Latin American pathways

A tribute to the thought and memory of Professor Werner Baer

Latin America: are inflation and low growth inevitable?

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Initial remarks and road map

Thank you very much for inviting me to talk about Latin America Pathways, in tribute to Professor Werner Baer. The passion of Professor Baer in his studies on inflation, growth and development in Latin America, and in particular in Brazil, is admirable. His contributions have not aged and are more relevant today than ever. It is an honour and a privilege to be able to share my perspective on what we have learnt, where we are now and what challenges and opportunities our region will face in the future.

Are high inflation and low growth inevitable in Latin America? I do not think so. Admittedly, the list of challenges is long, but there are no grounds for fatalism.

Over the past three decades, Latin American countries have built up strong macro financial policy frameworks. Between the turn of the millennium and last year, inflation in most countries of the region was lower and more stable than at any time in the 20th century, despite large shocks. Financial crises – a perennial feature of the past – have been notably absent in the region. This track record shows that good policies can and do make a difference.

Today, the challenge is to build on these achievements, get inflation back to target and embark on a trajectory of high and sustainable growth. Macroeconomic and financial stability are a necessary condition for this, but they are not enough. We also need structural

1 The views expressed are my own and not necessarily those of the BIS. I thank Ana Aguilar, Bernardus van Doornik, Jon Frost, Christian Upper and Fabrizio Zampolli for input, and Cecilia Franco for support with data and graphs.

policies to make our economies more competitive and dynamic, social policies to make growth inclusive and environmental policies to make development sustainable.

Lessons from decades past

In most of Latin America, the 20th century was marked by massive swings in economic activity, high inflation and financial instability. This changed in the late 1990s and early 2000s, when most central banks became independent or autonomous and their ability to finance the public sector, ie to provide monetary financing, was restricted. Most countries abandoned fixed exchange rates and chose a flexible regime with inflation targeting as their nominal anchor.[2]

Central bank independence is key, but it needs to be accompanied by sustainable public finances to keep inflation low and stable. Most countries took steps to consolidate public finances and strengthen fiscal institutions, for instance by introducing fiscal responsibility laws and, in some cases, fiscal councils.

Countries also opened their economies to trade and foreign capital. To prevent the dangerous booms and busts that followed past efforts of financial liberalisation, they adopted policies to mitigate currency mismatches.

Financial markets have also become deeper thanks in part to pension reforms and the removal of legal and administrative obstacles to foreign investment.

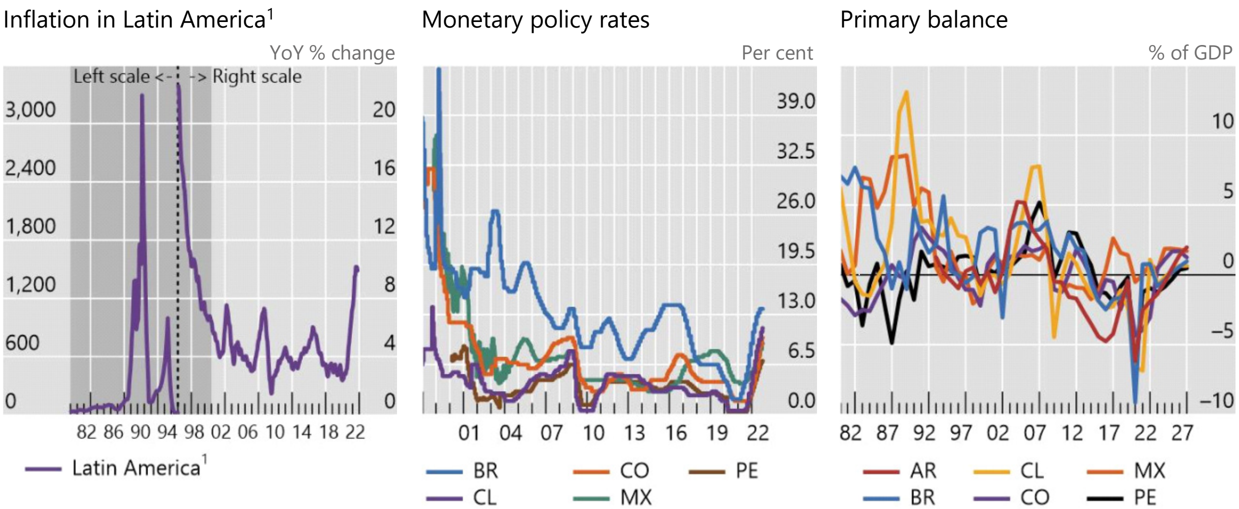
Having suffered financial crises in the 1980s and 1990s, authorities strengthened their banking systems by requiring larger capital reserves and improving prudential supervision. Notably, they took these steps well before the Great Financial Crisis (GFC).

In short, at the beginning of the millennium, countries adopted macro-financial stability frameworks that deliver low and stable inflation.

These new frameworks were successful: inflation fell sharply and interest rates were reduced (Graph 1). As public finances became more sustainable, countries were able to use fiscal policy more counter-cyclically.

[2] For a rich historical account, see T Kehoe and J Nicolini (eds.) (2021), *A Monetary and Fiscal History of Latin America, 1960–2017*, Minneapolis: University of Minnesota Press.

The conquest of macroeconomic instability Graph 1



[1] Simple average of the annual inflation rate of BR, CL, CO, MX and PE. Hyperinflation episodes are included in the simple average.

Sources: DataStream, IMF, national data.

While this shift in policy was clearly helped by low inflation globally, it was not all smooth sailing. Even with greater fiscal discipline than in the past, the problems of excessive indebtedness or boom-and-bust cycles in financial markets did not go away. With more open economies, policymakers had to deal with the ups and downs of the global economy. Central banks had to deal with large and volatile capital flows and swings in external monetary and liquidity conditions, which amplified the economic cycle and increased output volatility. Other challenges included financial stability risks, such as the excessive reliance on short-term debt and unhedged currency exposures.

Unlike in most advanced economies, the interest rate instrument was not sufficient to address these challenges. In a world with large fluctuations in capital flows and international asset prices, the sole use of monetary policy instrument may pose two dilemmas.

- First, if inflation is already close to target, inflation-targeting central banks may have less room to raise interest rates to curb excessive credit growth.
- Second, an increase in short-term interest rates may attract further capital inflows.

The same forces can also operate in the opposite direction.

In general, most central banks managed to navigate through episodes of strong capital inflows and outflows quite successfully. It is no coincidence that most Latin American economies did not experience any major crises when the GFC hit in 2008, or during the Taper Tantrum in 2013.[3]

Why? An important reason is the use of multiple instruments, the build-up of buffers and the inclusion of financial stability considerations in the work of central banking. Indeed, central banks in the region highlighted the use of several instruments in a survey and a report coordinated by the BIS.[4]

In fact, the central banks of Latin America have made use of not only the policy interest rate but also of macroprudential tools and foreign exchange interventions. Importantly, they have done so not only during recessions or periods of financial stress, but also during booms. This multiple-instrument approach has increased financial resilience. It has reduced the sensitivity of the financial system to changes in the exchange rate. In good times it reduced the fear of floating and increased the scope for the exchange rate to act as a shock absorber in bad times.[5]

Where are we now?

Despite these successes, we now face new challenges arising from a unique set of events. As we emerge from the Covid-19 pandemic, with major fiscal support and supply chain disruptions, inflation is high almost everywhere. Growth is declining and central banks around the globe are hiking rates. The war in Ukraine further complicates an already difficult situation. Commodity prices surged in the first half of the year, although they have mostly returned to the levels prevailing before the invasion.

Inflation has gone up in 2022. It has peaked in a few economies but remains at very high levels virtually everywhere (Graph 2). In quite a number of countries, the increase

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3 See A Aguilar, A Tombini and F Zampolli (2023), "Monetary Policy Frameworks in Latin America: Evolution, Resilience and Future Challenges", in C Borio, E Robinson and H S Shin (eds.), *Macro-financial stability policy in a globalised world: lessons from international experience*, proceedings from the Asian Monetary Policy Forum 2021 Special Edition and MAS-BIS Conference, Singapore: World Scientific Publishing Company.

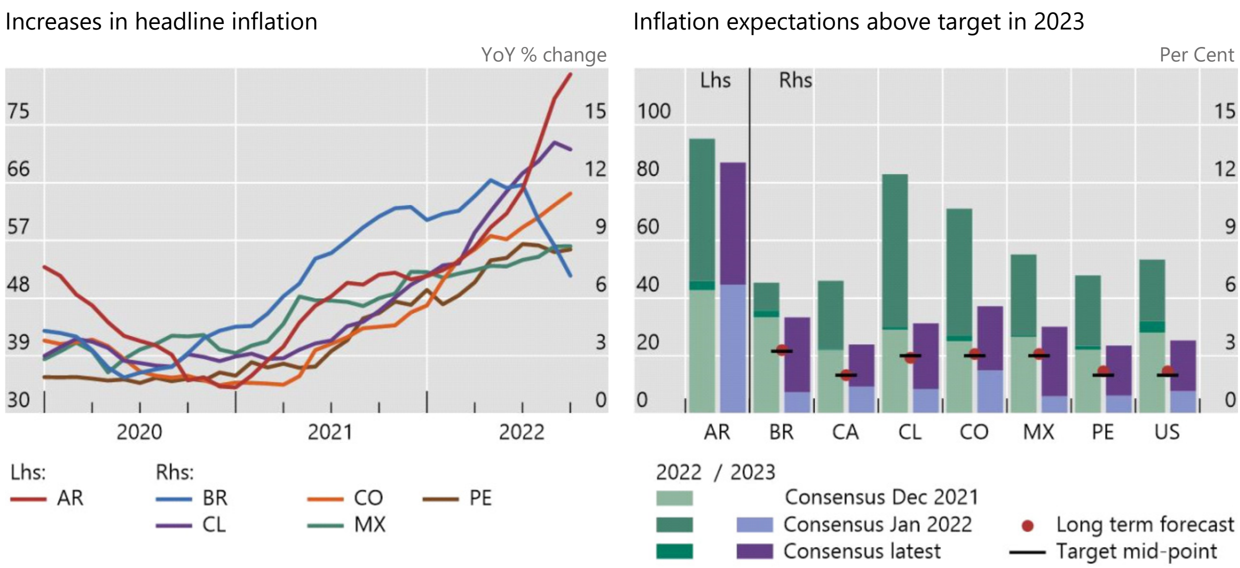
4 See Bank for International Settlements (2021), *Capital flows, exchange rates and monetary policy frameworks in Latin American and other economies*, a report by a group of central banks including members of the Consultative Council for the Americas and the central banks of South Africa and Turkey.

5 See Bank for International Settlements (2019), "Monetary policy frameworks in EMEs: inflation targeting, the exchange rate and financial stability", Chapter II, Annual Economic Report, June.

in inflation would have been larger had fiscal measures not constrained energy and food price increases.

On the positive side, long-term inflation expectations have generally remained anchored amidst the increase in short and medium-term expectations for 2022-2023.

Inflation Graph 2



Source: Consensus Forecast, national data.

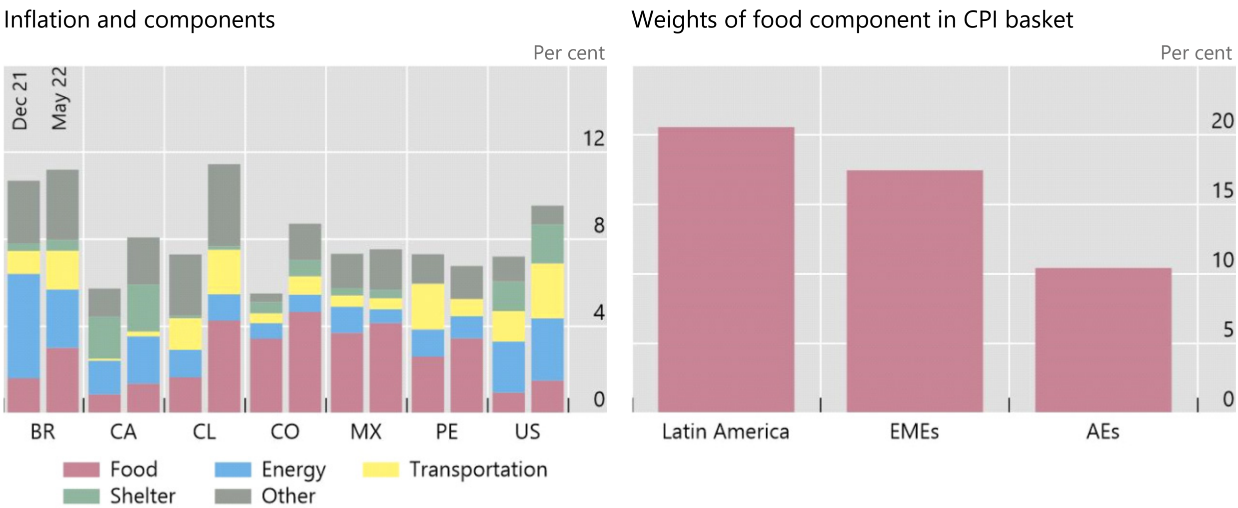
Moreover, a sharp increase in inflation – and particularly in food prices – affects people in Latin America even more than those in advanced economies. In Latin America, an increase in inflation fuelled by food prices usually translates into an increase in poverty. There are at least three reasons for this:

1. A large share of the population has precarious personal finances and spends most of its income on essential items.

2. A large share of household expenditure is on food (Graph 3), especially in the lower brackets of the income distribution.

3. Given the still limited level of financial inclusion, there are fewer possibilities to access financial products that could help protect against inflation.

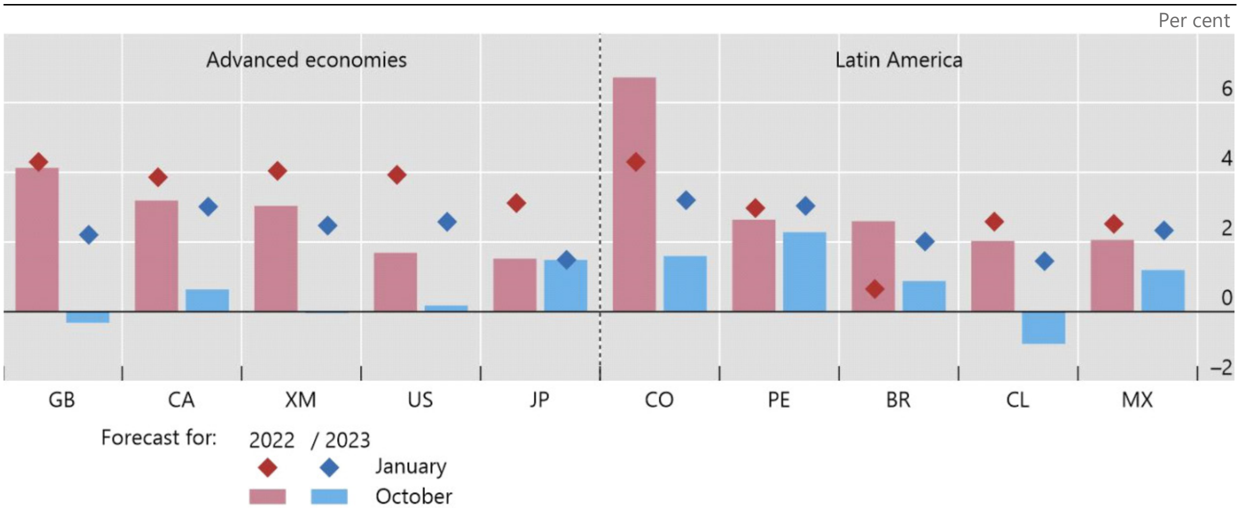
Latin America is more sensitive to food and energy price inflation — Graph 3



Source: IMF, national sources, BIS calculations.

Meanwhile, growth and consumption recovered fast in late 2020 and 2021. This was due in part to expansionary policies, including large pension withdrawals in some countries, and higher global demand, mainly from the US. In most economies, output recovered to pre-pandemic levels, and labour markets remained strong. Even in 2022, higher commodity prices improved the terms-of-trade and pushed up growth (Graph 4). For 2023, however, analysts expect a clear deceleration, with the possibility of some economies even facing a mild recession.

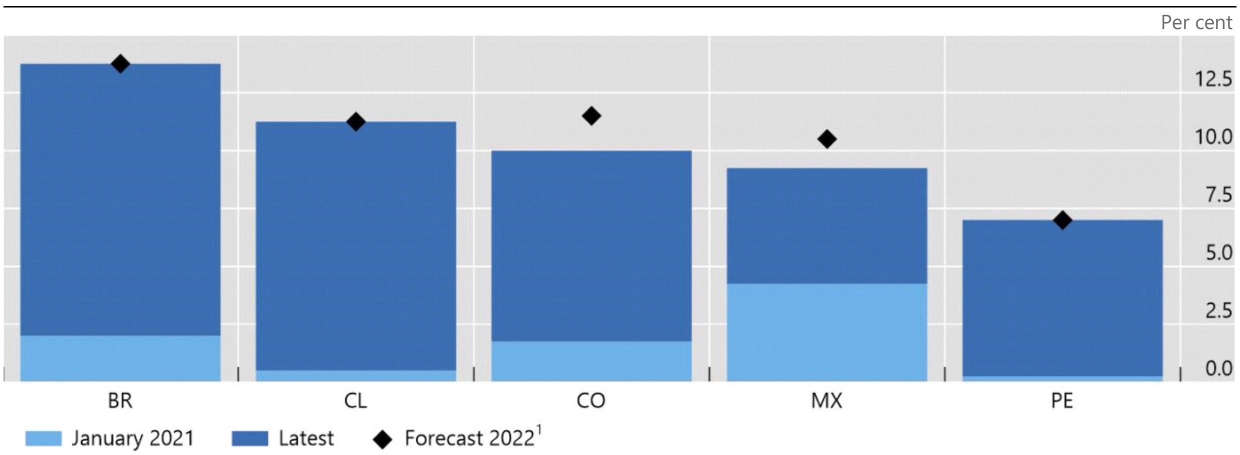
GDP growth forecasts: better in 2022, but worse in 2023 — Graph 4



Fuente: Consensus Economics.

Latin American central banks have been bold and decisive in the face of rising inflation. They have raised rates decisively (Graph 5). And they did so well before most of their peers.

Monetary policy has tightened precipitously — Graph 5



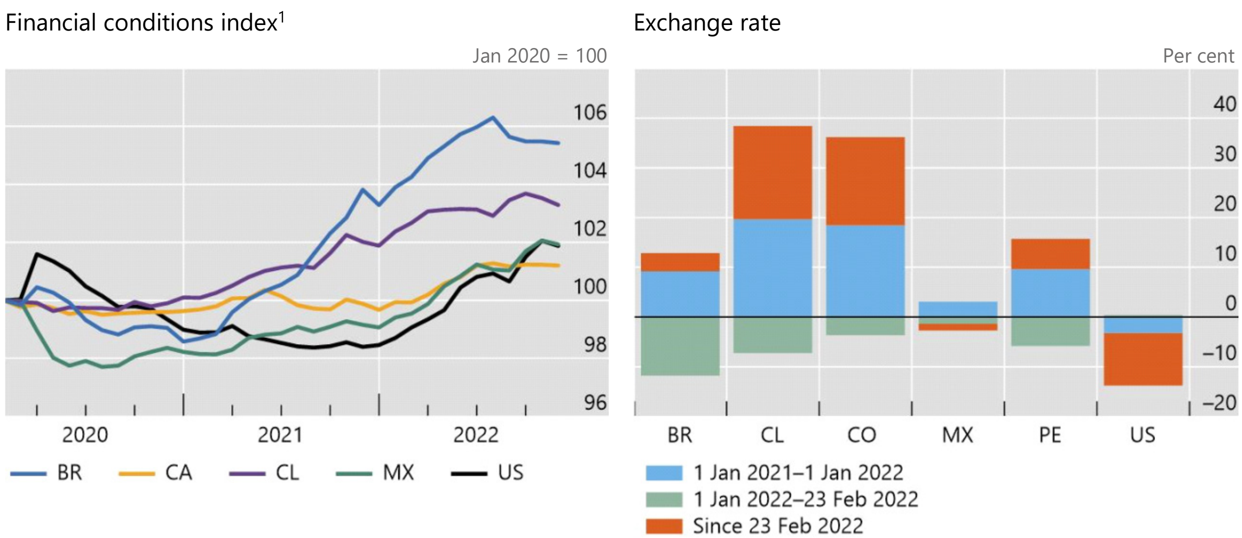
[1] Median of the Bloomberg economic forecast from 21 October 2022.

Source: national data.

As domestic and global rates rose, financial conditions tightened considerably (Graph 6, left-hand panel), with higher bond yields and CDS spreads. Exchange rates were more stable, at least for most countries (right-hand panel). Interest rate increases led to higher carry-to-risk indicators. Yield curves flattened in most economies and even inverted in some. Global financial markets were also very volatile in recent months. So far, they have continued to function smoothly in most cases. Yet we know that risk-off episodes tend to hit emerging markets particularly hard.

Financial markets in Latin America have been rattled, but have continued functioning

Graph 6



[1] Goldman Sachs financial conditions index. A higher value indicates tighter financial conditions.

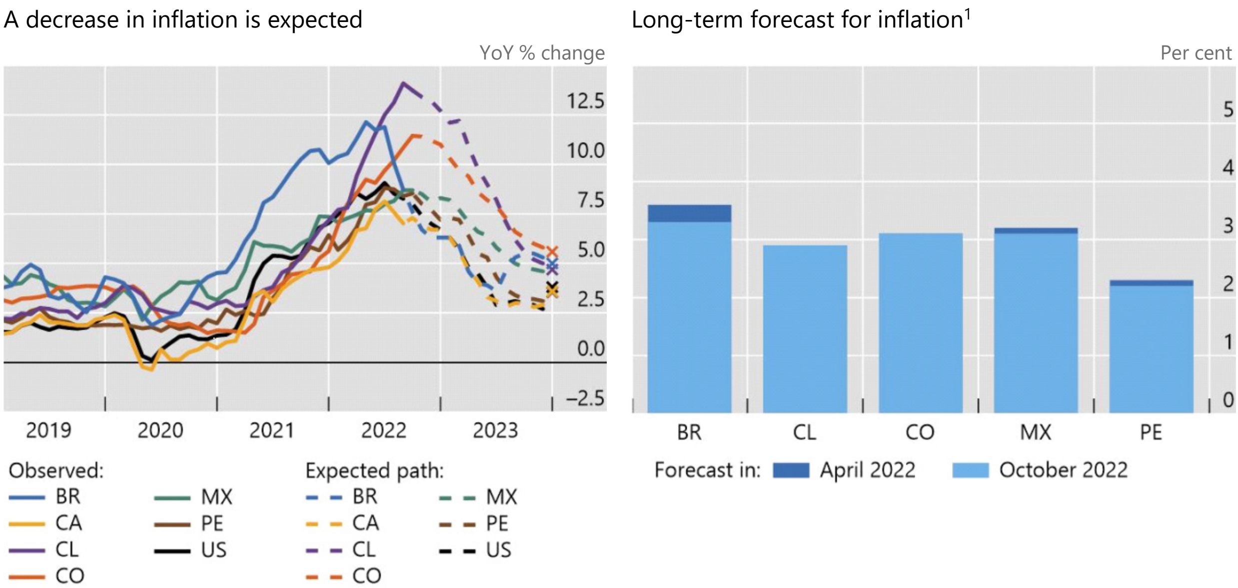
Source: Bloomberg, national data.

Overall, early actions by central banks in the region have helped economies and financial markets cope with higher volatility. That said, monetary authorities should guard against the risk of excessive optimism by market participants in assuming a benign disinflation path going forward.

Challenges ahead

At the moment, the first and most important challenge for central banks is getting inflation back to target. Inflation in some major economies in Latin America seems to be peaking, if it hasn't peaked already (Graph 7, left-hand panel). However, it needs to decline substantially to get close to the levels central banks and the population are comfortable with.

The disinflation process will take time Graph 7



[1] Average for the period 2028-2032.

Source: Consensus Economics Forecast.

The first stage of disinflation could come from a combination of lower global demand, an easing of supply bottlenecks, lower commodity prices, and the impact of the monetary tightening put in place over the last year and a half. These temporary factors could push inflation down fast.

The second phase of disinflation could be more difficult. It is possible – perhaps even likely – that the pace of disinflation will slow down, as second-round effects from indexation clauses or higher inflation expectations kick in. While wage increases, both within and outside the region, have generally remained well below the rate of inflation, there are signs that wage negotiations are becoming more frequent and indexation clauses more common in some countries. And even if expectations remain anchored for now (Graph 7, right-hand panel), they could inch up as inflation remains elevated. A warning sign is the fact that core inflation – which reflects the inflation trend – is still going up in most countries.

The second challenge is to find the optimal time to stop increasing rates. Given the amount of tightening already in the pipeline, there could be a case for central banks to pause at some point and wait for the effect of the cumulative tightening to slow inflation. Yet even if domestic conditions warrant a pause, it may be difficult to do so owing to three factors:

1. The Fed and other advanced economy central banks may continue tightening for some time. While interest rate differentials are very high, it can be difficult for Latin American central banks to decouple from the Fed and follow a different policy trajectory. Especially for countries where inflation is not (yet) on a clear path downwards, a pause could result in a loss of confidence by external and internal investors, leading to capital outflows and depreciation. That, in turn, would create inflationary pressure.

2. A possible retrenchment by global investors. The global environment is exceptionally uncertain, which contributed to the significant market volatility that we have seen in recent months. Core markets, such as US Treasuries, have become less liquid. And shifting to other markets is no solution since they are even less liquid.

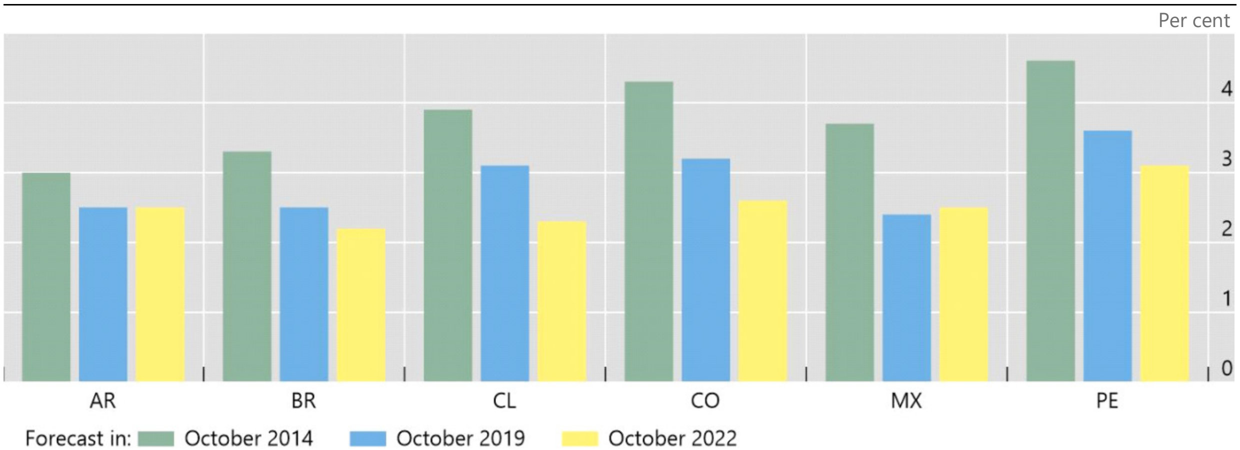
3. Uncertainty about fiscal policy and other policies may force central banks to keep rates higher than would otherwise be optimal given the path of domestic inflation.

While financial conditions in the region have already tightened, we could see even more spillovers from higher global interest rates. Moreover, this could happen even if the tightening in advanced economies is well telegraphed to the market, as it has been in recent years.

The third challenge is low growth, both cyclically and structurally. First, the post-pandemic rebound is (predictably) running out of steam, setting the scene for more normal rates of expansion. Second, financial conditions are much tighter in the wake of monetary policy tightening inside and outside the region. Third, and from a more structural perspective, there is less external stimulus given lower global growth, mainly from China. Fourth, accumulated savings, which had supported private consumption in the recovery, are exhausted in some economies, also due to pension withdrawals. Fifth, political risk in the region is likely to remain high. Long-term growth expectations for the region have fallen substantially in the wake of the pandemic and even more so since 2014 when such data became available (Graph 8).

Long-term growth forecast for 2022

Graph 8

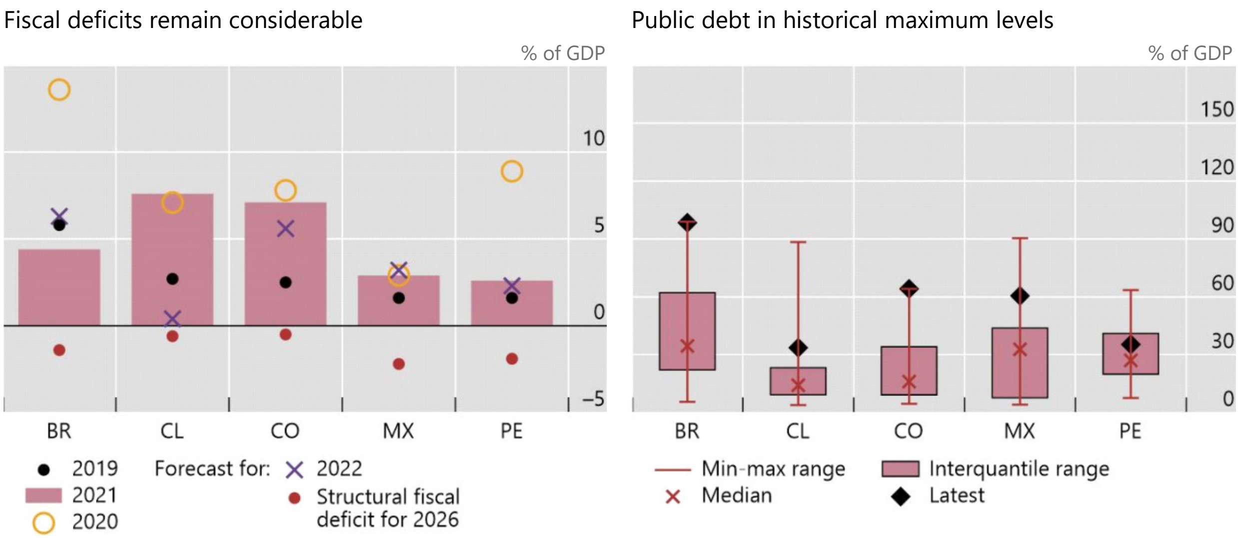


Source: Consensus Economics.

In the medium term, expected fiscal deficits and high public debt could be yet another drag on growth if they translate in higher risk premia. Structural fiscal surpluses are not expected until 2026 (Graph 9, left-hand panel), and debt is at historically high levels (right-hand panel).

Public finances could be vulnerable

Graph 9



Source: Consensus Economics; Global Financial Data; IMF, *World Economic Outlook*.

Macro-financial stability is very important, but it is not enough: the region needs new reforms to reinvigorate growth.[6] There are also factors that could support growth. First, households, firms and financial institutions appear to be in good enough shape to weather the downturn, since there are no major imbalances in the private sector and debt profiles seem generally healthy. Second, the impact of the digital revolution may translate into greater efficiency and higher productivity. More efficient payments and new digital services could be a boon to economies, and particularly to firms and households in remote areas. Of course, this requires the appropriate digital infrastructure to be in place.[7] Third, the green transition may provide growth opportunities for Latin America. Countries in the region have abundant natural resources and are well positioned to generate green assets, attract foreign investors and mobilise large volumes of financing to support the energy transition and a more sustainable future. Fourth, countries in Latin America can also benefit from geopolitical developments, as so-called "near-shoring" or "friend-shoring" could bring investment to boost production and exports to the United States and Europe.

Conclusion

Let me conclude with five takeaways.

First, countries in the region have improved their macro-financial stability frameworks, having heeded the lessons of past crises. Second, they have adapted frameworks to current challenges and used them well, including during and after the pandemic. This has anchored investors' expectations and confidence and leaves them better equipped to deal with the current episode of inflation. Third, central banks in Latin America have acted earlier than advanced economies' central banks to fight inflation. Fourth, fiscal policies have benefited from strong institutions and rules. But consolidation should not be put in doubt. Fifth, and finally, ensuring macro financial stability is not enough. It is essential for greater long-term growth but need to be coupled with growth enhancing structural reforms, to grasp the opportunities going forward.

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6 See A Carstens (2022), "A story of tailwinds and headwinds: aggregate supply and macroeconomic stabilisation", speech at the Jackson Hole Economic Symposium, 26 August.

7 See K Croxson, J Frost, L Gambacorta and T Valletti (2022), "Platform-based business models and financial inclusion: policy trade-offs and approaches", Journal of Competition Law & Economics; and E Feyen, J Frost, L Gambacorta and H Natarajan (2021), "Fintech and the digital transformation of financial services: implications for market structure and public policy", BIS Papers, no 117.