Mexico: Banxico's balancing act

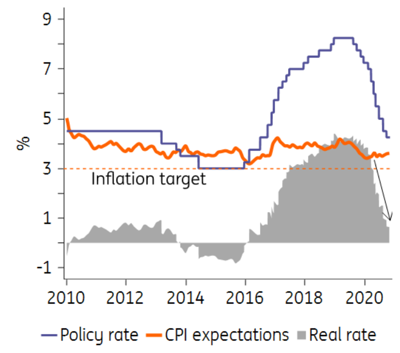
At their last policy meeting, Mexican policymakers signaled a readiness to conclude the monetary easing cycle, with a pause at this week's meeting. The risk-on market sentiment may have, however, created a window of opportunity for the implementation of one last rate cut

Policy drivers moved in opposite directions

Mexico's central bank officials have refrained from replicating the aggressive rate-cutting cycles seen throughout LATAM in recent months and, at their last meeting, a small majority appeared to have formed in favor of a pause in the easing cycle.

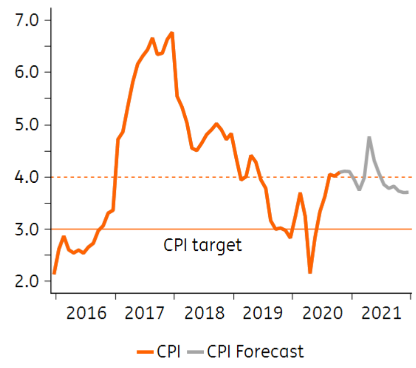
Hawkish voices inside the board have grown louder, signaling a growing discomfort with the consequences of additional rate cuts. At the current 4.25% level for the policy rate, the real rate is approaching zero (see chart below), while headline inflation (4.1% in October) and inflation expectations have moved higher, away from the 3% target.

Real rates are nearing zero while inflation ...



Source: Macrobond, ING

stays near the upper-bound of targeted range



Source: Macrobond, ING

The recent MXN rally has contributed to muddle the waters somewhat however, as it has intensified calls for a more dovish policy outcome.

We continue to worry about the outlook for domestic demand, specially given the unusually modest fiscal stimulus implemented by the government, and remain bearish about Mexico's economic recovery prospects.

Having said that, among policymakers, the case for one last rate cut should rest primarily on the fact that the MXN has rallied sharply in recent weeks, and appears on track to reach 20 at some point in the near future, amid prospects of a vaccine-fueled recovery.

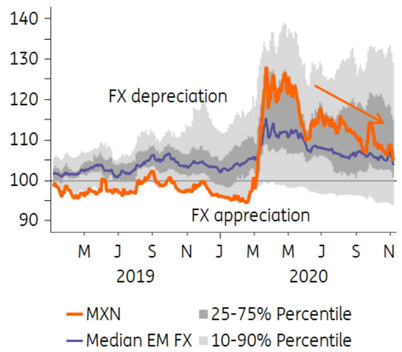
Ultimately, we expect policymakers to weigh the slight deterioration in inflation against the stronger FX dynamics to decide on the next steps for monetary policy.

A very close call

Analysts are split on what Banxico will do, with a majority now expecting one last 25bp rate cut this Thursday. We opt to stick to our original call however, with Banxico opting to err on the side of caution and keeping the benchmark rate unchanged at 4.25%, with a neutral guidance. But we recognize that this is a very close call, as the impressive MXN rally has increased the risk of another rate cut.

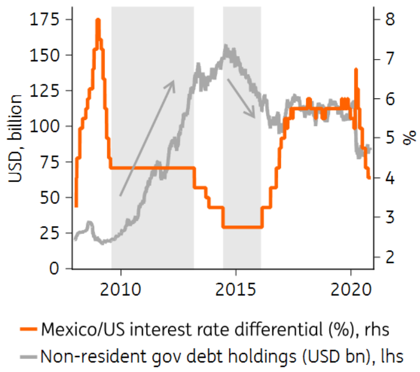
In our view, a pause would be more consistent with the bank's current guidance and its traditionally more "risk-averse" decision process. Despite the positive vaccine news, the risk of financial market instability remains elevated with the resurgence of Covid-19 cases in the US and Europe and the uncertain global growth outlook, along with the unclear fate of the proposed US fiscal stimulus.

The MXN's rally has stood out among its EM peers and it may continue ...



Source: Macrobond, ING

... but it remains dependent on an attractive Mexico/US rate differential



Source: Macrobond, ING

Moreover, as we've discussed before, Banxico often cites the Mexico/US interest rate differential as an important input in its reaction function, given its perceived impact over FX flows. As seen in the chart above, that differential has already dropped to 4.0%, or 175bp below the level prevailing in the recent 2017-20 period, which was marked but broad stability in non-resident holdings in the local government debt market.

4% may still provide a significant cushion, and help support FX flows, as it is still 125bp higher than the rate differential seen in 2014-16, which coincided with a wave of outflows. But additional drops from here could prove more destabilizing in a reflationary world.