

23-16 Monetary policy in Latin America: The easing cycle has begun

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This Policy Brief is based on joint work on monetary policy rules in Latin America with Gonzalo Huertas, who also provided very useful comments. It also benefited from comments and suggestions from Olivier Blanchard, Monica de Bolle, Martina Copelman, Alexis Milo, Maury Obstfeld, Ángel Ubide, and other PIIE senior fellows.

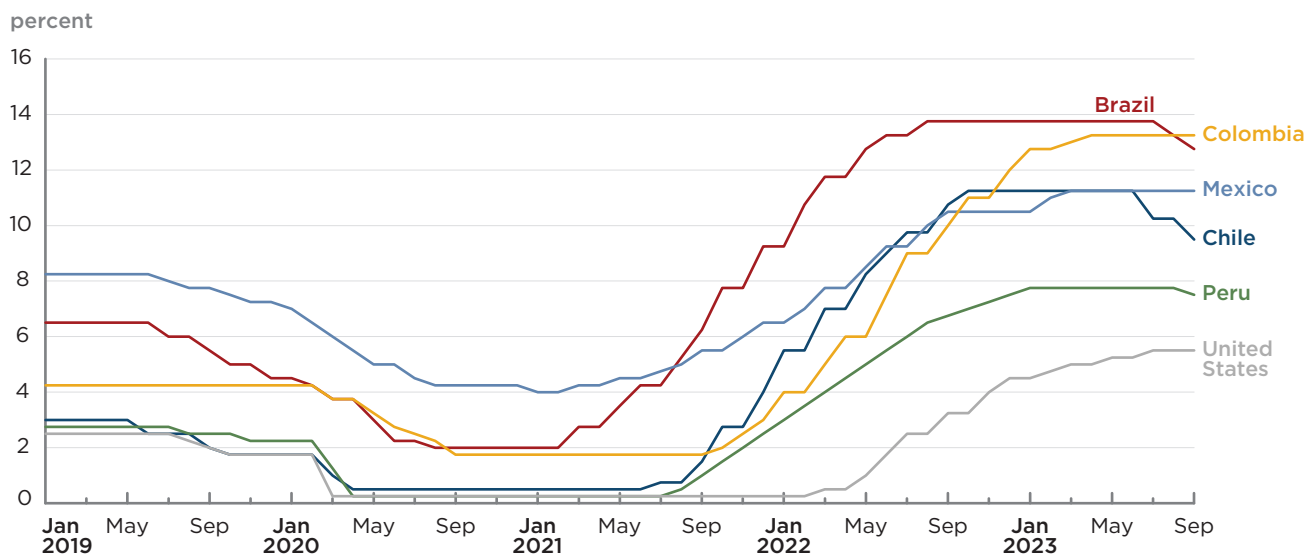
The response of central bankers to the recent global inflationary surge has been very different in Latin America compared with the response in advanced economies. Monetary authorities in the developed world did not react when inflation started increasing and instead debated whether demand or supply was spurring inflation. In contrast, Latin American central bankers acted immediately.

The region's history with inflation makes it much more susceptible to a deanchoring of inflation expectations, and monetary authorities viewed the rise in headline inflation as warranting a swift response. As figure 1 shows, Brazil moved to tighten rates in early 2021, and the rest of the pack started tightening later in the year. It is important to highlight that the first leg of inflationary pressures in Brazil took place during the second half of 2020, before the increase in global inflation, and was therefore driven by domestic factors. In contrast, in the four other Latin American countries, the increase in inflation coincided with the acceleration of inflation in the United States. So, what seems to be a more anticipatory response on Brazil's part was in fact very similar qualitatively to the response in other countries, given that Brazil's inflation acceleration process started before the global one did.

These decisions were also spurred by the highly unusual macroeconomic context. Latin America, like the rest of the world, underwent an extraordinary loosening of financial conditions in response to the COVID pandemic, but negative output gaps were shrinking, paving the way for a normalization of monetary policy. Fiscal impulses also had been larger than originally expected, and there was uncertainty about how fast they would be undone, opening the possibility that fiscal policy would add to the inflationary pressures by maintaining fiscal impulses for too long.

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Figure 1
Monetary policy rates in Brazil, Chile, Colombia, Mexico, Peru, and the United States, January 2019-September 2023



Note: Figure shows monetary policy rates at the end of the month indicated: US (upper federal funds target limit), Brazil (federal funds target rate, Selic), Chile (target rate, TPM), Colombia (monetary policy rate), Mexico (overnight target rate), and Peru (reference rate).

Sources: Banco Central do Brasil, Banco Central de Chile, Banco de la República de Colombia, Banco de México, and Banco Central de Reserva del Perú.

The mainstream inflationary targeting setup used by central banks to communicate supply shocks (distinguishing between core and noncore components of inflation) was at least partially misleading during this episode because an important fraction of the external imported inflation stemmed from core components of the price index. This Policy Brief focuses on the implementation of monetary policy since 2020 in Latin America's five largest economies with inflation targeting regimes.

After the region's early reaction, domestic policy rates closely followed the US Federal Reserve's own tightening process to counter excess market volatility as the international financial cycle turned. In short, Latin America's central banks acted promptly and decisively to contain the medium-term consequences of the global inflation shock.

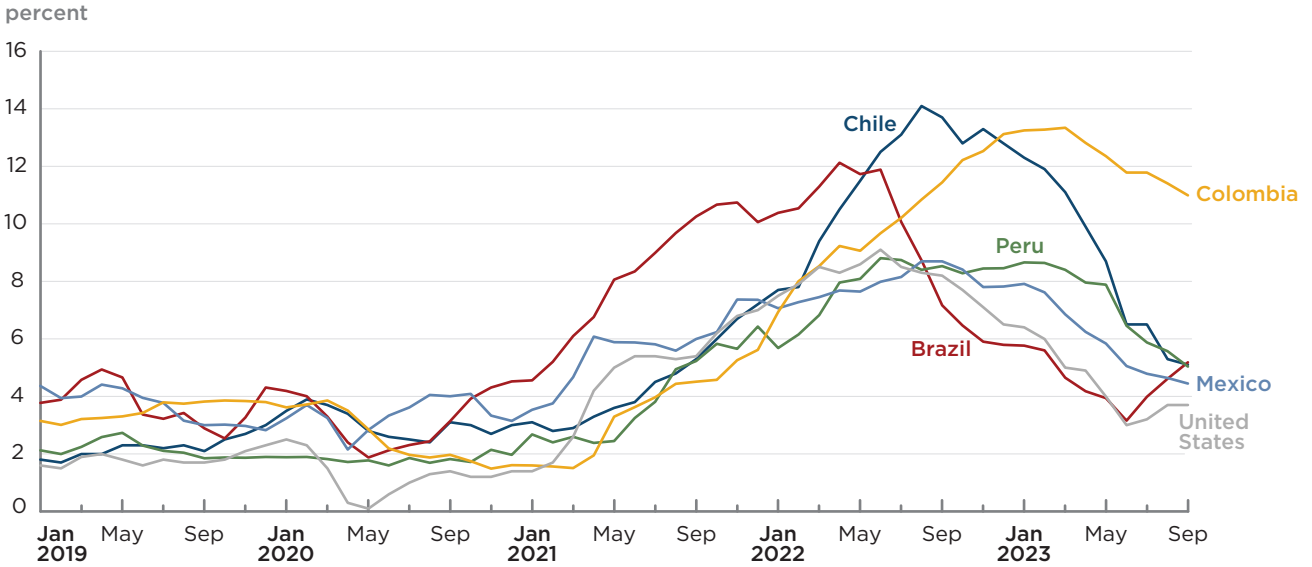
Since then, however, headline and core inflation have come down within the region, real growth has slowed, and the Federal Reserve appears to have settled on a (however brief) pause of its own tightening cycle. Has the time come for a gradual return to looser financial conditions in Latin America? And, if so, how should such policies be designed? We see at least five factors that suggest this discussion is a relevant and timely one.

FACTOR 1

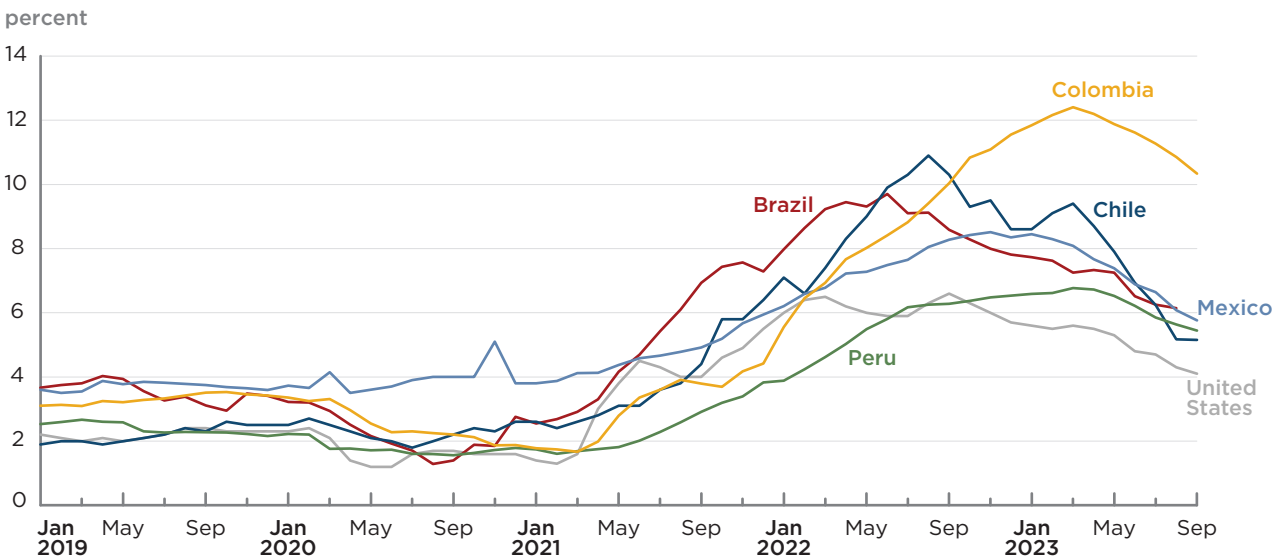
As mentioned previously, both headline and core inflation are falling, albeit at different rates across each country (see figures 2a and 2b). The process started in the second half of 2022 in Brazil, Chile, and Mexico, whereas in Peru this decline is more recent, and in Colombia prices are still increasing at an unpleasant pace.

Figure 2
**Inflation in Brazil, Chile, Colombia, Mexico, Peru, and the United States,
 January 2019-September 2023**

a. Year-over-year headline CPI inflation



b. Year-over-year core CPI inflation



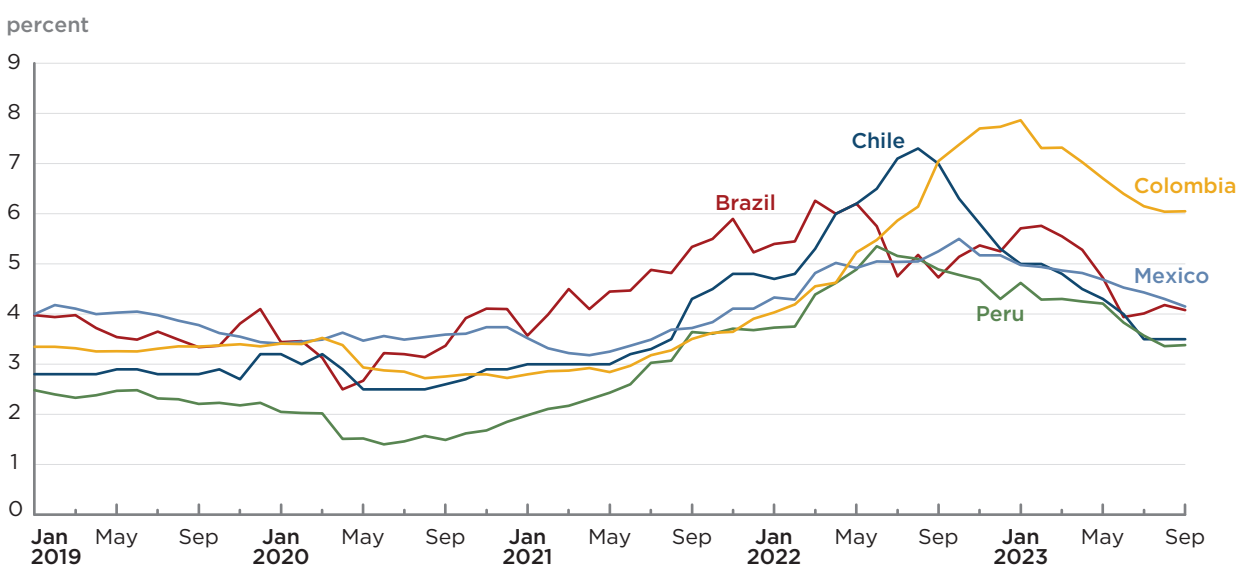
CPI = consumer price index

Sources: US Bureau of Labor Statistics, Instituto Brasileiro de Geografia e Estatística (IBGE), Instituto Nacional de Estadísticas de Chile, Departamento Administrativo Nacional de Estadística de Colombia (DANE), Instituto Nacional de Estadística y Geografía of Mexico (INEGI), and Instituto Nacional de Estadística e Informática of Perú (INEI).

FACTOR 2

All measures of inflation expectations are coming down (figure 3). Medium-term inflation expectations in the region have not become deanchored, and in three out of the five countries surveyed here, they stand at prepandemic levels. Most of these countries' currencies also have appreciated with respect to the US dollar since the start of the year, suggesting that monetary conditions might be too tight (from January to October 2023: Brazil, 5.0 percent; Colombia, 15.9 percent; and Mexico, 10.7 percent; meanwhile, Chile's and Peru's currencies have been stable).

Figure 3
12-month inflation expectations in Brazil, Chile, Colombia, Mexico, and Peru,
January 2019–September 2023



Note: Forecasts surveyed by central banks among private sector analysts.

Sources: Banco Central do Brasil, Banco Central de Chile, Banco de la República de Colombia, Banco de México, and Banco Central de Reserva del Perú.

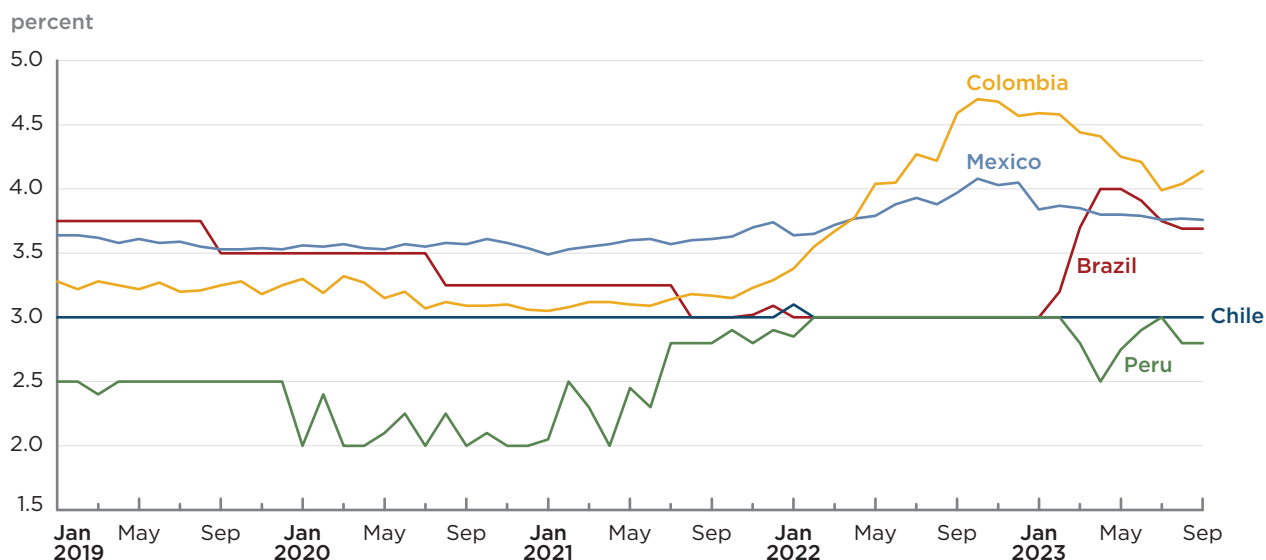
FACTOR 3

Throughout this monetary tightening episode an important objective of monetary authorities has been the anchoring of medium-term inflation expectations. As can be seen in figure 4, inflation expectations in countries that reacted earlier—Brazil, Chile, and Mexico—have been well anchored, in contrast with Colombia and Peru, which waited a bit longer and experienced an increase in medium-term inflation expectations. In the Brazilian case, the increase in inflation expectations occurred in the beginning of 2023 and was related to the new government's discussions about possibly increasing the medium-term inflation target. Once those discussions died down, expectations began to descend.

One can also argue that the credibility gained by these central banks was behind the anchoring, and there was no need to tighten. This hypothesis does not seem to be validated by the cross-sectional comparison. One can claim that Chile's central bank has the strongest credibility in the region, but it is hard to argue that the monetary authorities in Colombia and Peru are less

credible than those in Brazil and Mexico. Although figure 4 clearly suggests that acting early helped the anchoring process, it does not explain whether such an important rate increase was needed. However, in Colombia and Peru long-term expectations moved up, perhaps because these are the countries where long-term expectations are collected for the shortest horizon. For Peru, the cost of deanchoring does not seem to be too large. Peru's central bank was able to maintain the lowest interest rates in the region, and as inflation begins to fall, medium-term expectations are moving back to their long-term level. For Colombia, though, the deanchoring seems more challenging, and expectations are not coming down fast enough. My preliminary takeaway is that moving early did pay off, but moving aggressively might have been an overkill.

Figure 4
Medium-term inflation expectations in Brazil, Chile, Colombia, Mexico, and Peru, January 2019-September 2023



Note: Figure shows inflation expectations for the longest horizon published by each central bank and therefore they differ from country to country. Expectations for Brazil, Colombia and Peru are for 2 years ahead, Chile 3 years ahead, and Mexico for 5 to 8 years. Forecasts surveyed by central banks among private sector analysts.

Sources: Banco Central do Brasil, Banco Central de Chile, Banco de la República de Colombia, Banco de México, and Banco Central de Reserva del Perú.

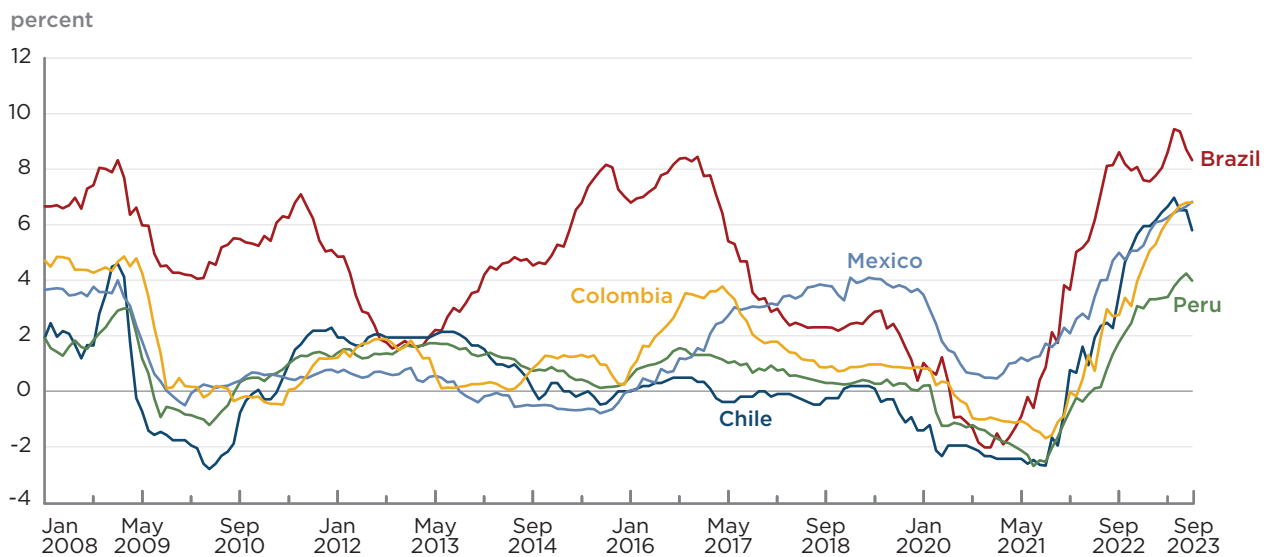
Clarifying the expected transmission channel from monetary tightening to inflation expectations might also help reduce the size of the adjustment. Did the authorities aim for a faster slowdown of the economy, which would lead to milder wage pressures? Did they think that by signaling their “strong” type, expectations were going to be affected and, subsequently, prices and wages would reflect this milder inflation expectation? Or, did they assume that fiscal normalization was going to take longer and therefore would not be supportive of the disinflation process?

FACTOR 4

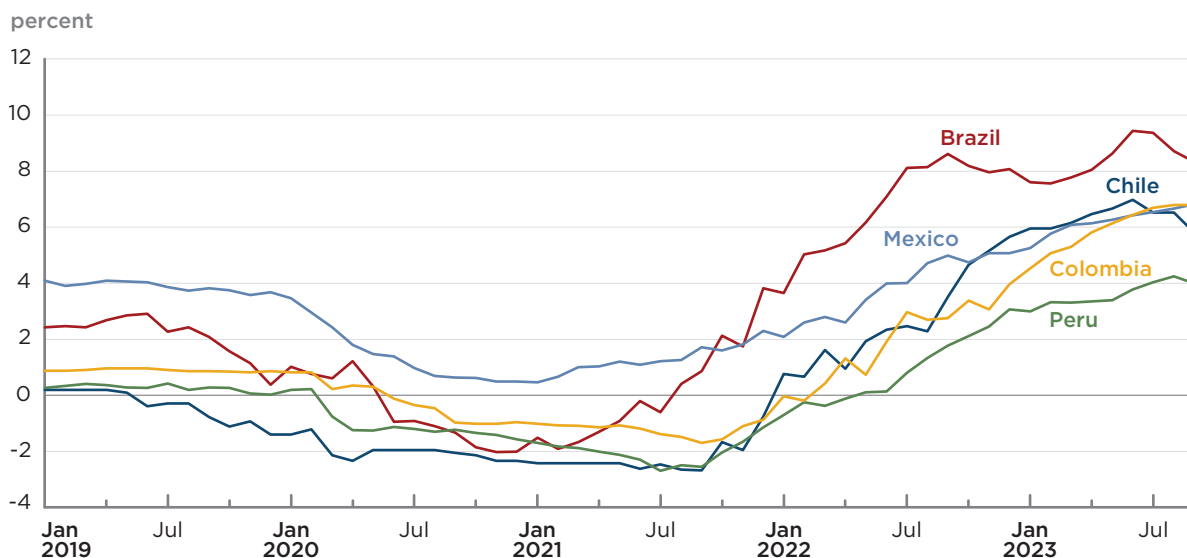
If policy rates are kept constant, the decrease in headline and expected inflation will lead to a persistent rise in real interest rates (as it is happening in Mexico and Colombia), which are high from a historical perspective and are significantly higher than neutral (see figure 5). These are the estimated neutral real rates (midpoint of the range published by central banks): Brazil, 4.75 percent; Chile, 1.00 percent; Colombia, 2.84 percent; and Mexico, 2.6 percent (Peru does not publish a neutral real rate).

Figure 5
Real interest rates in Brazil, Chile, Colombia, Mexico, and Peru

a. January 2008-September 2023



b. January 2019-September 2023



Note: The authors estimate the real interest rate (r) using the Fisher equation, discounting the 12-month expected inflation (π^e) from the annualized nominal policy rate (i), so $(1+r)=(1+i)/(1+\pi^e)$.

Source: Banco Central do Brasil, Banco Central de Chile, Banco de la República de Colombia, Banco de México, and Banco Central de Reserva del Perú.

FACTOR 5

If we estimate simple long-term Taylor rules for these countries that ignore short-term adjustment dynamics, in some cases the past behavioral pattern captured by these rules signals that interest rates are higher than recommended by these long-term relationships. We compare the current rate versus that estimated by the model up to the moment in which central banks in Chile, Brazil, and Peru started lowering rates.

Specifically, we estimate the reaction function of the region's central banks by a standard Taylor rule of the following form:

$$i_t = \alpha_0 + \alpha_1 \cdot \pi_{t-1} + \alpha_2 \cdot (y_{t-1} - \bar{y}_{t-1}) + \varepsilon_t$$

where π is headline inflation, y is output (measured by a monthly economic activity index), and \bar{y} is potential output (estimated through a Hodrick-Prescott filter). In sum, the policy rate reacts both to inflation and to the output gap. These results are illustrative and should be taken with more than a grain of salt because past behavior might not be the best guide to recent monetary policy decisions, given the uniqueness of the post pandemic inflationary shock.

In the graphs in figure 6, the actual policy rate lags the estimated one due to the desire of central banks to smooth the adjustment. It is clear from these graphs that Brazil reacted immediately once the “estimated” rate jumped; Mexico was also very quick in reacting; and Chile, Colombia, and Peru waited longer. From the discussion presented above and each countries' figures, monetary policy in Brazil, Chile, Mexico, and Peru may be getting too tight. Meanwhile, conditions in Colombia would appear to call for continued monetary restraint.

Central banks might be reluctant to loosen financial conditions: The disinflation process is not entirely complete, and there is always the possibility that it might prove stubbornly sticky. Moreover, Latin America's turbulent history with extreme inflation weighs heavy on its central banks, many of which prefer to maintain a “hawkish” reputation lest they risk losing their hard-won monetary credibility. Finally, the uncertainty regarding future US monetary policy, and whether further interest rate hikes are in the pipeline, increases the downside risks for financial conditions in the region.

These considerations notwithstanding, some central banks have already started reducing rates, and others are getting close to that moment. Our analysis shows that it makes sense for most of these countries to start reducing their historically high interest rates, and there is significant space to do this. This conclusion comes from the several factors considered above: Real interest rates are at historically high levels; inflation—both headline and core—is coming down; medium-term inflation expectations proved to be well anchored; and the large difference between actual and neutral real rates, coupled with the traditional gradual approach to rate reduction taken by central banks, means that rates will continue to be in restrictive mode for the foreseeable future. Such a loosening strategy could follow a two-step process:

- 1 These five countries in Latin America built a significant precautionary level into real rates to contain the potential reversion of inflation expectations. Now that inflation expectations have been reined in, central banks can undo all or part of this cushion. In addition, once this overall adjustment is done

and as inflation continues to drop, authorities might communicate that their monetary policy stance should be measured by the real rate rather than the nominal one. This would clarify why nominal rates can follow the decrease in inflation without “softening” monetary conditions.

- 2 The second stage in this disinflation process would imply bringing real rates back to the natural rate, as inflation converges to the target, possibly around the end of 2025.

Brazil, Chile, and Peru have already started this process, and there seems to be significant space to continue it, and according to our analysis Mexico should follow, with Colombia waiting for more clear signals of disinflation.

Figure 6
Actual and projected policy rates in Brazil, Chile, Colombia, Mexico, and Peru (percent)

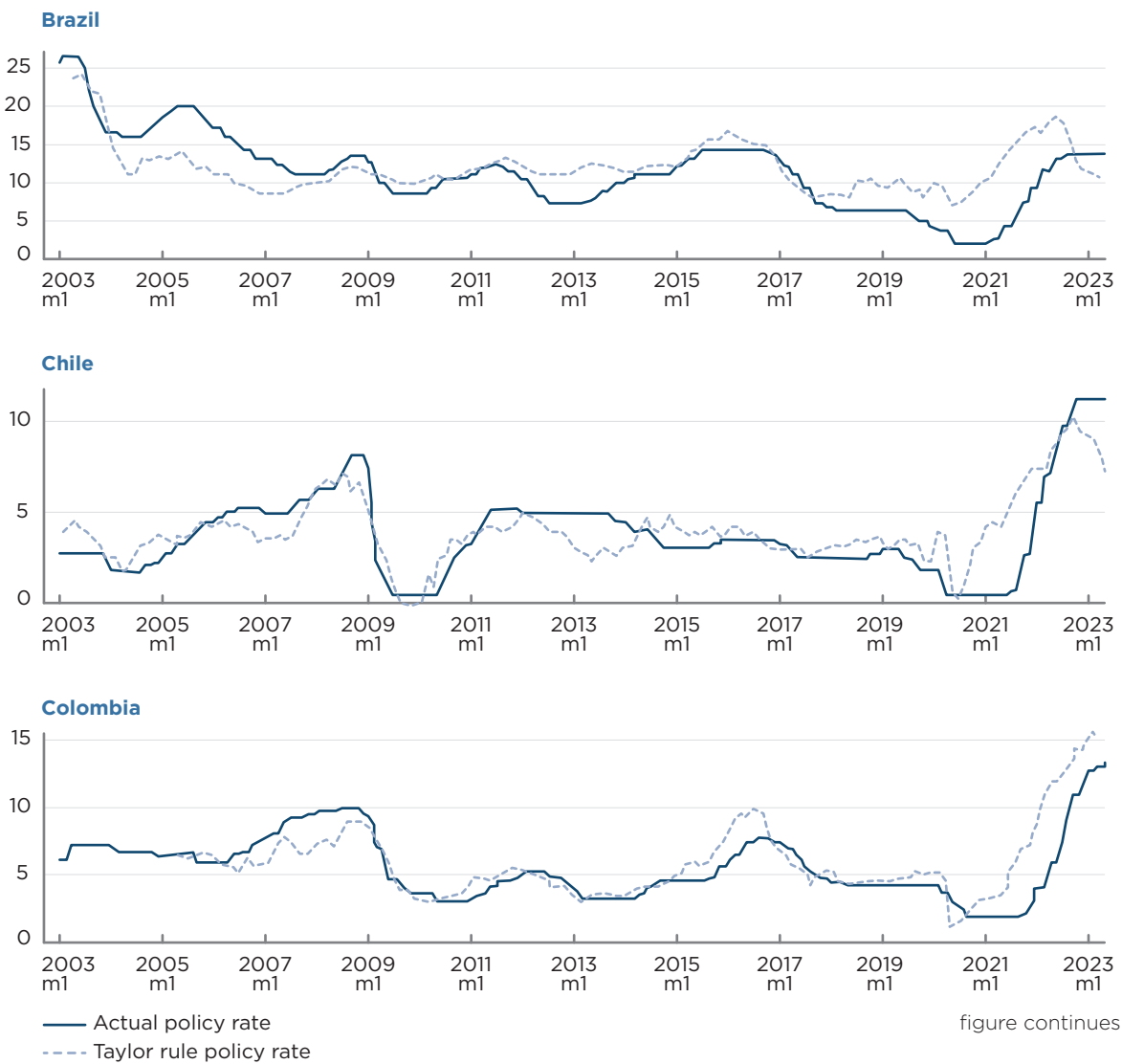


Figure 6 continued
Actual and projected policy rates in Brazil, Chile, Colombia, Mexico, and Peru (percent)



Note: Output gap is calculated by applying a one-sided Hodrick-Prescott filter with the smoothing parameter of 129,600 to the logarithm of monthly economic activity index. Taylor rule's parameters for each country are estimated based on January 2003-December 2019 data. Peru's policy rate is a splice of the overnight deposit rate for January 2003-December 2018 with the monetary policy reference rate since January 2019, both from Central Reserve Bank of Peru.

Sources: See figure 2 for inflation data; policy rates for all countries but Peru are from the Bank for International Settlements, and they can differ from those used in figure 1; economic activity indices are from Banco Central do Brasil, Departamento Administrativo Nacional de Estadística (DANE), Banco Central de Chile, Instituto Nacional de Estadística y Geografía (INEGI), and Instituto Nacional de Estadística e Informática; and author's calculations.



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