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Alexandre Tombini: Almost there – navigating the last mile of disinflation in Latin America

Speech delivered at the Market News International, MNI, 28 October 2024

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Introduction

First of all, let me thank Bill White and MNI (Market News International) for the kind invitation to this dialogue. I look forward to a fruitful exchange of ideas.

The past few years have been challenging for central bankers. The lockdowns and freeze in global capital markets during the Covid-19 pandemic required unprecedented and bold policy actions. The good news is that the economy recovered more quickly than expected. The bad news is that inflation rose to levels not seen in decades. Central banks around the globe reacted by raising policy rates. They have been successful. As you can see in Graph 1.A, inflation has been declining for some years. Graph 1.B shows that analysts expect disinflation to continue in the coming years.

Overall, central banks have navigated the multiple challenges well, and I believe they will continue to do so as we move towards the final stage of disinflation.

In most countries, inflation fell without the economy falling into recession. The decisive, forceful and, in Latin America at least, timely tightening of monetary policy has kept long-term inflation expectations anchored – as you can see in Graph 1.C. In other words, the public was always confident that central banks were committed to bringing inflation back to target. In countries with an inflationary history, like many in Latin America, this represents a success for the region's monetary policy frameworks, achieved after decades of strengthening credibility. This has helped avoid a price and wage spiral similar to those experienced during previous episodes.[1] Moreover, unlike in many episodes of the 1980s and 1990s, there has been no financial or banking crisis.

However, we cannot claim victory yet. The last stretch of convergence to the inflation target, "the last mile", may be the hardest of all. Reducing inflation must remain the priority objective. While the challenges in this final phase are notable, I am hopeful that central banks are on the right path to bringing inflation down to target. I will talk about this next.

In the remainder of my talk, let me discuss the challenges during this last mile in more detail. I will mainly focus on the larger Latin American economies, ie Brazil, Colombia, Chile, Mexico and Peru. I will not discuss the case of Argentina, which is very specific. That said, let me note that inflation in Argentina has also been declining rapidly, even though the levels are quite different than in the other economies.

Let me start with the first phase of disinflation, which has been much less painful than many observers had expected. I will then turn to the role of monetary policy in this final stretch in the

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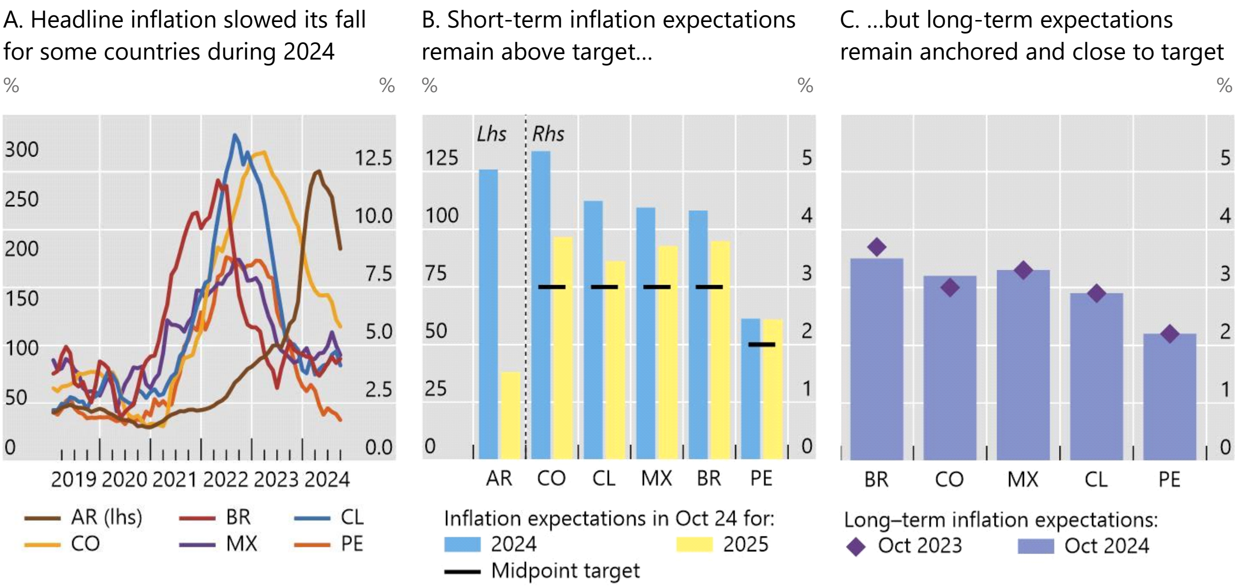
[1] BIS (2024).

fight against inflation and conclude with my reasons for being hopeful about achieving the inflation targets.

Inflation is falling and expectations are approaching the targets — Graph 1



Sources: Consensus Economics; national data.

The first phase of disinflation

Inflation in the five large Latin American economies has fallen significantly from a peak of 9% in 2022 to 4% in less than two years. Analysts project further declines in 2024 and 2025. In Peru, inflation is already at target. In the remaining countries, analysts expect it to reach target by 2026.

The decline in inflation is the result of a series of factors.

The first was the dissipation of many of the shocks that had pushed up inflation in the first place. These include the supply disruptions during and after the pandemic, the rise in commodity prices after the Russian invasion of Ukraine and the demand rotation from services to goods and then back to services after the lifting of lockdowns.

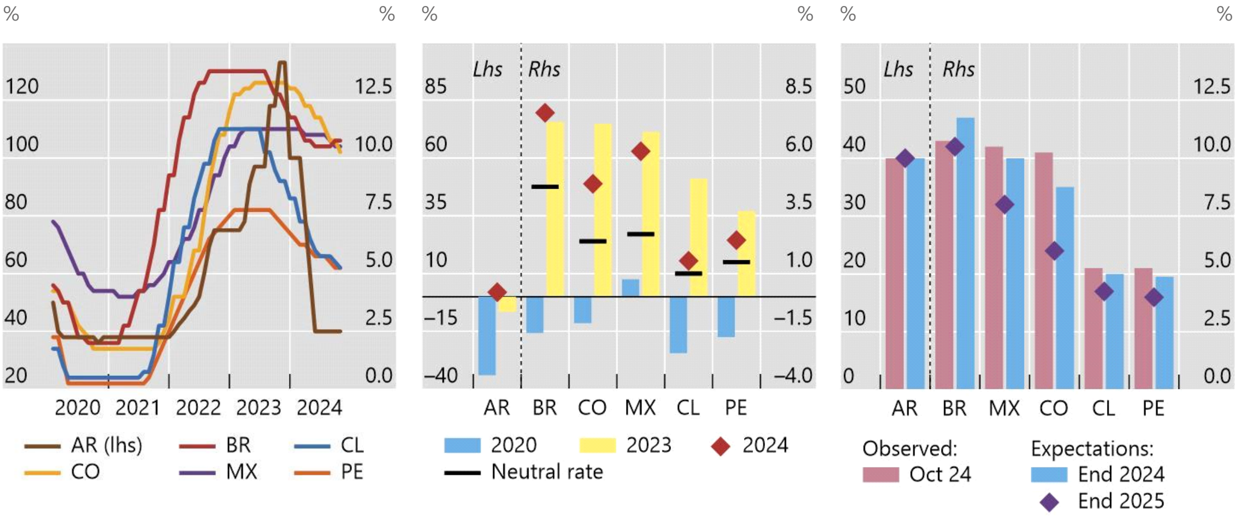
The second was the policy response. As you can see in Graph 2.A, during the initial stages of the pandemic, Latin American central banks reduced interest rates to record lows in order to weaken the blow to the economy. However, when prices started to go up in 2021, they reversed course and swiftly began to increase policy rates, well ahead of almost all of their peers around the globe. The Central Bank of Brazil began raising rates as early as March 2021, followed by those of Mexico in June, Chile in July, Peru in August and Colombia in September. Policy rates in those five Latin American economies increased by close to 10 percentage points on average, bringing them to a peak of 11.5%. As you can see in Graph 2.B, this pushed ex ante real interest rates above central banks' estimates of the neutral interest rate, indicating that monetary policy was well in restrictive territory. Most central banks are now expected to ease slightly through the end of 2025, as seen in Graph 2.C.

Monetary easing is expected to continue during 2024 and 2025 in most countries — Graph 2

A. Monetary policy rates have continued easing during 2024…[1]

B. …but are still above neutral real rate estimates…[2]

C. …and are expected to keep easing during 2025



[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-months-ahead inflation in month *t* is proxied by a weighted average of Consensus Economics forecasts for the current and the next year inflation available at *t*.

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

Why did central banks in Latin America act earlier than their global peers? I believe that the answer is quite easy: they simply did not have the luxury of waiting to confirm whether or not inflationary pressures were transitory. They had to respond to rising inflation by hiking rates early and significantly, which is what they did.

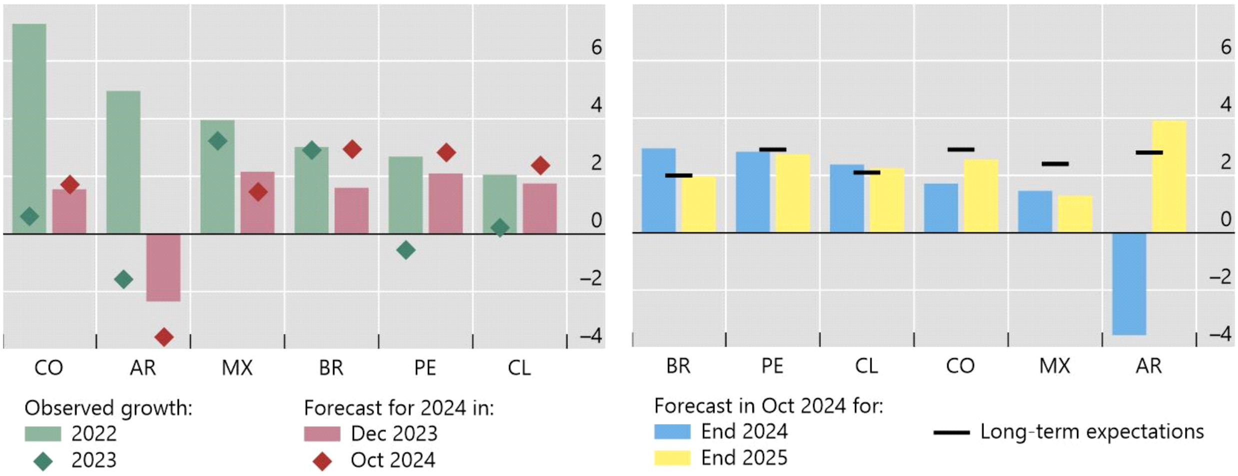
What is truly stunning is that the first phase of disinflation has not been accompanied by a contraction in output or financial stress. Of course, this is not only the case in Latin America. After many years of discussing whether the US economy would experience a hard or a soft landing, the truly remarkable thing is that it didn't land at all, at least not so far.

Economic activity remained surprisingly resilient in most Latin American economies. Graph 3.A shows that of the five countries, only Peru experienced a contraction. Other economies vastly outperformed expectations. In most countries, this can be explained by resilient consumption, which in turn reflects robust labour markets and savings accumulated during the pandemic. Analysts expect this growth to continue during 2024 and 2025.

Growth remains resilient

In per cent — Graph 3

A. Growth forecasts have been revised up during 2024... B. ...and are moderate for 2025



Sources: Consensus Economics; IMF; national data.

Financial markets in Latin America also weathered the rise in interest rates quite well. Market rates generally followed policy rates, at least at the short end of the curve. At the long end, risk premia remained contained, as seen in the Graph 4.A. This is due not least to the high interest rate differentials compared with advanced economies, seen in Graph 4.B. Exchange rates had appreciated in many countries in 2023 and saw a correction in 2024, meaning that they have been at roughly stable levels over the two years as a whole, as seen in Graph 4.C.

Finally, the banking sector in Latin American countries has proved to be stable. This is a welcome departure from the past, when external shocks regularly resulted in financial instability, with great economic and social costs. Defaults have been contained, at least on average, and the banking sector remains well capitalised and liquid. The anticipated deterioration in the creditworthiness of borrowers after the lifting of emergency support measures did not materialise or was mild. With a few exceptions, the share of non-performing loans remains low by historical standards.

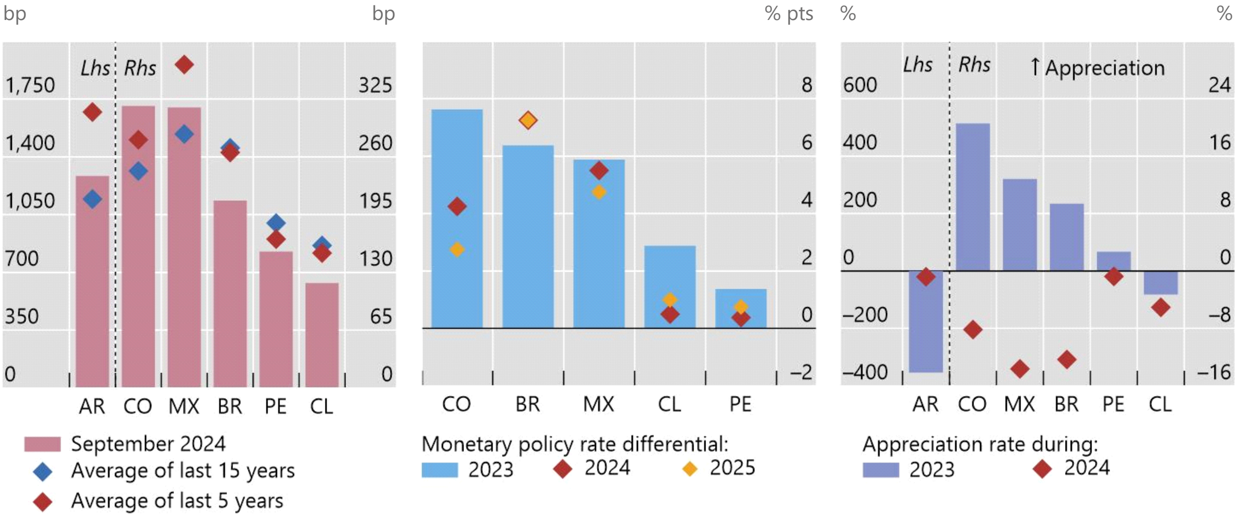
One reason for the strength is that households and businesses entered the monetary policy tightening with robust balance sheets. The stimulus in the wake of the pandemic allowed them to repay debt and increase their precautionary savings. Many also used the low interest rates during the pandemic to refinance debt at very low rates. Last but not least, high employment also provided a buffer.

Financial markets have properly assimilated higher interest rates — Graph 4

A. For most countries, risk premia are lower than in past years[1]

B. Policy rate differentials with the US remain sizable in most coutries[2]

C. Latin American currencies appreciated in 2023, but have depreciated over 2024[3]



[1] The Emerging Markets Bonds Index is a benchmark index that measures the spread between the yield on emerging market bonds and US Treasury bonds. [2] Bloomberg forecast for expected rates for 2024 and 2025 up to 8 October 2024. [3] Bilateral exchange rate to the US dollar.

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

In addition, banks have more capital than in the past and enjoy abundant liquidity. Together with high margins on some loans, this provides a sizeable buffer against deteriorating credit quality.

Even so, the big question remains whether this benign outlook will persist with rates above pre-pandemic levels for a prolonged period. At some point, rising credit losses may erode reserves and make the financial system more susceptible to future shocks.

Will the last mile be more difficult?

Inflation in all major economies of Latin America has declined significantly over the past two years. This has allowed central banks to cut interest rates. Even so, the monetary policy stance remains restrictive, as interest rates in 2024 are likely to remain above central banks' neutral rates. It is too early to declare victory. Inflation is *close to* but not yet *at* target in most countries. In some, we have even seen a rebound in inflation.

The last mile is likely to be quite different from the first stage of disinflation.

First, the dissipation of transitory factors and base effects play a much smaller role than in 2023.

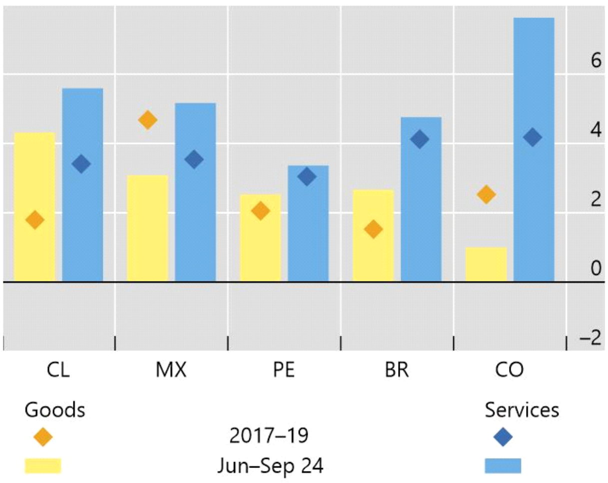
Second, the focus of inflation has shifted from goods to services. Graph 5.A shows that services prices have risen at a rate persistently above the target and, in most economies, above their pre-pandemic trend.

Third, wages could play a much greater role. The inflation of recent years provoked an erosion of workers' purchasing power. One would expect them to strike a hard bargain to bring real wages back to pre-pandemic levels. In several countries of Latin America, minimum wages play an important role, especially in services prices. This is because services tend to have a higher labour content than goods. Graph 5.B shows that wages have indeed caught up with or surpassed inflation in most countries of the region. The question is whether this will push up inflation. The historical record suggests that this need not be the case. BIS estimates show that the transmission from wages to prices has traditionally been less pronounced than that from prices to wages.[2]

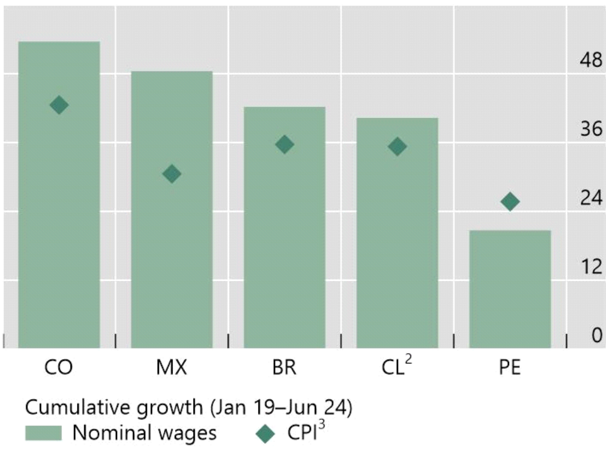
Services inflation is under pressure from resilient output growth and wages

In per cent — Graph 5

A. Services inflation is higher than before the pandemic and higher than goods inflation



B. Most wages in Latin America have grown faster than inflation[1]



[1] For BR, nominal effective earnings; for CL and CO, nominal wage index, retail commerce; for MX, average daily wage; for PE, monthly wage; [2] For CL, data up to Mar 2024. [3] Consumer Price Index (CPI)

Sources: LSEG Datastream; national data; BIS.

Fourth, in many countries expansionary fiscal policy is working at cross purposes with restrictive monetary policy. It is as if you were driving with one foot on the accelerator and one on the brake, which is usually not very effective. Graph 6.A shows that fiscal consolidation gets pushed back. As seen in Graph 6.B, cyclically adjusted fiscal balances in 2024 are similar or larger than in 2010–19, suggesting that fiscal policy is expansionary – even as monetary policy is contractionary.

[2] Caballero et al (2023).

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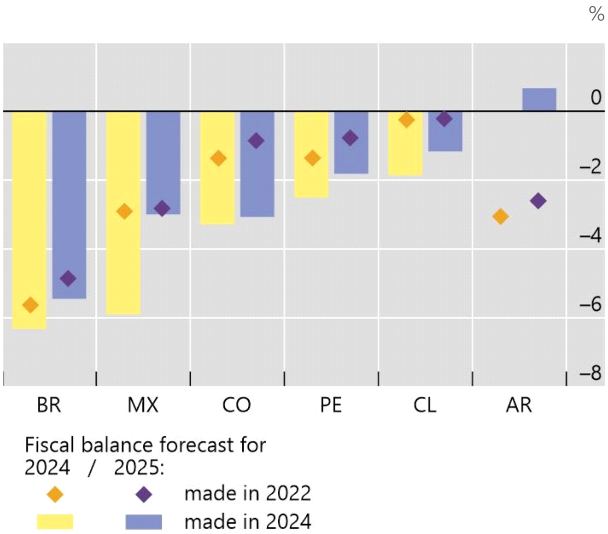
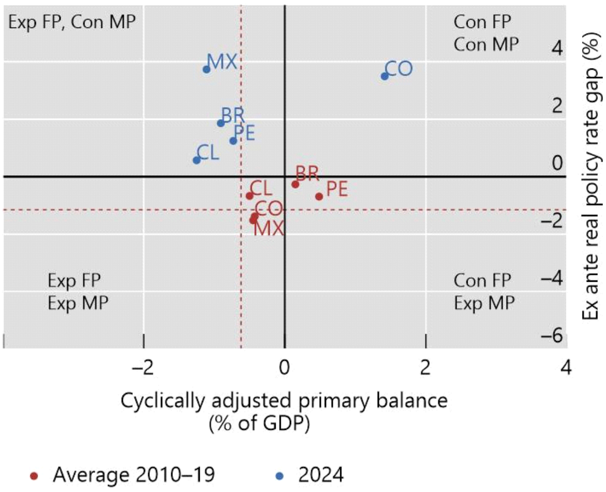
Fiscal and monetary policy may be working at cross purposes — Graph 6

A. Fiscal consolidation keeps getting pushed back

B. While monetary policy is tight, the fiscal stance is still loose[1]





[1] Con = contractionary; Exp = expansionary; FP = fiscal policy; MP = monetary policy. Ex ante real rates minus latest release of neutral rate reported for each central bank. Cyclically adjusted primary balances are sourced from the International Monetary Fund (IMF).

Sources: Consensus Economics; IMF; national data.

Fifth, the drivers of inflation have changed. Global factors have lost importance and have been replaced by domestic factors as the main drivers of inflation. Using principal component analysis, we can decompose headline inflation into a global factor representing the co-movement of inflation across countries and domestic factors that explains the remaining variation. The global factor, shown in Graph 7.A, explains most of the rise and fall in inflation until early 2023. Since then, however, domestic drivers have taken the front seat, as shown in Graph 7.B. The greater importance of the domestic factors reflects a greater dispersion among countries in the amount of slack in the economy and labour market conditions.

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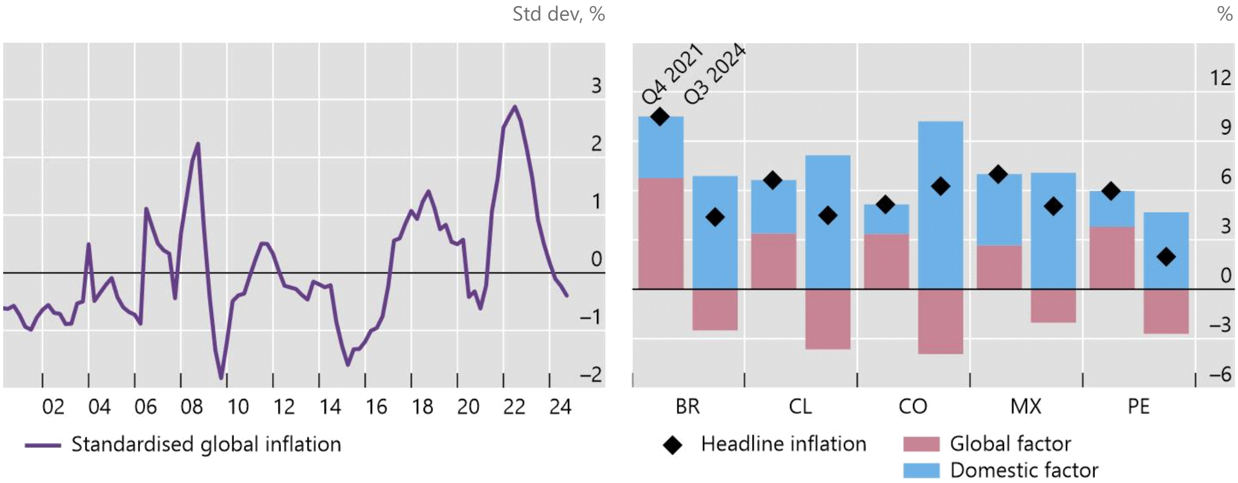
Domestic factors increasingly drive inflation dynamics[1] Graph 7

A. Global inflation receded after reaching a high in 2022

B. While domestic factors gain momentum, global factor now lowers headline inflation



[1] Estimations based on Aguilar et al (2024).

Sources: Aguilar et al (2024); BIS.

The growing importance of domestic conditions may complicate disinflation, owing to their effect on inflation expectations. A recent study by colleagues at the BIS shows that inflation with a large domestic component has a larger impact on both short- and long-term inflation expectations than inflation driven mainly by global factors.[3]

Monetary policy in the final stretch

As mentioned before, monetary policy in most of Latin America remains restrictive, despite the sharp rate cuts over the last year and half. Ex ante real interest rates are positive and above central banks' estimates of the neutral rate. In most countries the pace of the reduction in rates is slowing. A few of weeks ago, the Central Bank of Brazil even increased its policy rate in response to rising inflation. This probably reflects the central banks' reluctance to declare victory before inflation has squarely returned to target.

The last mile of disinflation is likely to be a bumpy one and no easier to navigate than the previous ones. I would like to highlight potential reasons for this.

First of all, policies are diverging more across countries, which can lead to turbulence in financial markets. The carry trade unwinding of early August is a case in point. The decline in the rate differentials between investment currencies such as the US dollar, Brazilian real and Mexican peso and funding currencies such as the yen, combined with a sharp increase in market volatility, led to an unwinding of carry trades with global repercussions. Fortunately, the turbulence in early August

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[3] Aguilar et al (2024).

turned out to be short-lived and, as importantly, ended without any need for direct public intervention. But there is no guarantee that something similar will not happen again in the period ahead.

Second, monetary policy is becoming more data dependent as policy rates approach their neutral level and the future path of interest rates becomes less clear. Data dependency is not a bad thing per se, but it can result in volatility if markets become oversensitive to new data. The responses of market expectations to recent data releases, such as the US job report, suggest an exaggerated interpretation by market participants of what data dependency actually means. Central banks are always data dependent. They set policy in line with their outlook for growth and inflation, which obviously depends on incoming data. It is worth stressing that this outlook depends on a large amount of data, not just individual data points like the monthly job report. Market participants would do well to bear this in mind.

The third factor that could lead to bumps is fiscal policy. I already mentioned that fiscal and monetary policy work at cross purposes. With fiscal balances stretched in most economies, markets are very sensitive to any news on the fiscal outlook. There is evidence that Latin American bond yields are highly responsive to fiscal news. Globally, a 1 percentage point deterioration in the primary surplus (in terms of GDP) is associated with a 4.5 basis point increase in 10-year sovereign yields. In Latin America this effect is 14 basis points.

A fourth factor is financial vulnerabilities. Let me highlight a few. Household debt is at historical highs in some economies. Although the high margins charged by many lenders may mean that a significant increase in defaults is required to jeopardise financial stability, high household debt can still have macroeconomic repercussions by depressing consumption and economic activity. While this would lower inflation, it also increases the risk of a hard landing.

Firms may also face a refinancing challenge. Graph 8 shows that many loans taken out at low interest rates during the pandemic will need refinancing in the coming years. This should not be a problem unless interest rates do not decrease as quickly as anticipated or if interest rates remain high in the post-pandemic new normal. This will lead to higher debt service costs and fewer resources for households and businesses. Last but not least, public debt remains very high in most Latin American economies. Given the crucial role of government securities in the financial system, increases in risk premia can permeate the system and raise financial stability concerns.

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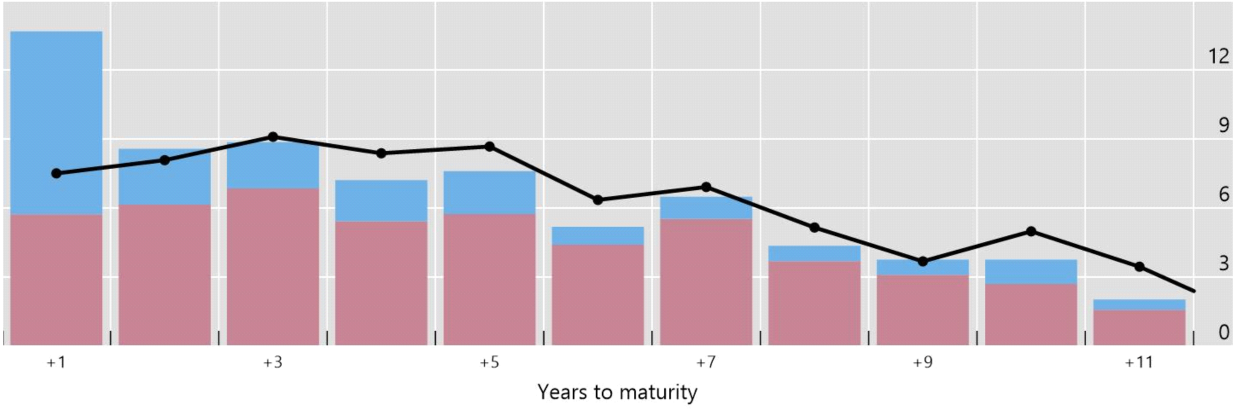
Latin American companies' debt structure by type of borrowing[1]

As percentage of total debt

Graph 8



[1] Debt maturing over the next year (+1), in one to two years (+2) etc across a sample of listed firms in the region, relative to total debt (with a maturity date) of firms with data available in both years. For 2024, debt structure as of latest available quarter per company; Q4 for 2019. Latin America = AR, BR, CL, CO, MX and PE. [2] Includes term loans, revolving credit, capital leases, commercial paper, preferred trust and other borrowing.

Sources: Capital IQ; BIS.

A fifth factor is external shocks. While Latin American economies are much less vulnerable to such shocks today than in many periods in the past, the global landscape is very complex. Geopolitical risk is exceedingly high.

Finally, as usual there could be new shocks. Navigating these could be quite challenging. With inflation still a recent memory and prices at unprecedented levels, there is understandably little tolerance for further price increases. Therefore, central banks need to proceed cautiously.

In this environment, communication between central banks and the public will be crucial. The success achieved so far is very valuable; we cannot let our guard down and risk excessive monetary easing. The priority remains price stability.

Conclusion

We are entering the last lap in the fight against inflation. This last lap will be bumpy. But central banks in Latin America shall be able to navigate these bumps and bring inflation back to target while ensuring a soft landing in real activity.

Why am I cautiously optimistic?

- The first reason is the sound policy frameworks and credibility of central banks. Monetary policy frameworks have passed their test. Central banks delivered the price stability that is at the core of their mandates. They have shown that they have the tools, analytical capacity and, no less important, the will to fulfil their objectives.

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- The second reason is the much stronger financial systems today than in the past, which are underappreciated until they stop holding. The financial crises that plagued Latin America for decades are history, and its banks in particular have much higher capital and liquidity buffers than in the past.

Thank you very much for your attention.

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