

Sovereign Macro- Banxico minutes, tipping your pitch?

January 6, 2022

Bottom line: Four members converged to the idea that the gradual pace of normalization had been ineffective and a more decisive message to preserve the anti-inflation credentials of the institution and re-anchor expectations was required. The discussions reflected a bit of exasperation with the results of gradual policy normalization noting that the real ex-ante policy rate had barely moved due to the continued increase in expectations. The majority of members acknowledged that the balance of risks to inflation had deteriorated and continued to the upside. In an interesting opinion -I think from ten governor Diaz de Leon, and if not I apologize for the error- ADDL noted that in the current context the trajectory of monetary policy implies a rate above the neutrality band in real terms. This is what baseball aficionados call tipping your pitch. According to Inning Ace: "It is the term used to describe when the pitcher accidentally or unknowingly provides hints on how he is going to pitch the ball" I think the governor was tipping his pitch before heading to the dugout. The neutrality band is between 1.8 and 3.4%. If we assume that the inflation makes it to the target of 3% in the policy horizon (highly doubtful), then a policy setting above 3.4% in real terms implies a nominal policy rate of 6.5%, at least. Am I right? You tell me. Incidentally ADDL's commentary in the minutes constitutes the one and only forward guidance tidbit that we have seen so far. As I wrote in my commentary after the decision: *"While today's decision is a step in the right direction, more needs to be done. With 12-month inflation expectations at 4%, at the very least we are looking at a terminal rate of 6.5-6.75% (ADDL would seem to agree with this) to only get to neutral. If one considers that Banxico should move to the upper end of the neutral range of 3.4%, then a terminal rate of 7.4% would be required. I am not too ambitious. I have a 4.5% inflation forecast for 2022 and would like to get to the midpoint of the neutral range at 2.6%. I believe that the policy rate should go to 7-7.25% in 2022, the sooner the better. With all the caveats that we know about the new configuration of the board, I am penciling in another 50bp for the February meeting to 6%. A slowing of the pace would be a mistake considering how much ground Banxico needs to cover to normalize policy"*. After the minutes I continue to stand by my comment. As always, the attribution of the members' opinions noted below are my own and apologize in advance of any inaccuracies. These are purely speculative on my part. For investment purposes I still like MXN, receiving 1y1y and consider also long dated UDIs.

- The board is deeply concerned about the behavior of core inflation -of goods an increasingly of services- and the increase in the diffusion indices. A member noted already the second-round effects of inflation. Presumably through higher inflation expectations.
- There was also an extensive discussion about the upside risks of inflation expectations noting that they were already above 4% for 2022 and an increasing probability that they surpass 5%. One member noted that there is a significant discrepancy between the market's and the bank's opinions -much slower deceleration- about the speed in which inflation will decline. Another member indicated that it was paramount to address rising inflation expectations and three members thought that the de-anchoring of expectations was one of the most important policy challenges.

- Two members noted that the idea of transitory inflation prompted by relative price adjustments was no longer appropriate. Indeed, inflationary expectations already reflected a much stronger, persistent, and widespread inflation phenomenon.
- Upside risks include further cost pressures, currency depreciation, energy prices and minimum wage increases.
- **Esquivel** said that it was necessary to reinforce moderately the monetary stance (a 25bp hike). This should be done cautiously since “a stance that is too tight may eventually have adverse effects on growth, capital flows and the FX”. He was critical of past monetary decisions saying that they had sacrificed precious policy space needed today. He added that hiking too early ahead of the FED would set Mexico in a trap of low growth and financial instability. In his opinion the recent hiking cycle has been ineffective in controlling inflation and that the argument to hike to contain inflation expectations appeared insufficient to justify it.
- **ADDL** noted that despite the recent rate increases, the real ex-ante policy rate had barely increased due to increasing expectations. He noted that in the current context the trajectory of monetary policy implies a level above the neutrality band in real terms. The neutrality band is between 1.8 and 3.4%. If we assume that the inflation makes it to the target of 3 % in the policy horizon, then a policy setting above 3.4% in real terms implies a nominal policy rate of 6.5%, at least. Am I right? If inflation didn't reach the target in the policy horizon, then the policy rate should be somewhat above 6.5%, as I believe.
- **Espinosa** said that the dissemination of inflation pressures requires a faster pace of adjustment, decisive and proactive. She noted that avoiding rate hikes due to its fiscal costs could include elements of fiscal dominance. She noted that the idea that hiking would deteriorate expectations is inconsistent with the current monetary framework and increases inflation risks for instance like in Turkey. She argued that the response of monetary policy has to be proportional to the inflation outlook to preserve the banks credibility and the anchoring of long-term inflation expectations. She was in favor of sending clear signals of the commitment to ensure the convergence of inflation to the target.
- **Borja** said that her vote aimed at promoting an adequate process of formation of expectations, looking for a more solid anchoring. The acceleration of the withdrawal of stimulus by the FED and the deterioration of expectations required a firmer policy action looking to re-anchor expectations. She also noted that the real ex-ante policy rate had not improved by much despite the ongoing hiking cycle. Given the uncertain global backdrop it was necessary to show an unequivocal commitment to the Bank's constitutional mandate and this required a more robust attitude.
- **Heath** argued that due to the inflation risks including the significant adjustments to the forecasts, it was indispensable to accelerate the pace of withdrawal of monetary stimulus. Lack of action would seriously harm the institution's credibility. Taking into account the results seen so far, it was time to reconsider the policy strategy. So far the gradual approach in conjunction with the continuous and significant upward revisions to inflation projections has been insufficient to control inflation or the deterioration of expectations.

- As I noted in my commentary at the time of the last policy decision “While today’s decision is a step in the right direction, more needs to be done. With 12-month inflation expectations at 4%, at the very least we are looking at a terminal rate of 6.5-6.75% to only get to neutral. If one considers that Banxico should move to the upper end of the neutral range of 3.4%, then a terminal rate of 7.4% would be required. I am not too ambitious. I have a 4.5% inflation forecast for 2022 and would like to get to the midpoint of the neutral range at 2.6%. I believe that the policy rate should go to 7-7.25% in 2022, the sooner the better. With all the caveats that we know about the new configuration of the board, I am penciling in another 50bp for the February meeting to 6%. A slowing of the pace would be a mistake considering how much ground Banxico needs to cover to normalize policy”

Jaime Valdivia

Sovereign Macro

Founder and Chief economist

jaime.valdivia@sovereignmacro.com

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