

Sovereign Macro-Banxico Minutes and commentary

October 14, 2021

Bottom line: the overall tone of the minutes is hawkish but with some nuances. There is broad concern about current and prospective inflation dynamics, it may not all be transitory including through structural factors. Inflation rigidity fuels inflation expectations which continue to increase. Core inflation is expected to stay above 5% over the next 9 months and its persistence is of particular concern to most members. The minutes indicated that the board had decided to reinforce its monetary stance adjusting its required trajectory so that inflation converges to the target in the forecast horizon. The term “required trajectory” may indicate there are more hikes in the pipeline and for as long as necessary but there is no indication that the pace will accelerate. Two members, including the governor, are comfortable to maintain the pace to allow for the smooth adjustment of relative prices; gradual adjustments have worked. Deputy governor Espinosa called the board to reflect on whether the current pace of normalization was appropriate, showing she was open to a 50 bp hike as she has already declared publicly. Deputy governor Heath indicated that if inflation continues to rise, it may be necessary to move to a neutral stance or even contractionary. So, both were hawkish but one was about the pace and another about the terminal level. For now, I don't see the required 3 votes for a 50bp hike, we would have to see a significant disruption of inflation data. There were two other interesting points. Two members thought that it was advisable to have a preemptive policy stance perhaps indicating that they would like to continue to tighten. There were differences of opinion about the relative monetary position. Esquivel was concerned that hiking now would reduce future policy space to act when the FED started hiking. ADDL notes that it is unclear whether the policy rate differential is what matters or the additional policy adjustments. My policy outlook remains unchanged. It was clear that the rhetoric turned hawkish, but I believe that the board will keep the current pace of 25bp per meeting, the chances of a 50 increased a bit. I also believe that the board will move to a neutral real policy rate.

A note of caution. My attribution of the individual board members' views is purely speculative.

Details

- The international environment is complex and inflation risks are to the upside. This will put additional pressure on domestic inflation.
- Inflation acceleration is explained by supply bottlenecks and global prices of food commodities. There is a large share of imported inflation. Inflation of tradables remains high despite the strength of the peso.
- Inflation is sticky despite a weak recovery and persistently high levels runs the risk of de-anchoring expectations. A couple of members indicated that inflation pressures are receding at the margin except in goods including core where changes in the pattern of consumption and supply chain disruptions have had the largest impact. Esquivel noted that in the latest inflation print, there was a 109bp reversal of price increases of apparel and services.
- Core goods inflation remains the main source of concern. 2 mentioned that core has stayed above 4% for far too long and it is sipping through to the rest of the basket. More than 50% of the basket shows price increases above 4% (Heath). It is noteworthy that core goods inflationary pressures didn't abate even during the pandemic. There are looming concerns about core services inflation as the reopening will make it converge towards its mean after staying below for some time.
- Propane price controls are probably underestimating inflation given the large increases in natural gas prices recently.
- The majority said that inflation expectations have increased recently and are way above the target.
- One said that inflation would converge to the target in q3 2023 assuming that there are no new shocks or that the existing ones don't linger for too long. Their revised projections called for headline ending 2021 at 6.4% and core above 5% during the next 9 months and reaching a maximum of 5.6% in February 2022. One member said that price pressures continue to worsen and "transitory" seems less plausible.
- One said that there are structural and inertial factors of core inflation that can hardly be considered transitory and reinforce its downward rigidity (ADDL). He indicated that it is unlikely that changes in relative prices (goods vs services) will stay in place for along time.

- MONETARY POLICY DISCUSSIONS: Given the risks for price formation and inflation expectations the board decided to reinforce its monetary stance adjusting its required trajectory so that inflation converges to the target in the forecast horizon. ADDL highlighted the fact that the trajectory of the policy rate was adjusted accordingly. The board will adjust the policy path so that it is consistent, at all times, with the convergence of inflation to the target.
 - Esquivel said that given the transitory and exogenous nature of the shocks a less accommodative stance would be inefficient because it doesn't solve the root problems of inflation. Its effects would be counterproductive on the recovery. Moreover, hiking would be unnecessary since the strong fiscal stance is already helping to anchor the FX and country risk. He also said that higher policy rates would reduce the room to maneuver when the FED hikes. ADDL disagrees, because it is unclear what matters more, the policy rate differential or the incremental changes to the policy rate: Esquivel believes the latter and ADDL the former. In a recent conference ADDL also indicated that Banxico doesn't need to be linked to the FED. Finally, Esquivel observed that since the first hike, short term market based inflation expectations had continued to increase. It was noteworthy that Esquivel did not mention that rate hikes were necessary to anchor inflation expectations or that they were indeed a source of concern. In fact he insinuated that rate hikes were responsible for increasing expectations. He noted that the real ex-ante policy rate was positive in contrast to many other economies.
 - Borja indicated that in order to avoid de-anchoring of expectations Banxico has acted with prudence, predictability and made well communicated decisions. *Reinforcing the policy stance allows Banxico to act preemptively in light of the upcoming tightening of global financial conditions* and also in response to inflation surprises and rise in expectations. She noted that the real neutral real policy rate may be lower than before the pandemic.
 - Heath said that recent increases of inflation require a decisive action from Banxico. *He noted that market pricing of further rate hikes may be justified and failing to follow the market guidance could send a signal of complacency.*

Moreover, the absolute and relative monetary position suggest that there is room for further hikes. He disagreed with Esquivel about the causality between rate hikes and expectations. He said that rate hikes were a preemptive measure to tackle temporary shocks that may be of uncertain duration and may extend beyond the policy horizon. Hiking is the best signal to indicate that Banxico will not tolerate rising inflation expectations.

Importantly, he noted that if inflation continues to increase, it may be necessary to move to a neutral policy stance or even restrictive to tackle the inflation deviation from the target and a smaller output gap than expected.

- Espinosa said that Banxico needs to act in a timely fashion to avoid de-anchoring of long term inflation expectations. *She believed that the board should consider the appropriate pace of normalization and argued that the board should make a stronger effort in order to avoid FX depreciation and an acceleration of inflation. If the bank wants to act preemptively a faster normalization would be required. She appears willing to consider a 50 bp hike.*
- Diaz de Leon opined that even if the shocks are mostly transitory there is a risk that inflation expectations are contaminated due to the wide range of prices affected, the magnitude of the shocks, their persistence and high uncertainty. He said that tolerating high inflation without policy action consistent with the objective of bringing inflation toward the target in the forecasting horizon will deteriorate the price formation and contaminate expectations thus eroding the credibility of Banxico.

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