ECONOMICS: LATIN AMERICA PERSPECTIVES

LATIN AMERICA: EXCHANGE RATES AND INFLATION—AGAIN

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Falling commodity prices, subdued economic growth and the prospect of higher US interest rates have pressured currencies throughout emerging markets. Persistent currency weakness is bound to feed through to domestic prices eventually. That will push central banks toward tighter monetary policy.

Weak Currencies Galore

Emerging-market (EM) currencies have been under relentless pressure. In Latin America, the depreciation wave began with the 2013 "taper tantrum" and it has continued to varying degrees across the countries in the region. The Brazilian real and the Colombian peso have come under the most pressure, each losing more than half its value against the US dollar between May 2013 and July 2015.

But no country has been spared. Even Chile and Mexico—countries with relatively high credit ratings—saw their currencies weaken by 36% and 28%, respectively, over the same time period. In Colombia, depreciation began to accelerate in the third quarter of 2014 as the government failed to embrace an effective policy response to falling oil prices (*Display 1*).

Inflation has increased throughout the region since the "taper tantrum," though in most countries the move has been fairly modest considering the magnitude of the currency movements. Brazil is the exception, with inflation rising more quickly as a result of a correction in administered prices in early 2015. Annual inflation, however, is currently above target in all Latin American economies save Mexico's (*Display 2*).

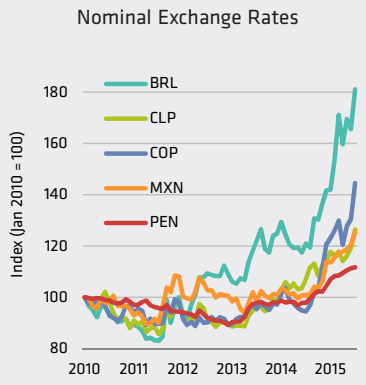
The moderate inflation increases suggest pass-through from depreciation to prices has been mild. This is largely because most of these economies have been operating under negative output gaps, and therefore growing at less than their potential growth rates. The resulting weak consumer demand has made it hard for firms to pass on the higher costs of imported materials to consumers.

The limited inflation pass-through, along with a favorable global interest-rate environment, has allowed regional central banks to keep their policy rates low, with Brazil again being the exception. Indeed, the gradual increase in inflation and stable nominal policy rates mean real interest rates have decreased.

All Things Come to an End

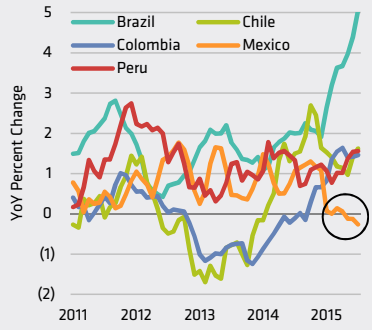
There's a limit to how long this state of affairs can persist. Currencies can't depreciate indefinitely without affecting inflation. We ran an econometric regression analysis to calculate the pass-through coefficients for five Latin American countries (*Display 3, next page*). We found

Display 1
No LatAm Currency Has Been Spared



Through August 20, 2015
Source: Haver Analytics and AB

Display 2
Inflation Rates Generally Above Target



Through August 20, 2015
Source: Haver Analytics, regional central banks and AB

that short term pass-through coefficients are indeed low, but after a period of several quarters, the long-term pass-through tends to be two to three times higher than the short term effect of currency depreciation on inflation.

Since the currency weakness started a couple of years ago, chances are good that pass-through will pick up speed in the coming quarters. And this is likely to occur just as the US Federal Reserve is tightening its own monetary policy. Central banks in countries where the chance of long-term pass-through is high—Brazil, Chile, Mexico and Colombia—may be forced to act.

Brazil hiked its Selic benchmark interest rate preemptively to put it in a better position relative to other countries in Latin America. We believe the central bank may reduce it next year. Mexico, on the other hand, may have some margin for maneuver as inflation is still under the official target.

Elsewhere in the region, there's almost no room left for monetary stimulus, and we expect central banks to shift gradually into tightening mode. Colombia, for instance, will likely remain under pressure since inflation is already above the ceiling of the target range, the economy is growing (albeit moderately) and the peso has been badly battered—it's down some 25% against the US dollar over the past three months alone.

Central banks tend to worry about pass-through relationships not being linear: that is, a spike in the currency could lead to a temporary jump in inflation. In Colombia, two of the bank's seven board members voted in favor of a 25-basis-point hike at July's policy meeting. At that time, the US dollar bought 2,880 Colombian pesos. But the peso has tumbled since then. At the time of this writing, it was trading at 3,050 per US dollar, suggesting the time for policy action is drawing near.■

Display 3
Pass-Through Increases Over Time

Pass-Through Estimates
Quarterly Data, 2000-2015

	Short Term	Long Term
Brazil	0.035	0.099
Chile	0.027	0.092
Colombia	0.017	0.044
Mexico	0.033	0.078
Peru	0.019	0.040

Through August 20, 2015
Source: AB