

# Central banking in Latin America – the next decade

*Alejandro Werner*

## Introduction

Monetary policy in Latin America has undergone an extremely successful institutional transformation in the last three decades. Most economies in the region were able to contain inflation and sustainably bring it back to close to the levels in advanced economies, establish well-functioning floating exchange regimes and institute inflation targeting frameworks. Important legal reforms laid the foundations for this transformation together with a paramount change in the conduct of fiscal policy. On the back of these changes, inflation in the region dropped from an average of 168% in the 1980s to an average of 5.6% in the second decade of the 21st century. The establishment of a credible monetary framework opened the door for the first time in the region to implement a countercyclical monetary policy, a feature that was widely used during the Great Financial Crisis (GFC) and the global pandemic.

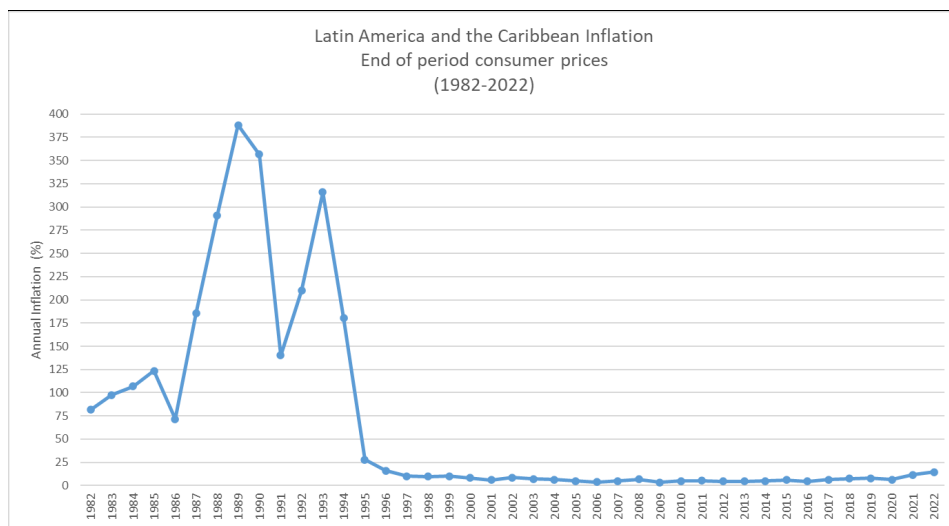
Regional central banks are now facing yet another important test: the global inflationary shock that has affected advanced, emerging and developing economies alike. As a product of both aggregate supply and aggregate demand shocks, world inflation increased by 620 basis points between 2020 and 2022. For some advanced economies, the rate of inflation in 2022 was the highest it had been in the last 40 years. In Latin America, average inflation increased from 2020 to 2022, reaching 14.6%. Although central banks in the region reacted much earlier to the inflation shock than those in advanced economies, and in some countries the initial phase of disinflation has been more pronounced than in advanced economies, there is still a long road ahead before inflation falls sustainably back to the inflation target. Throughout this process, the economies of Latin America will be facing a difficult macroeconomic environment. It is highly likely that, between 2015 and 2025, the region will experience another lost decade in terms of GDP per capita; debt ratios have increased and politics have become more polarised, making it harder to introduce significant fiscal and structural reforms. Other important challenges that central banks in the region will deal with – but which are not addressed in this paper – are the role of central bank digital currencies, regulation of the digital payments system to maximise economies of scale and reduce fragmentation, and cyber security issues for the financial system.

Following this introduction, Section 2 of the paper will present a summary of the most significant monetary and macroeconomic policy accomplishments in Latin America over the last 25 years, and Sections 3 and 4 will highlight some of the challenges that monetary policy still faces and which need to be addressed in the coming years. Section 5 will address Latin America's growth challenge, which could become an important constraint on the future conduct of monetary policy as a determinant of social unrest and political polarisation.

## The golden years of central banking in Latin America

In the late 1960s, inflation in Latin America experienced a significant uptick that continued throughout the 1970s and 1980s, with several countries suffering hyperinflation. Between the late 1980s and the early 1990s, most countries in the region were able to bring inflation down significantly, as shown in Graph 1. However, in 2022, Venezuela and Argentina were still among the five countries in the world with the highest inflation rates.

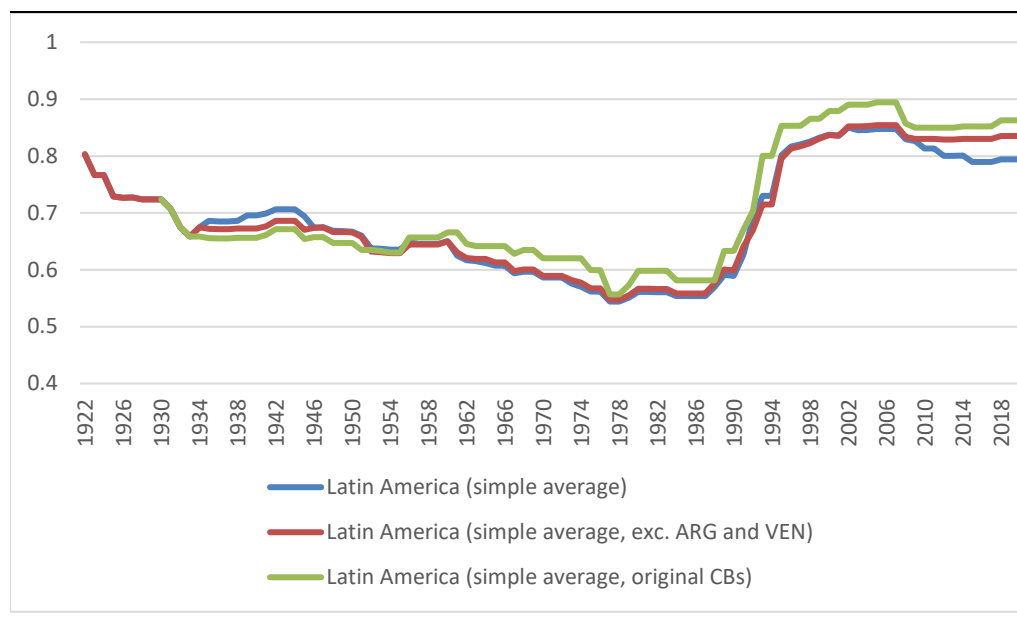
Graph 1



Declining inflation in Latin America was the product of stabilisation programmes that initially used an exchange rate anchor and included an important fiscal consolidation effort, as well as structural reforms to make economies more competitive. At different points in these stabilisation efforts, countries moved to grant independence to their central banks. The purpose of this reform was to provide a strong institutional shield to nominal stability that would provide significant assurance that the decline in inflation was permanent and, in some cases, would also help in the last stage of inflation reduction. The three main components of this reform included prohibiting central banks from providing financing to the government in order to eliminate a historically significant source of inflation, establishing price stability as the central bank's main mandate, and providing these institutions with governance that isolated them from political pressures. As shown in Graph 2, which plots the Jácome and Pienknagura (2022) index of central bank independence, Latin American central banks became significantly more independent in the 1990s. This index is an extension of the one introduced by Cukierman, Webb and Neyapti (1992), which measures de jure independence, and it fluctuates between one and zero, where the closer the index is to one, the more independent central banks are.

Central bank independence index

Graph 2

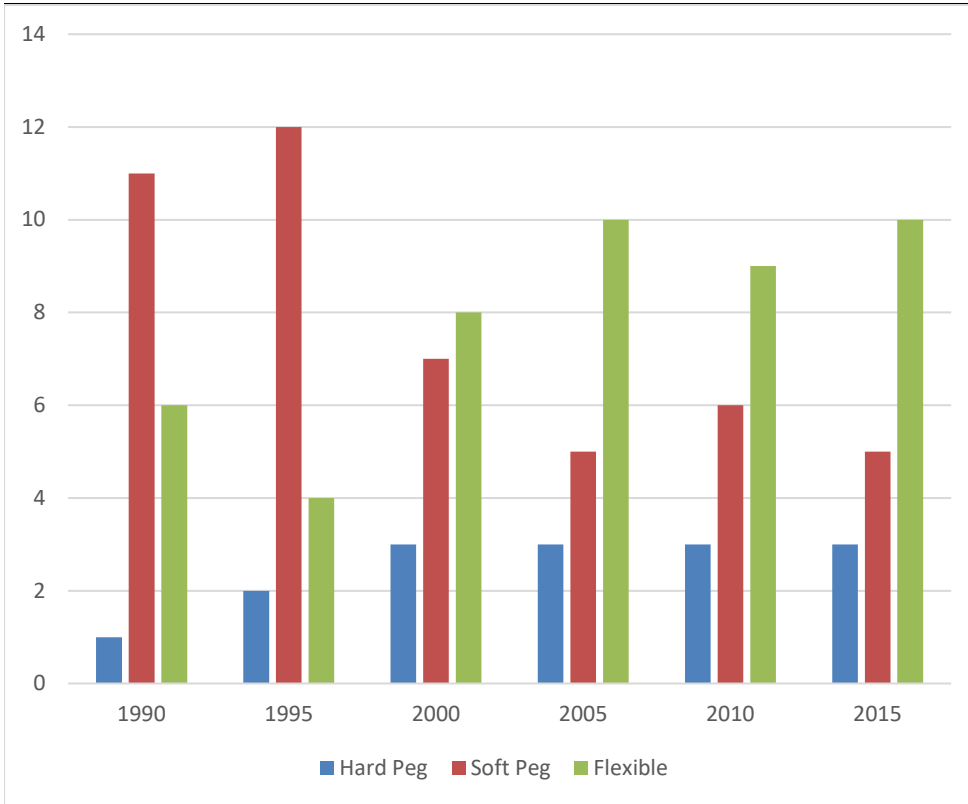


In the late 1980s and early 1990s, the idea of transitioning towards an independent monetary policy with a floating exchange rate and interest-setting central bank committees was not popular. Some countries moved gradually towards floating as they widened their foreign exchange target zones (Chile and Colombia), while others were forced to abruptly adopt floating regimes as a product of currency crises (Mexico and Brazil), but even during these transitions questions remained as to the suitability of floating exchange rates for emerging markets. The experiences of Australia, Canada and New Zealand – small, open, advanced economies with well-functioning floating exchange rate regimes within an inflation targeting monetary framework – served as an important reference for all of these countries. Another interesting experience is that of Peru, which, due to the dollarised nature of its economy, floats its currency, but also maintains a much lower exchange rate volatility within a floating regime through frequent interventions, a high level of international reserves and strong credibility.

## Exchange rate regimes in Latin America

Number of countries

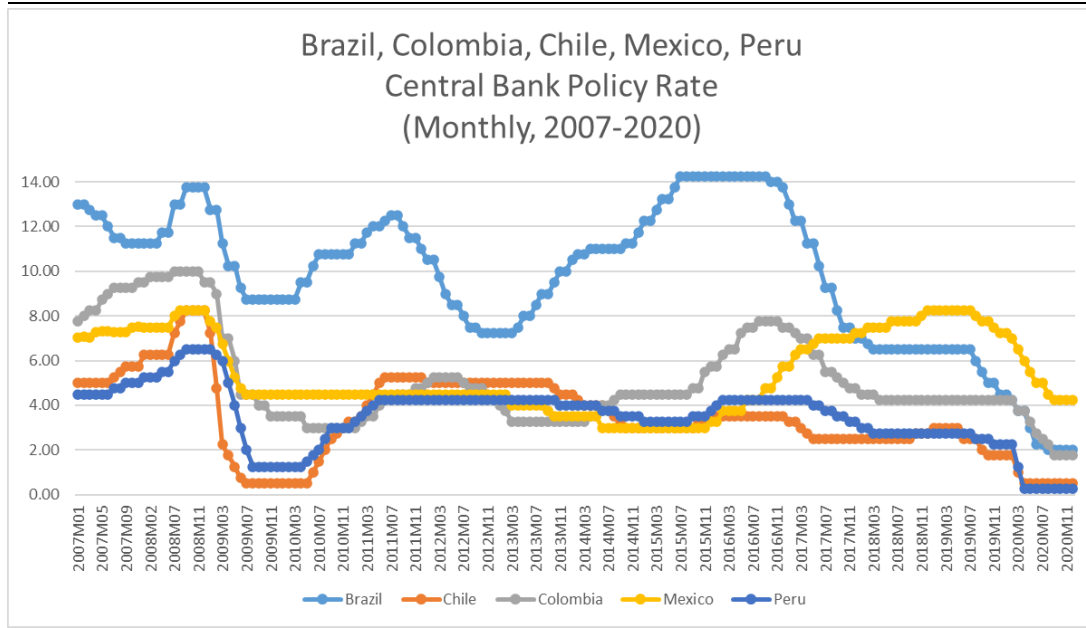
Graph 3



The credibility gained after many years of consistent implementation of these frameworks allowed these countries to run a countercyclical monetary policy during the GFC. As can be observed in Graph 4, interest rates were brought down significantly during both the GFC and the Covid-19 crisis.

Brazil, Colombia, Chile, Mexico, Peru  
Central Bank Policy Rate

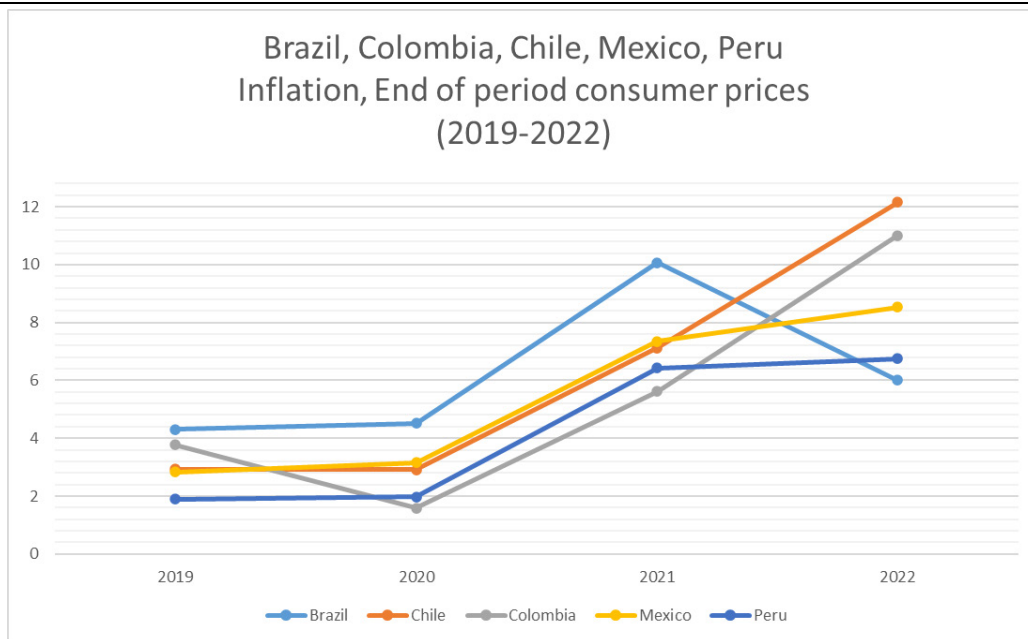
Graph 4

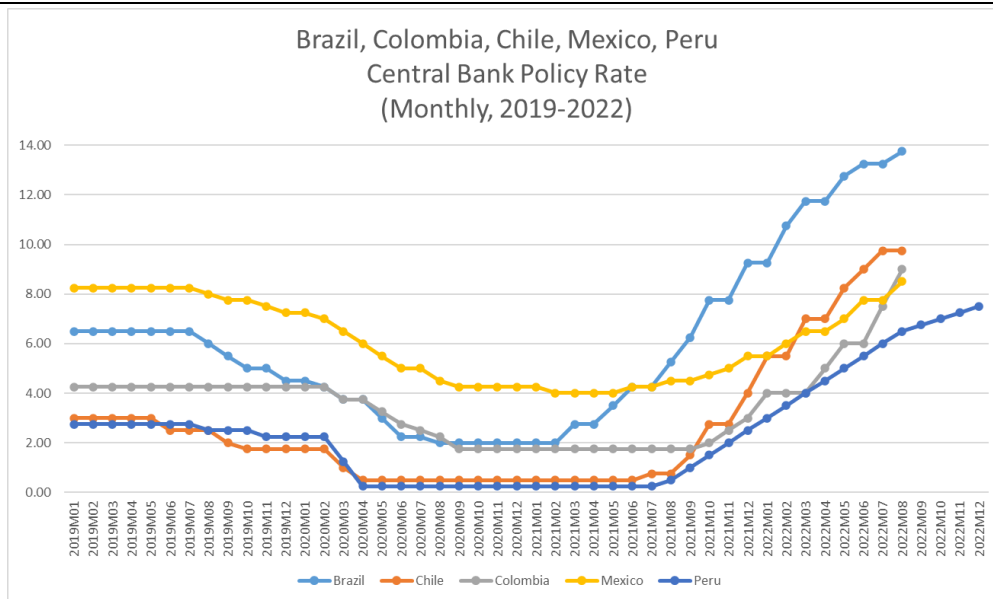


Following the extremely aggressive countercyclical response during the Covid-19 recession, central banks in Latin America are now facing another important challenge: the significant increase in inflation triggered by global dynamics and, in some cases, domestic inflationary pressures. As Graph 5 shows, inflation in Latin America's largest economies rose from around 2–4% in 2019 to around 7.5–12% in 2022. Central banks reacted early, with Brazil leading the inflationary and tightening cycle.

Brazil, Colombia, Chile, Mexico, Peru  
Inflation, End of period consumer prices

Graph 5





## The immediate challenge: bringing inflation back to target

In 2021 and 2022, median inflation in Latin America increased to levels not seen since the 1990s. Central banks reacted quickly, not waiting to see if the supply shock contaminated inflation expectations. The logic was that, given the region's inflationary history, the cost-benefit analysis pointed towards a pre-emptive strike. In addition, some countries were also exhibiting symptoms of overheating, Chile in particular. The policy paid off, as inflation expectations were mostly anchored, and by early 2023 disinflation was clearly in train in Brazil and developing in other countries.

In addition to the original challenge of disentangling the roles that supply and demand shocks were having on inflation and the possibility of inflation expectations becoming unanchored, monetary authorities had to deal with the problem of additional supply shocks affecting inflation with the Russian invasion of Ukraine. What was initially thought to be a two-year process of returning inflation to target has become at least a three-year process due to the additional shocks and a slower decline in world inflation. Moreover, the initial reaction to inflation implied an overreaction in interest rates in order to contain the revision of inflation expectations. So, what does this mean for inflation today as it comes down at a slower pace than originally expected? Should interest rates increase as a result of a higher-than-expected inflation rate? What are the relevant trade-offs between different paths to reductions in interest rates? Should interest rates stay constant but communications signal that they will fall faster once disinflation is clearly underway, or it is preferable to start reducing them early but at a slower pace? Is there still room for a slower reduction in rates since inflation expectations have been well contained and therefore the initial overreaction can be reduced?

The pace of disinflation and the trade-off between increasing rates and maintaining rates at a high level for a longer period.

## Technical, policy and political challenges faced by central banks

### a) Technical issues

Central banks in Latin America and the Caribbean still need to deepen their understanding of the monetary policy transmission mechanism and some of the key parameters governing the economy. This is due to the short time-series data that central bank staffers have to perform econometrics in order to answer the key questions that guide monetary policy. The ever-evolving nature of the transmission mechanism as stability is achieved and financial markets develop also complicates this identification. In my opinion, the discussion on the neutral real rate can be strengthened in many countries. We still find that many central banks calculate it using a variety of methods and then take an average or produce a range. There is no consideration of the fact that some of those methods are derived from a closed economy model, while others are developed in the context of a totally open economy with complete capital mobility. Theoretically, in a closed economy model, the real interest rate is the endogenous variable that equilibrates the demand for investment with the supply of savings, while in an open economy the interest rate is determined exogenously (up to a risk premium) from financial arbitrage (interest rate parity conditions), with the exchange rate playing the role of the endogenous variable that equilibrates savings and investment. During a period with so many changes in the international neutral real rate, this difference is very important.

With respect to our understanding of the transmission mechanism, more work with sectoral data is needed. Deepening our understanding of interest rates' effects on mortgages, different types of investment and consumption is important. Studies using micro data to understand consumption and investment decisions in the economy are also a priority. Finally, given the important role that expectations play in the transmission mechanism, more empirical work on their determination would be useful.

Another technical challenge faced by central banks is the fine-tuning of their analysis in order to understand the structural changes that regional economies are undergoing due to the pandemic. The first of these challenges is associated with the measurement of potential GDP and the output gap. According to the IMF, average scarring for the region will be approximately 4%. This means that, in the medium term, potential GDP will be permanently lower than what was predicted before the pandemic. Clearly, these estimates were not made with significant input from microeconomic data on the destruction of firms, the degree of educational losses, or the increase in mortality. Our assessment of potential output will guide our view of the output gap and of the degree of slack in the economy. A deeper understanding is needed of the permanent losses triggered by the pandemic, from the loss of human capital to the reduced efficiency of job market matches to other hysteresis effects that present themselves after deep contractions in economic activity. Changes in productivity associated with the accelerated adoption of new technologies, changes in participation rates based on households' lifetime choices and the effects of hybrid work on productivity and labour market dynamics present significant areas of research and uncertainty about steady-state parameters of the economy.

## b) Policy issues

As emerging market economies developed their inflation targeting frameworks, they modelled them based on the experiences of small, open, advanced economies that had adopted these models in the past, as well as the example set by the British, which served as the benchmark to which many countries aspired at the time. However, over time, it was clear that the underdevelopment of capital markets in EMEs and the high inflation memory of economic agents were features that made the exchange rate's role more salient through its effects on inflation expectations and financial stability. The preferred instrument for dealing with these challenges in Latin America has been FX intervention. However, the environment in which these interventions have been undertaken is far less formal and does not have as strong an analytical foundation as the framework for how interest rate decisions are made. This is clearly an area where central banks could advance much more in presenting frameworks and policy guidelines under which this second instrument of monetary policy is to be deployed.

Central banks in Latin America intervene in foreign exchange markets for multiple reasons. The IMF has provided a useful taxonomy and review of regional FX intervention policies in Chamon et al (2019), which mentions the following drivers of intervention: accumulation of international reserves, attenuation of financial stability risks, addressing high and fast pass-through from the exchange rate to inflation, and dealing with persistent shocks that can have Dutch disease-type effects or international portfolio adjustment shocks that can have large effects on the exchange rate. Another important factor is how the intervention takes place; we have witnessed a multiplicity of strategies as central banks have acted on the spot and derivative markets and used rules and discretion. Although this is not the place for a thorough review of these policies, the degree of transparency and communication from central banks regarding these policies is significantly lower than that used to explain their actions through the interest rate. In this area, and with the development of the Integrated Monetary Policy Framework by the IMF (2020), there is space for a significant redesign of these policies and important improvements in their communication, which would increase their effectiveness. Moreover, coordination with the fiscal authority might become more important in a world in which debt ratios are increasing;  $(r-g)$  is going up as both terms are moving against the government, and fiscal authorities might want to fight the slowdown needed to consolidate the reduction in inflation through a more expansionary fiscal policy.

## c) Political economy issues

Political economy issues include fiscal pressures for faster reductions in rates. Governments and societies were supportive of tightening when inflation reached extremely high levels, but as inflation drops towards more tolerant ranges, the pressure to declare victory too soon and reduce rates faster will emerge. This will materialise as calls for a looser monetary policy and an upward revision of the inflation targets. Central banks should be prepared to engage in this analytical debate and argue strongly against these short-sighted solutions that would lead to a steepening of the yield curve, an increase in real rates and a decrease in potential GDP for the sake of a short-lived bump in growth.



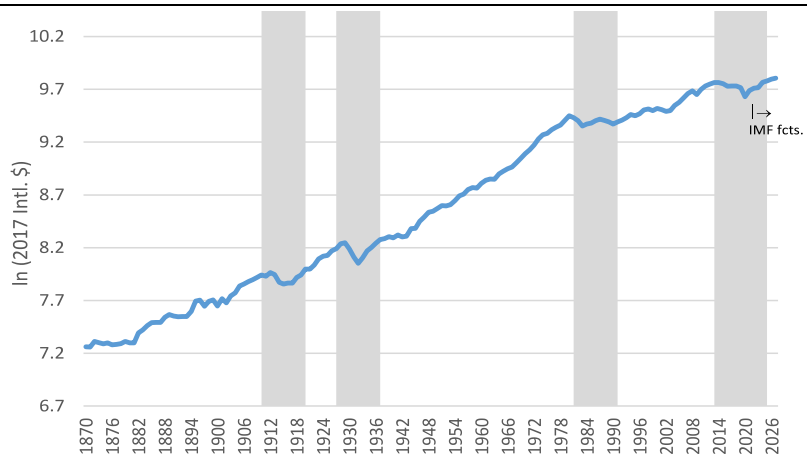
## Latin America's growth challenge

Latin America has experienced an extremely low average rate of growth in the last 50 years. This situation will continue and may worsen in the years to come. Graphs 7 and 8 show how Latin America's GDP per capita growth has slowed significantly since the 1980s and how, in the last 50 years, only a small number of countries comprising only 14% of the region's population have grown at rates higher than those of advanced economies. In addition, according to IMF forecasts, it is highly likely that the effect of the drop in commodity prices in 2014–15, together with the effects of the Covid-19 pandemic, will result in another lost decade in Latin America during 2015–25.

### GDP per capita for the historical Latin American aggregate

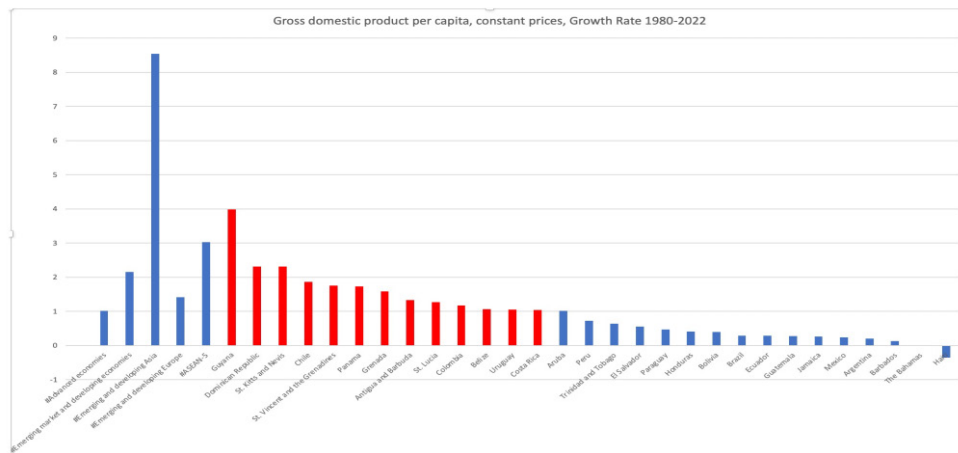
(Levels in 2017 International \$; logs)

Graph 7



### Only 14% of LA's population lives in countries converging to AE's GDP during 1980-2022

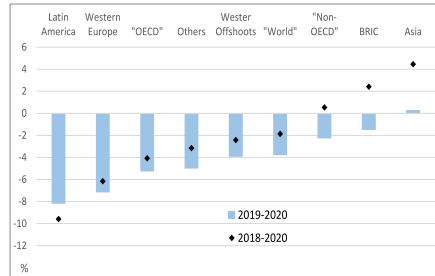
Graph 8



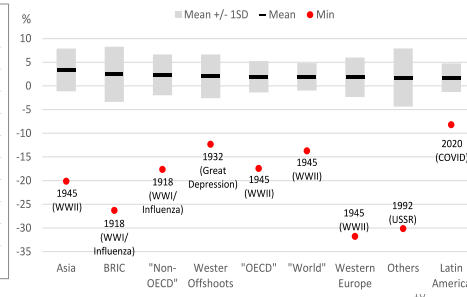
During Covid, Latam suffered the largest regional contraction and its deepest regional recession in the last 120 years.

Graph 9

**Exhibit 2:** COVID-19 GDP per capita declines in historical country aggregates: 2019 through 2020, and 2018 through 2020



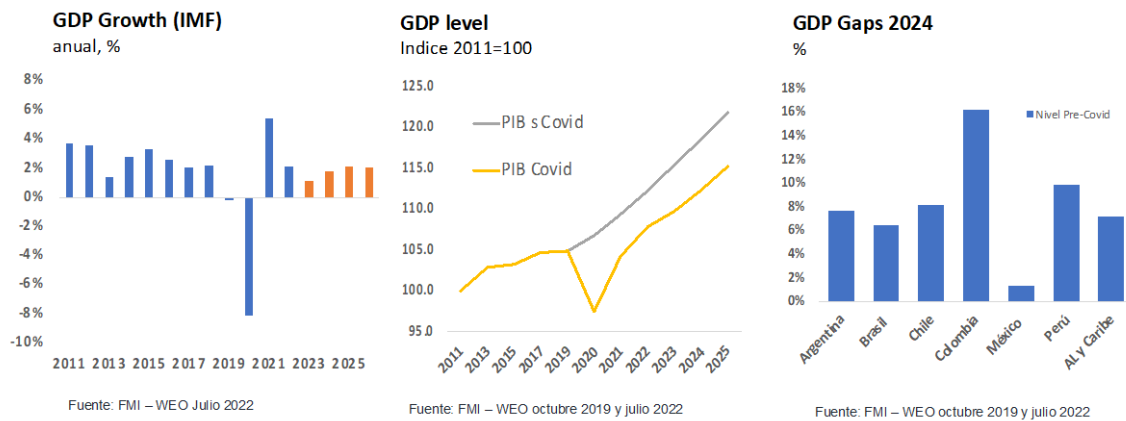
**Exhibit 3:** 2020 GDP per capita declines in historical country aggregates vs. historical distributions and record minimum yearly changes since 1905



Latin America was the region of the world that experienced the largest decrease in GDP per capita during the pandemic, and it is the only region of the world where the 2020 recession was the deepest on record. The permanent effects of this recession, called "scarring" by analysts, are expected to be significant.

The IMF forecast significant economic scarring from the pandemic

Graph 10



A silver lining for many Latin American countries will come from an external environment that could support higher growth. One element of this is the energy transition, as Latin America is a region with abundant renewable energy sources that, with the right regulation, could attract important investments in generating these types of electricity. Many nations in the region are abundant with the key minerals needed to store, transmit and distribute electricity. For example, Argentina, Bolivia and Chile are among the top five countries with the largest lithium reserves. In addition, the need to redesign global value chains in manufacturing as firms consider greater natural disaster risks, geopolitical tensions, higher tariffs and trade disputes has led to the processes known as nearshoring, friend-shoring and ally-shoring, which will benefit some countries in Latin America. For example, the Inter-American

Development Bank (IDB) estimates that this process will increase regional exports by approximately 80 billion dollars, while projections made by other institutions put the number as high as 150 billion. More than half of this effect is expected to be captured by Mexico. If one takes the most optimistic estimates, they represent, at most, 10% of the region's exports. Even so, the estimated impact on the country is significantly smaller than the increase in Mexican exports after NAFTA entered into force. In summary, the nearshoring process represents an important positive shock for the region, but not a transformational event in terms of medium-term growth.

In open, democratic societies like most Latin American countries, the recent economic malaise, together with the political polarisation that many of the region's countries are experiencing, will complicate the consensus building necessary for big reforms that increase productivity and growth, improve income distribution and maintain stability. It is in these difficult political environments that central banks will undertake their main responsibility of bringing back and maintaining price and financial stability. Central banks should continue to clearly communicate the benefits of price stability and the risks of declaring an early victory once inflation is low but not on target. An outcome where central banks declare victory too early will feed into medium-term inflation expectations, raising them higher and increasing their volatility, with important negative effects on long-term interest rates and potential growth.

## References

Basu, S, E Boz, G Gopinath, F Roch and F Unsal (2020): "A conceptual model for the integrated policy framework", *IMF Working Papers*, no 2020/121, 7 July.

Carriere-Swallow, Y, L Jácome, N Magud and A Werner (2016): "Central banking in Latin America: the way forward", *IMF Working Papers*, no 2016/197, 30 September.

Chamon, M, D Hofman, N Magud and A Werner (2019): *Foreign exchange intervention in inflation targeters in Latin America*, 28 February.

Cukierman, A, S Webb and B Neyapti (1992): "Measuring the independence of central banks and its effect on policy outcomes", World Bank Group, *The World Bank Economic Review*, vol 6, no 3, September, pp 353–98.

Inter-American Development Bank (IDB) (2022): "Nearshoring can add annual \$78 bln in exports from Latin America and Caribbean", 7 June.

Jácome, L and S Pienknagura (2022): "Central bank independence and inflation in Latin America – through the lens of history", *IMF Working Papers*, no 2022/186, 16 September.

Ursua, F and A Werner (2023): *Macroeconomic rare disasters and lost decades in Latin America: the Covid-19 experience in a historical context*, forthcoming.