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Monetary policy and challenges for the Americas in 2024

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Introduction

First of all, I would like to thank the International Monetary Fund for the kind invitation to this Regional Conference and also to extend a special greeting to our host, Roger Madrigal. I am very honoured to share this forum with colleagues from central banks in the region and other institutions and to listen to their reflections.

These are indeed challenging times for central banking. There is great uncertainty about the challenges facing the economy as well as the appropriate policy response.

As inflation continues to decline, activity remains resilient. At the same time, the financial system appears to have adjusted smoothly to higher interest rates. The global economy, and in particular the region's economies, seem poised for a smooth landing.[2]

We must acknowledge the success of central banks globally, but especially in Latin America. They faced the largest and most sustained rise in global inflation since the 1970s. Vigorous action was taken globally. *And it worked.* In particular, the region's central banks have been strengthened by their hard work in keeping inflation in line over the past few decades, but they were aware of the risks.[3] Thus, they did not hesitate to react and decisively raise benchmark interest rates, before the rest of the world did.

Inflation has declined with little collateral damage to growth, employment or financial stability.[4] To a large extent, this was possible because of central bank credibility, which prevented a

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[1]   The views expressed in this speech are those of the author and do not necessarily represent those of the Bank for International Settlements. I thank Ana Aguilar, Alison Arnot and Jon Frost for comments, and Rafael Guerra and Pablo Tomasini for data support.

[2]   See BIS (2024).

[3]   See BIS (2021).

[4]   In this presentation I will discuss the outlook for the Americas, focusing mainly on the economies that make up the Bank for International Settlements Consultative Council for the Americas.

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price and wage spiral, as we have seen in the past, and avoided a high-inflation mindset. This greatly reduced the costs of disinflation. Had central banks not acted, we could have faced a long period of high inflation.

While these developments are welcome, *we cannot claim victory yet,* as we outlined in our recent Annual Economic Report. The last leg of the inflation decline, "the last mile", may be the most difficult to achieve.[5] Inflation is well below its peak but not yet low enough. Risks to food and energy prices due to geopolitical tensions, are ever present. High rates may still be needed for some time, testing the resilience of the economy and the financial system. And some risks are beyond the control of central banks. In many jurisdictions, unsustainable fiscal paths threaten macro-financial stability. Slow productivity growth could make the economic and political environment even more challenging. This is why monetary policy decisions will have to consider a number of risk factors.

I will discuss these in more detail here. I will first take stock of where we stand so far. I will then consider some global risks and conclude with a reflection on what monetary policy in the region can do in this context.

How far we have come

After averaging 8.7% in the region in 2022, inflation has been declining steadily over the past two years, to an average of 4.9% in December 2023 and 4.1% in June 2024, albeit with some volatility recently (Graph 1). Inflation is projected to continue to fall in 2024 and 2025, reaching levels close to the target and in some countries de facto reaching it (Graph 1.B).

I would like to highlight something that, for me, is one of the best pieces of news. At all times, inflation was expected to decline, and longer-term inflation expectations remained anchored and close to the inflation target (Graph 1.C). This reflects the fact that the public was always confident that central banks were committed to bringing inflation back to target. In countries with an inflationary history, such as many of ours, this represents success for the region's monetary policy frameworks, which has been achieved after decades of strengthening their credibility.[6] This is the first time that central banks have been able to bring inflation back to target.

That said, concerns regarding inflation remain. In many cases, core and services inflation are still above their historical averages (Graph 2.A). The strength of the labour market, and hence of wage negotiations, may also be a factor delaying achievement of inflation targets (Graph 2.B). It should be noted, however, that recent wage negotiations are taking place with inflation expectations closer to target levels.
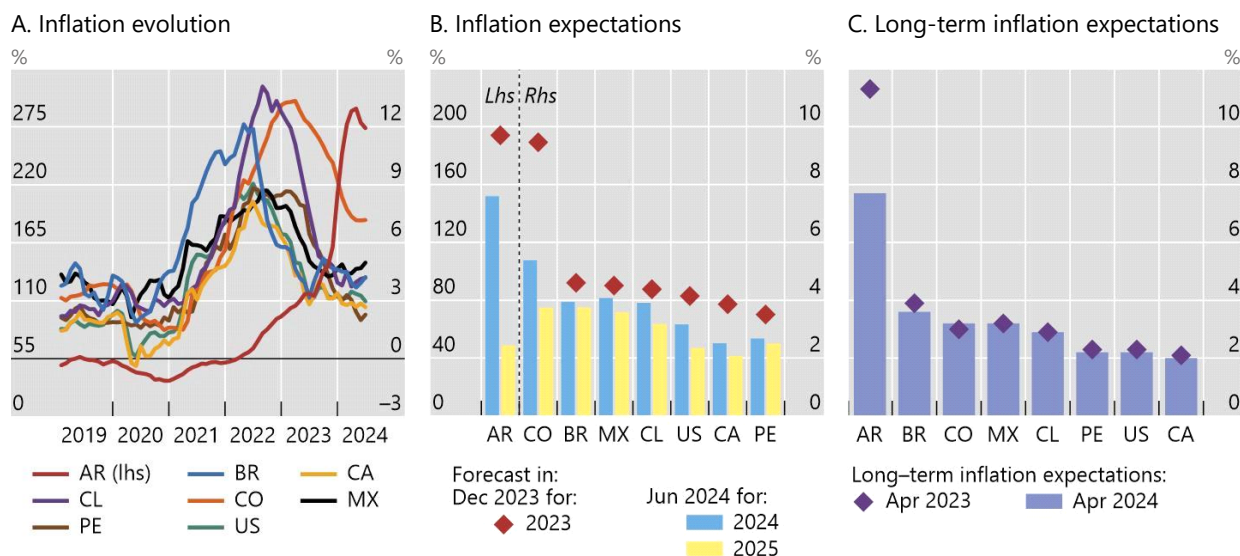
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[5]   See Carstens (2024).

[6]   See Tombini et al (2023).

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Inflation decreases and expectations are closer to the target

Graph 1

A. Inflation evolution

Legend		
AR (lhs)	BR	CA
CL	CO	MX
PE	US	

B. Inflation expectations

Forecast in:
Dec 2023 for:
◆ 2023

Jun 2024 for:
▢ 2024
▢ 2025

C. Long-term inflation expectations

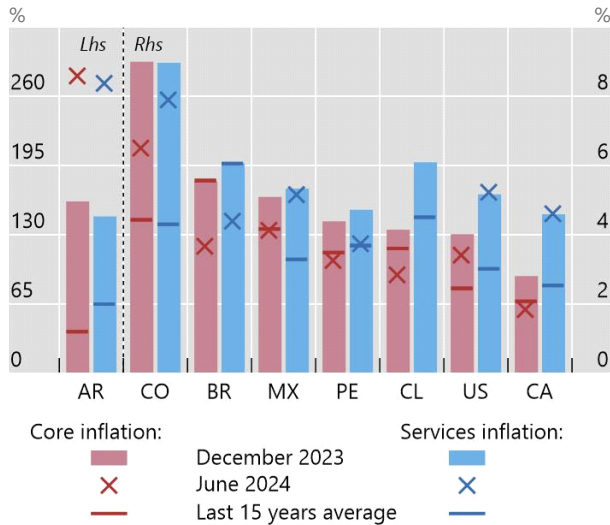Long–term inflation expectations:
◆ Apr 2023   ▪ Apr 2024

Sources: Consensus Economics; national data.

Even with tighter monetary policy, economies were resilient, with some exceptions, and most performed better than expected at the beginning of last year (Graph 3.A). Overall, growth turned out to be more resilient than expected for several reasons. First, labour markets were unusually resilient. The strength of the labour market was partly due to pandemic-induced behavioural changes, especially the strong rebound in the labour-intensive services sector. Second, the transmission of monetary policy to the real economy was smooth. Tighter conditions were gradually transmitted to real activity. And savings accumulated during the pandemic continued to strengthen household consumption.
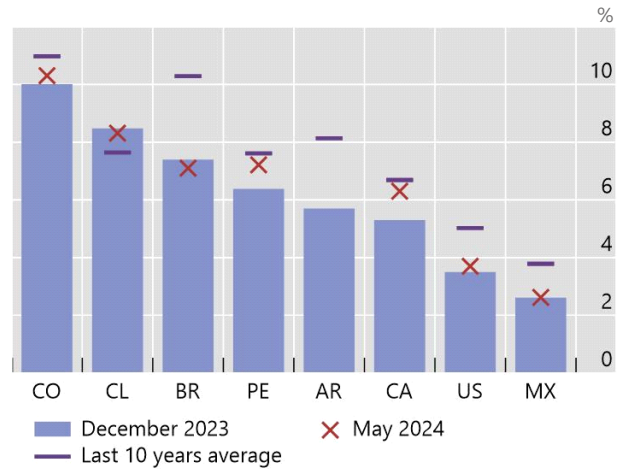
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Persistency in core inflation in the face of a strong labour markets

Graph 2

A. Inflation rates

Core inflation:
- December 2023
- × June 2024
- — Last 15 years average

Services inflation:
- December 2023
- × June 2024
- — Last 15 years average

B. Unemployment rates

- December 2023
- × May 2024
- — Last 10 years average

Source: National data.

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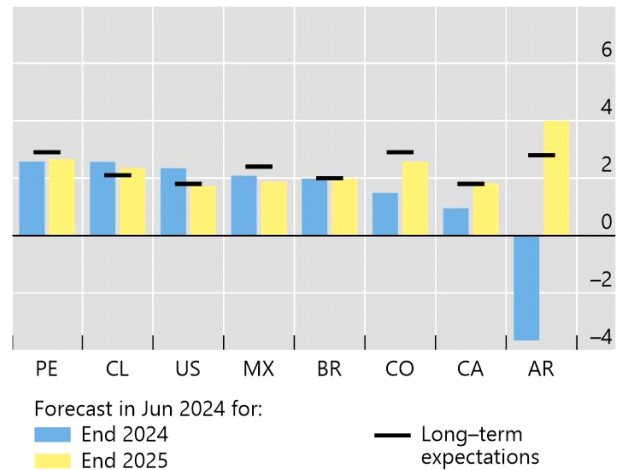## Higher than expected growth in 2023, a minor slowdown in 2024, returning to long-term levels in 2025

In per cent

Graph 3

A. GDP growth for 2022 and 2023 (observed) and expectations for 2024

Observed growth:
- 2022
- ◆ 2023

Forecast for 2024 in:
- Dec 2023
- ● Jul 2024

B. Growth expectations for 2024 and 2025 and long-term

Forecast in Jun 2024 for:
- End 2024
- End 2025
- — Long–term expectations

Sources: IMF, Consensus Economics; national data.

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Overall, performance was resilient but differed across countries. For example, for the United States, 2023 was a better year than expected at the end of 2022. However, other countries in the region experienced a slowdown in 2023 relative to 2022 (Graph 3.A). It is worth noting that, in contrast to previous episodes of global monetary tightening, emerging market economies performed better, thanks to stronger policy frameworks and robust domestic financial systems.

After lowering interest rates sharply in response to the pandemic in 2020, all central banks in the region started to raise benchmark rates in 2021, in the face of the imminent rise in inflation (Graph 4.A). This globally synchronised monetary tightening cycle led to tight financial conditions not seen for many years. For example, the ex ante real rate, which is adjusted for inflation expectations, reached levels above the estimated neutral, or natural, rate (Graph 4.B). As monetary policy tightening was broad-based, this helped to contain global demand and thus lower commodity prices. Rates are expected to decline gradually in 2024 and 2025 (Graph 4.C).

Monetary tightening withdrawal has been implemented in 2024 expected to continue in 2025

Graph 4

A. Monetary policy rates[1]   B. Ex ante real policy rates[2]   C. Interest rates
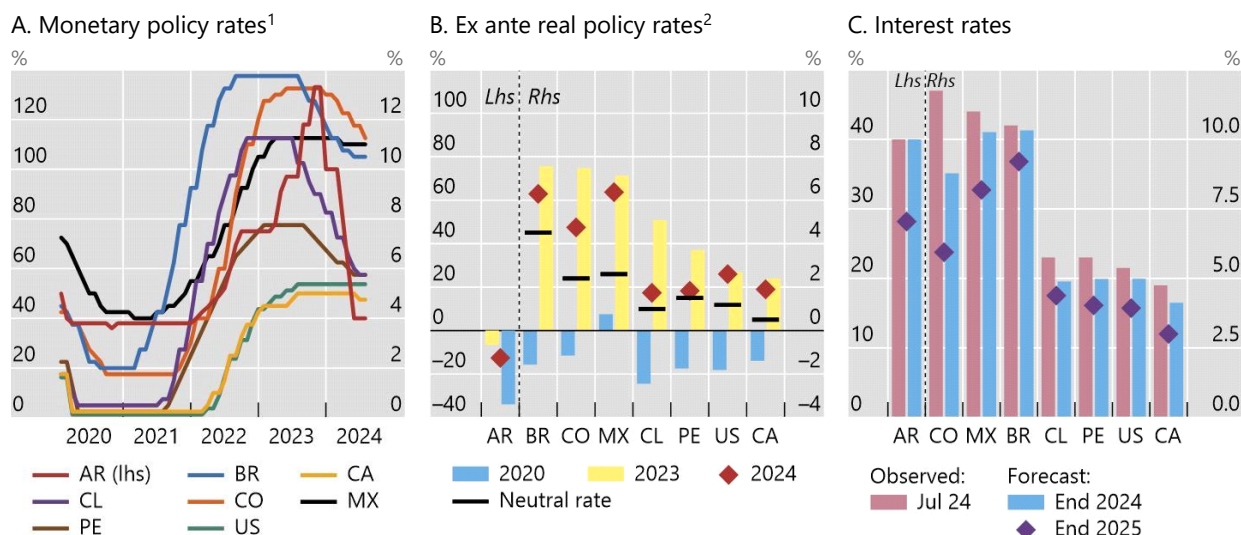
[1] Interest rate at the end of the month.   [2] Ex ante real interest rate is calculated from the relationship $1 + r_{ex-ante,t} = \frac{1+i_t^{policy-rate}}{1+E_t[\pi_{t+12}]}$, where the policy rate is end of month. Expected 12-month ahead inflation in month t is proxied by a weighted average of Consensus forecasts for the current and the next year's inflation available at t.

Sources: Bloomberg; Consensus Economics; national data; BIS.

Global financial markets have taken the higher interest rates in stride. For emerging market financial markets, this was partly due to high interest rate differentials vis-à-vis advanced economies, mainly the United States (Graph 5.A). There were no abrupt outflows of capital and no large or sudden increases in risk premia, except for a few bouts of volatility (Graph 5.B). Moreover, exchange rates remained stable and even appreciated in some currencies in 2023, although with some volatility (Graph
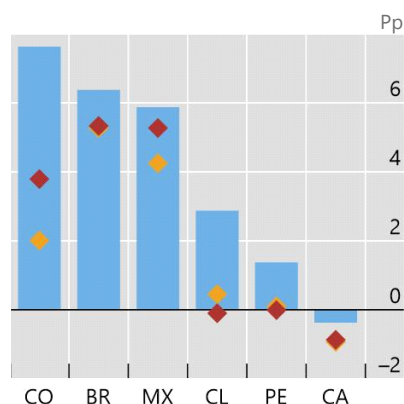
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5.C). It is worth noting the maturity and depth that these financial markets in several emerging economies have reached.[7]

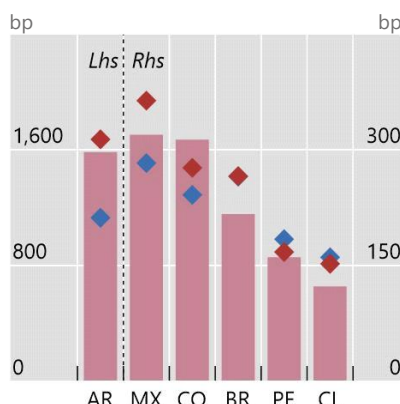Financial markets have properly assimilated higher interest rates   Graph 5
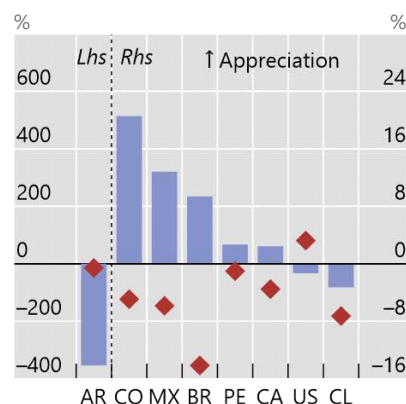
A. Policy rate differentials with Federal Reserve rate[1]

B. Risk premia[2]

C. Exchange rates vs USD[3]

A. Pp axis: 6, 4, 2, 0, −2. Categories: CO, BR, MX, CL, PE, CA.
Monetary policy rates differential: ■ 2023 ◆ 2024 ◆ 2025

B. Lhs (bp): 1,600, 800, 0. Rhs (bp): 300, 150, 0. Categories: AR, MX, CO, BR, PE, CL.
■ July 2024 ◆ Last 15 years average ◆ Last 5 years average

C. Lhs (%): 600, 400, 200, 0, −200, −400. Rhs (%): 24, 16, 8, 0, −8, −16. ↑ Appreciation. Categories: AR, CO, MX, BR, PE, CA, US, CL.
Appreciation rate during: ■ 2023 ◆ 2024

[1] Bloomberg forecast of expected rates for 2024 and 2025 up to 22 Jul 2024.   [2] Emerging Markets Bonds Index benchmark index that measures the spread between the yield on emerging market bonds and US treasury bonds.   [3] Bilateral exchange rate to USD. For US, BIS dollar broad index. Exchange rates up to 19 Jul 2024.

Sources: Bloomberg; JP Morgan; national data; BIS.

Currently, monetary policies have diverged. This was expected. The common supply shocks as well as commodity prices that led almost all central banks to tighten monetary policy have started to ease. This leaves domestic and country-specific price movements as the main drivers of inflation.

Global macroeconomic challenges for 2024–25

Overall, things have been going well in terms of inflation, growth and monetary tightening. There have been no major disruptions in these areas or in the financial and banking sectors. However, the expectation of a near-perfect scenario that financial markets seem to have is subject to a number of risks.

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[7]   See Tombini (2023a) and Doornik et al (2024).

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Four risks seem to me to be most pressing. These include macro-financial vulnerabilities, fiscal consolidation, limited room for manoeuvre for central banks and low productivity growth.

First are adverse macro-financial developments.[8] With high debt levels and depleted savings buffers, household and corporate balance sheets could be impacted by the cumulative effect of monetary tightening. The commercial real estate sector faces structural and cyclical challenges that could expose vulnerabilities in the financial system. In addition, asset valuations are under pressure and the credit cycle could amplify any emerging financial stress. We are still in the early stages of this process.

In emerging market economies, an increase in risk premia or currency depreciation is possible. One of the main risks in the region is divergence between monetary cycles in the process of lowering rates. This could generate volatility, higher risk premiums, possible capital outflows and exchange rate depreciations.[9]
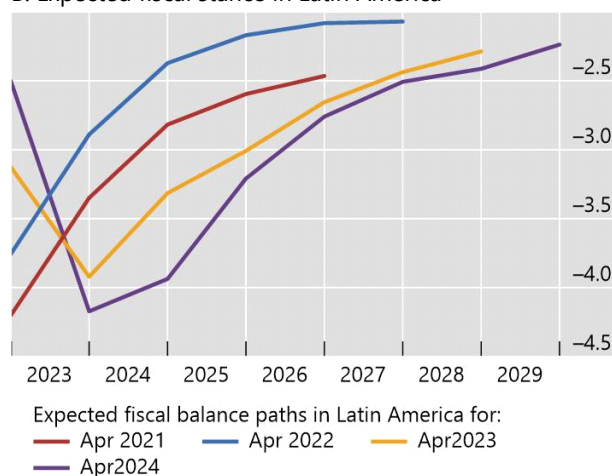

Fiscal policy remains expansive

As a percentage of GDP   Graph 6

A. Fiscal balance
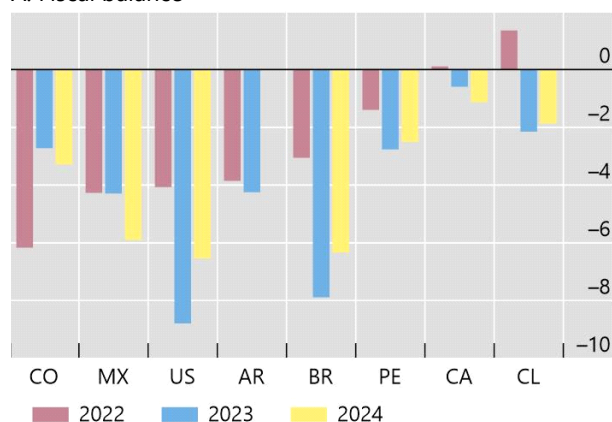
B. Expected fiscal stance in Latin America

Expected fiscal balance paths in Latin America for:
— Apr 2021   — Apr 2022   — Apr2023
— Apr2024

Source: IMF.

Second are fiscal positions. The overall fiscal outlook is even more worrying. High fiscal deficits, and even deteriorating fiscal deficits in some countries, work in the opposite direction to a still-

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8   See BIS (2024).

9   See Aguilar et al (2023).

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restrictive monetary policy that seeks to cool the economy and balance aggregate supply and demand in order to reduce inflation (Graph 6).[10] All this leads to an absorption of financial resources in times of tight global and local financial conditions, even leading to a crowding out of investment. Thus, the fiscal stance can hinder the work of monetary policy, delaying the progress made and increasing the length of time necessary to maintain a tight monetary stance. Costa Rica and its recent fiscal consolidation are a good exception to this trend.

Third, central banks have no room to let additional inflation shocks pass through, even if these shocks are supply-side and transitory. After a few years with the highest inflation in decades, the price level is high and there are fears that, given the strength of the labour market, wages will gradually try to compensate for lost purchasing power, causing further stickiness in inflation. Given this, additional shocks that divert inflation away from its convergence to the target will most likely have to be countered with monetary policy.

Fourth, productivity growth is key to sustained economic growth driven by the supply side. Before the Covid-19 pandemic, there was a prolonged period of low productivity growth. Growth in 2023 was even lower in many countries (Graph 7.A). Expectations for long-term growth are lower than in 2019, except in the United States (Graph 7.B). But it is not all bad news. Recent technological advances, including artificial intelligence, raise the possibility of a resurgence of high productivity growth in the coming years. But there is no guarantee of this. High productivity growth will happen only if the right institutional frameworks are put in place and the right policy measures are implemented.
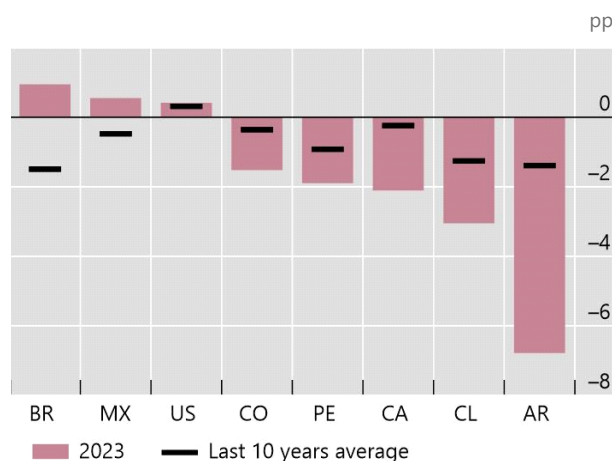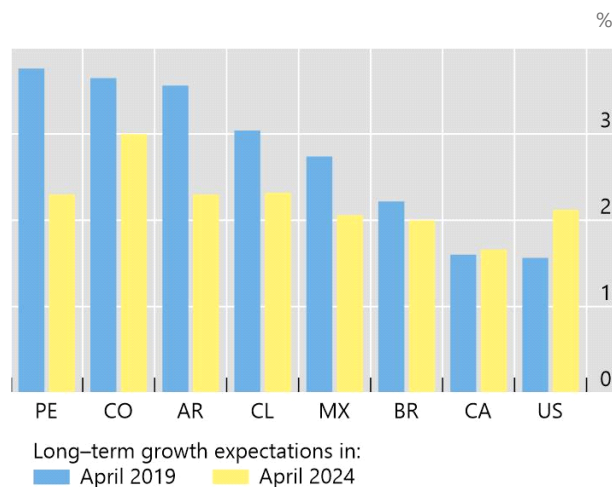
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[10]   Borio et al (2023).

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Concerns about productivity and long-term growth
Graph 7

A. Growth in productivity

pp

B. Change in long-term growth expectations

%

Fuentes: Conference Board; IMF; World Economic Outlook; BIS.

In this respect, the growing trend towards protectionist measures is a major concern, as it makes economies less dynamic, innovative and competitive. It exposes them to inflation in the short run, as they cannot take advantage of agile supply chains abroad to cushion changes in domestic aggregate demand. And, in the end, it makes them poorer in the long run.

What can monetary policy in the region do in this complex environment?

There is no doubt that the priority for monetary policy today is to restore price stability. This requires standing firm in the last stage of the disinflation process. It means being alert to setbacks and being prepared to tighten monetary policy again if necessary.

Currently there is a high degree of uncertainty about monetary policy. While the direction we are heading in is clear – rate cuts in most economies – how fast we will move and how far we will go, ie the terminal interest rate, are unknowns that monetary authorities will have to work out along the way.

Thus, in each decision, central banks will have to assess the various iterations that could play a role in the economy, an assessment that has been difficult since the pandemic.

To conclude, I would like to highlight **fourth** elements that I believe increase uncertainty in monetary policy decision-making now.

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First is difficulty in reading the economy. The increase in inflation came as a surprise to various observers of the economy. At first it was not possible to identify whether the rise was a temporary or a more persistent phenomenon. Economic models were put to the test and generally failed. Also, when tight monetary cycles started, a significant decline in growth was anticipated which did not materialise.

Second, given the changes in the economy, it has been difficult to assess the transmission mechanism of monetary policy, the relative strength of its channels and the time it takes for monetary policy to have an effect. This is compounded by the fact that firms and households refinanced debt at very low interest rates, so the transmission of higher interest rates was not as immediate. Thus, even now, it is difficult to assess how much monetary tightening is still in the economic pipeline, given that monetary policy operates with lags, and therefore how fast or how far to lower rates.

Third, the period of "easy" disinflation was the first in which the supply shocks that had affected inflation unwound (the disruption in global supply chains and commodity prices due to geopolitical problems). However, the latest phase of declining inflation involves more structural changes in inflation, such as much more downwardly resilient core and especially services inflation, as I mentioned earlier. In addition, in terms of aspects beyond the business cycle, there are more structural factors affecting inflation in the medium term, such as climate change, adjustments in international trade policy and geopolitical tensions.

Fourth, another big unknown is the level of the neutral, or natural, rate (r-star). This is an important benchmark for the terminal rate. Several factors influence r-star, such as demographics, productivity, inequality, ie those that influence the demand and supply of loanable funds in the long run.[11] In this case, I would like to mention one that increases r-star in the recent environment. I refer to fiscal policy, because fiscal deficits absorb financial resources and reduce aggregate savings and possibly crowd out aggregate investment. Also, high public debt constantly needs loanable funds for rollover, and investors demand a higher return to keep assets safe. In addition, in emerging economies all this implies higher sovereign risk premia, which could also affect the return demanded on safe assets offered by the government, increasing r-star.

Central banks' communication with the public will be crucial in this process of withdrawal from monetary tightening. The success achieved so far is very valuable, but we cannot let our guard down and run the risk of excessive monetary easing. Price stability remains the priority, and circumstances require central banks to be ready to take action.

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[11]   See Benigno et al (2024).

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