ECONOMICS: LATIN AMERICA PERSPECTIVES

LATIN AMERICA: THE MANY FLAVORS OF MONETARY POLICY

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One thing Latin American countries will have in common this year is subpar growth. That means regional central banks will probably keep monetary policy loose even as they monitor exchange-rate developments. But all monetary policies aren't alike, and we expect a rich variety of possible policy rate moves in 2015.

Slow Growth on the Horizon

Latin American economies have a tough year ahead of them. The drop in commodity prices has reduced national incomes, put pressure on fiscal accounts and discouraged investment. We expect the region's gross domestic product (GDP) to expand by no more than 1% this year on a weighted-average basis—a pace similar to that seen in 2014. Worse yet, risks to this forecast are weighted to the downside. Brazil's contraction could be even worse than expected if water and electricity shortages occur.

According to our calculations, Latin America's potential growth rate is at least twice as high as our forecast. That adds up to a negative output gap—even when taking into consideration the lower rate of trend growth caused by lower raw materials prices. In most countries, this should result in soft demand and limited pressure on prices. (Argentina and Venezuela are exceptions—both are facing high inflation.)

This should keep core inflation rates in the region in check. In fact, even headline inflation, which includes energy and food costs, should be modest, thanks to lower domestic gasoline prices. Weak demand dynamics around the region should also limit the pass-through from currency depreciation to domestic prices. This backdrop suggests that regional central banks are likely to maintain a fairly accommodative stance, at least until the US Federal Reserve launches its own tightening exercise.

Latin American central banks aren't the only ones embracing monetary accommodation. So far this year, 18 central banks across the globe have relaxed their monetary policies either by lowering reference rates or by introducing quantitative easing in response to subdued growth (***Display 1***). These moves also provide additional room for maneuver once the Fed lifts interest rates, although the minutes from the Fed's last monetary policy meeting suggest that may not happen until the second half of the year.

Brazil: The Regional Outlier

In Latin America, however, some differences have started to appear among countries. Brazil is the clear outlier. Monetary policy there has run counter to the regional norm this year. The start of a new presidential term and the arrival of a more orthodox economic team have resulted in tighter fiscal and monetary policies despite lackluster economic activity. This policy restraint is needed to rein in inflation and prevent further deterioration of Brazil's public debt ratios. The central bank resumed hiking rates just after the presidential election in October and has since pushed up policy rates by 125 basis points (***Display 2, next page***).

We think this tighter policy will lead to a decline in inflation rates, especially since Brazil's GDP is likely to contract this year. Therefore, we cannot rule out the possibili-

Display 1
Monetary Accommodation Galore

Central Banks That Have Relaxed Monetary Conditions So Far in 2015	
Albania	Pakistan
Australia	Peru
Canada	Romania
China	Russia
Denmark	Singapore
Egypt	Sweden
European Central Bank	Switzerland
India	Turkey
Indonesia	Uzbekistan

As of February 18, 2015
Source: Bloomberg

ty that the central bank will start to reduce rates toward the end of 2015.

Mexico Starts to Talk Tough

Mexico's central bank, meanwhile, has started to strike a more hawkish note in its communications. Since surprising the market with a rate cut last June, Banco de Mexico (Banxico) has remained neutral, maintaining its target funding rate at 3%. And while economic indicators have shown only a mild recovery over recent quarters and sharply lower inflation, recent messages from policymakers have been on the hawkish side. We think this is an attempt to reassure the market that lax monetary policy won't compromise overall financial stability.

But we shouldn't forget that annual inflation is now virtually in line with the medium-term target. That means recent Mexican peso depreciation hasn't resulted in sharply higher prices. We think Banxico will wait for the Fed to move first before adjusting interest rates, and we assign a low probability to its deciding to act first.

Dovish Bias in Andean Countries

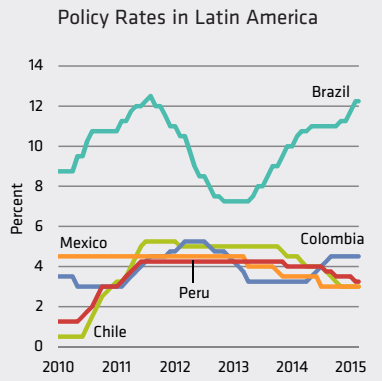
Colombia and Peru have been severely affected by the drop in commodity prices—for oil in the former, for metals and mining in the latter. In Colombia, GDP growth is expected to slow by roughly 2% this year. While the central bank would in principle have room to reduce its reference rate, recent statements by bank officials suggest they are satisfied with the endogenous relaxation of financial conditions caused by recent currency depreciation. We still think, though, that the central bank has a slight dovish bias and could cut rates if economic activity slows further.

In Peru, the central bank has been steadily reducing its reference rate for more than a year—it's down 100 basis points since November 2013. Peru's currency, like Colombia's, has weakened, and the central bank has relaxed financing conditions further by lowering mandatory reserve requirements.

However, there's still a significant gap between actual and potential growth. This is why we think policymakers in Peru also have a slight dovish bias and could reduce rates further.

Finally, Chile's central bank has adopted a neutral stance, but only after engineering an aggressive easing cycle that has shaved 225 basis points off the policy rate since the start of 2012. Growth has decelerated, but the central bank now appears willing to wait for the monetary transmission mechanism to work in full. For the time being, we don't expect any changes to the reference rate.■

Display 2
Brazil Is the Outlier



Through February 18, 2015
Source: Bloomberg and Haver Analytics