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ECONOMICS: LATIN AMERICA PERSPECTIVES

LATIN AMERICA: MONETARY POLICY OUTLOOK

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The probability of a US interest-rate hike has increased over the past month. A handful of Latin American countries have already started to tighten their own monetary policies. We expect others to follow suit this year and next.

Markets Bracing for December Fed Hike

After recent strong labor market data, many US Federal Reserve officials have hinted that an interest-rate hike is near. The market is listening. The implied probability of a rate increase at the Fed's December 16 policy meeting is now 68%, up from less than 30% in mid-October.

A Fed rate hike has been discussed at length and appears to be well anticipated. Even so, uncertainty remains, and not only about the precise timing of the move. Market participants are also wondering about the magnitude of the tightening cycle to come.

One thing's certain: the start of a Fed tightening cycle could usher in a major change in the global financial environment. In light of this, we think it makes sense to examine where economic activity, inflation and interest rates are going across Latin America.

Latin American Growth Subdued

Economic growth across the region has been slowing since 2010, and it took a turn for the worse after the "taper tantrum" in mid-2013. We estimate that regional trend growth is currently between 2% and 2.5%. But the regional average of actual growth is now in negative territory, having been severely affected by the ongoing contractions in Brazil *(Display 1*)and Venezuela. Many countries in the region are operating with a negative output gap—in some cases, a very sizable one.

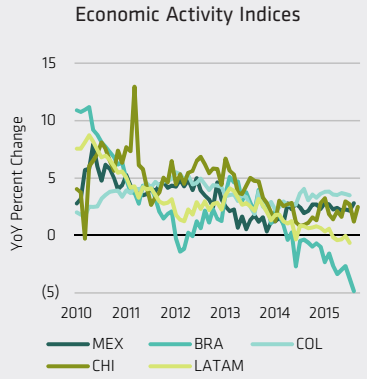
Currency Slide Should Feed Inflation

Exchange rates have depreciated markedly over the past two years on the back of softer commodity prices and prospects for higher US interest rates. The magnitude of the currency sell-off intensified after the taper tantrum, and currency weakness can be seen throughout the countries in the region, regardless of their credit ratings (*Display 2*).

Since the taper tantrum, nominal exchange rates have depreciated by as much as 59% in Colombia and 91% in Brazil. Even so, inflation has remained in check in most countries, save Venezuela and Argentina, which are extreme cases.

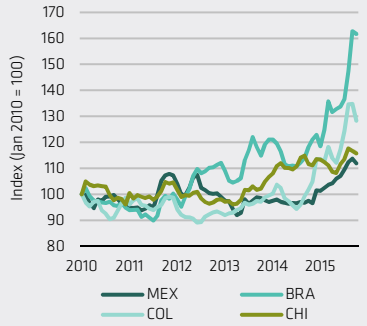
We can chalk this up to weak domestic demand and to the increased credibility of monetary policymakers in many countries, especially Mexico. Brazil is a special case, because the spike in inflation there has been due mostly to the adjustment of public prices in the beginning of the year.

Display 1
Weak Growth All Around the Region



Through November 19, 2015
Source: Haver Analytics and AB

Display 2
Currency Weakness Galore



Through November 18, 2015
Source: Haver Analytics and AB

However, we don't think this benign situation will last forever. A simple econometric regression analysis shows that the long-term pass-through from a weaker currency to headline prices will be significantly greater than it has been so far. That is, pass-through takes time to materialize in full (*Display 3*).

Room for Maneuver Shrinking

Since currency weakness began several quarters ago, it's likely that pass-through effects will speed up. There's evidence of this already in Colombia, Chile and Peru. Not surprisingly, these are the countries that opted to preempt the Fed and tighten monetary policy (*Display 4*).

In September, Peru increased its reference rate by 25 basis points to 3.5% and Colombia hiked its rate by 25 basis points to 4.75%. Colombia acted again in October, hiking rates to 5.25%, as inflation expectations rose above the central bank's target range, while Chile raised its policy rate to 3.25%.

Both Peru and Chile are expected to increase their policy rates further, possibly as soon as December. Even countries without a formal inflation-targeting regime are expected to increase their interest rates next year, with Argentina at the top of that list.

Brazil: a Special Case

Brazil's monetary policy cycle has been idiosyncratic, as the central bank has been increasing the target SELIC rate aggressively since the end of 2014, before President Dilma Rousseff's second term began. The SELIC rate, currently at 14.25%, has risen by 250 basis points this year and by 700 basis points since the second quarter of 2013.

Policymakers don't seem to have the appetite for more. While inflation is now hovering around 10%, well above the 6.5% ceiling of the official target range, the central bank has indicated that its policy of choice is to maintain SELIC at its current level until inflation converges to the target. It has no doubt ruled out further hikes because of the dire state of the real economy. Brazil's gross domestic product (GDP) is projected to shrink by more than 3% this year. While further hikes appear unlikely for now, the central bank may well have to keep SELIC at 14.25% for most or all of 2016 before target inflation returns to the policymakers' target range.

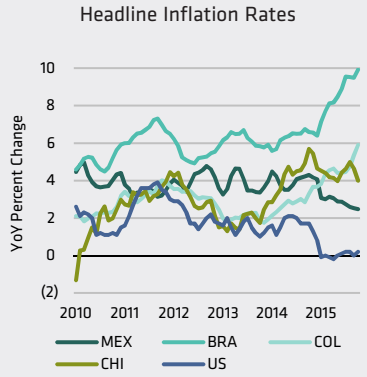
Mexico Weighs Its Options

Mexico's inflation has so far been almost completely unaffected by the substantial depreciation of the peso. There has only been some mild evidence of pass-through in the prices of durable consumption goods. We expect pass-through to accelerate gradually, and inflation to increase slightly beyond 3%, in 2016.

However, given the favorable initial condition for inflation, Banco de Mexico is in a comfortable position, and it could wait until next year to tighten monetary policy—even if the Fed hikes rates in December. Some of its board members have hinted, though, that financial stability may depend on avoiding a large change in interest-rate differentials between the US and Mexico. If that view prevails, the central bank will probably follow a Fed rate hike immediately with one of its own.

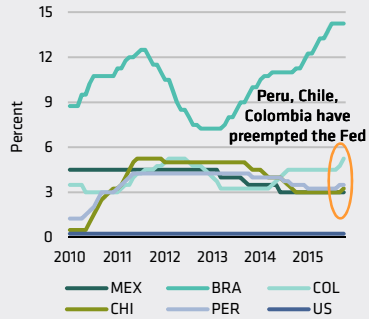
Our takeaway: expect policy rates to rise in most Latin American countries in the coming months—even in those countries where central banks have already started to tighten policy.■

Display 3
Pass-Through to Accelerate



Through November 18, 2015
Source: Haver Analytics and AB

Display 4
Further Hikes in the Pipeline



Through November 18, 2015
Source: Regional central banks and AB