing softness in Mexico's domestic investment and consumption demand (see the March 9 *Latam Weekly*). Recent market developments, however, imply a narrowing in the space for more monetary easing and we now anticipate only one -25 bps cut during Q3-2021 followed by a hold of the target rate at 3.75% through the end of the year (chart 1), as laid out in our March 10 *Forecast Tables*.

There are several factors that now lead us to believe that Banxico's Board will bring forward only one more rate cut this year, although we acknowledge that there is a material risk than even a single cut may not be implemented. Our change in call reflects the following points, among others:

- **Banxico's Board members have been very vocal in emphasizing that upcoming monetary policy moves will depend largely on the behaviour of inflation, consistent with the Bank's mandate on price stability.** While sequential month-on-month headline and core inflation are still well-contained (chart 2), level effects have pulled headline and core annual inflation to the top of Banxico's target range (chart 3), where they are likely to remain through Q2 on a transitory basis. High year-on-year inflation in energy prices (chart 4) is the corollary to last year's price reductions in the sector. These rises are feeding through from the CPI's non-core components to core goods prices and more than offsetting the pandemic-induced downturn in services prices (chart 5).

- **We still do not know the full effects and scope of reforms to the Electricity Industry Law.** These reforms could cause energy prices to remain high and, if this risk were to be realized, prices would continue to be pressured upward and inflation may not converge to the 3% y/y target as projected in the March *Quarterly Inflation Report*.

- **Many of the arguments for continuing to lower rates are aimed at giving a greater boost to the Mexican economy, but some data from the turn of the year and recent upward revisions to growth forecasts by Banxico, the Ministry of Finance, and international organizations tend to weaken this argument.** In our case we raised our 2021 outlook for real GDP growth from 3.3% y/y to 4.9% y/y in our March 9 *Latam Weekly*.

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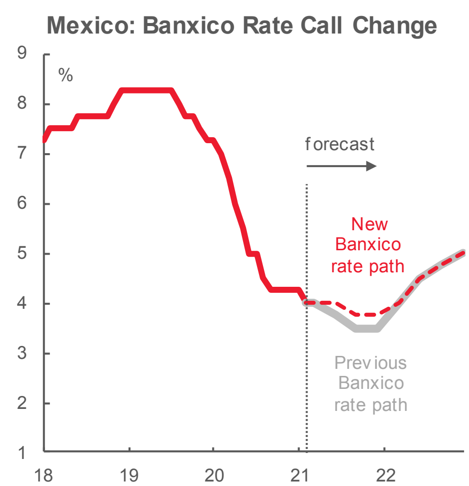
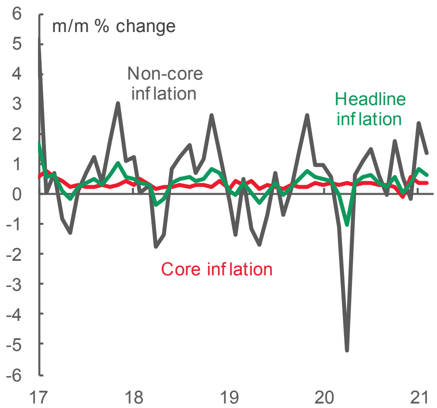
Chart 1



Sources: Scotiabank Economics, Banxico.

Chart 2

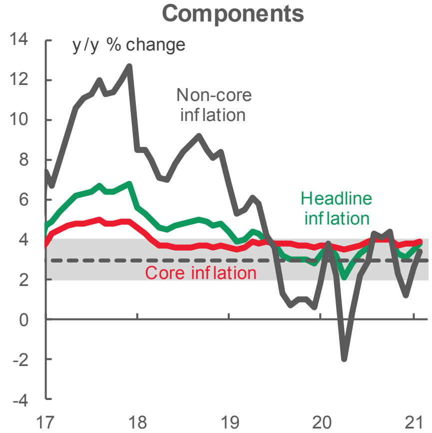
Mexico: Headline & Core Inflation



Sources: Scotiabank Economics, INEGI.

Chart 3

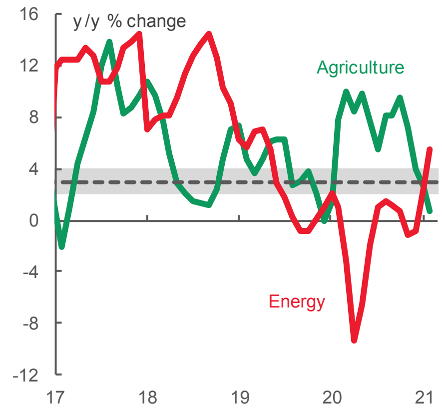
Mexico: Headline Inflation & Its Main Components



Sources: Scotiabank Economics, INEGI.

Chart 4

Mexico: Non-Core Components Inflation



Sources: Scotiabank Economics, INEGI.

- **The spread between US and Mexican rates has narrowed.** Recent market moves have induced a significant increase in longer-term US interest rates owing to ongoing acceleration in the country's economic recovery, the Biden Administration's looming fiscal stimulus package, and its possible further impact on demand and inflation.

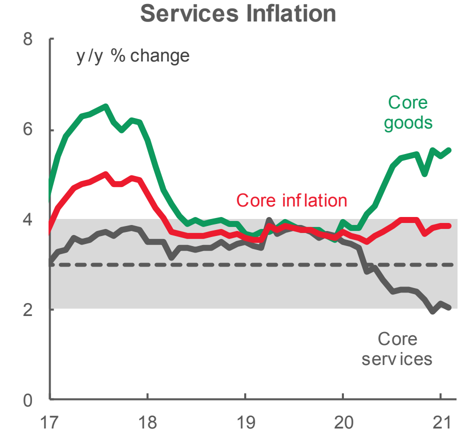
We recognize that Mexico's real policy rate is already one of the highest amongst emerging markets (see our February 12 *Latam Charts Weekly*, key economic chart 5), and that removing a cut from 2021's rate path would tighten financial conditions further for domestic businesses and households. But this implicit tightening is already being driven by international markets. The MXN has been under particular pressure during March's market moves and the balance of risks augurs against a cut by Banxico in Q2 that could exacerbate these forces.

To sum up, our revised call for Banxico's rate path now features just one more -25 bps cut in Q3 to bring the target rate to 3.75%, where we expect it to be held until a normalization cycle begins in Q1-2022 (chart 6).

—Paulina Villanueva

Chart 5

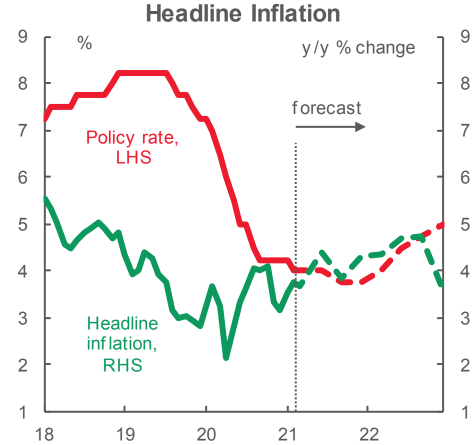
Mexico: Core Goods & Services Inflation



Sources: Scotiabank Economics, INEGI.

Chart 6

Mexico: Overnight Rate vs Headline Inflation



Sources: Scotiabank Economics, Banxico, INEGI.