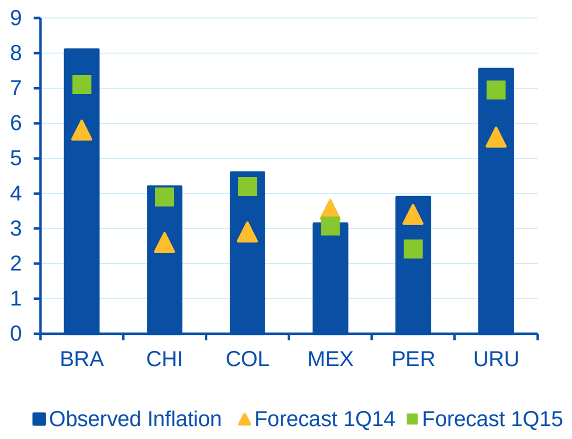
5 Inflation in the region has increased, but it should be back to target levels by the end of 2015 or early 2016

Inflation pressure is being sustained in those countries with inflation targets, despite the cyclical weakness

Inflation has surprised on the high side across a broad section of Latin American countries in recent months. Specifically, annual inflation at the close of 1Q15 was higher than expected a year ago and even more than what we were predicting three months ago for all the countries with inflation targets, with the exception of Mexico (Figure 5.1).

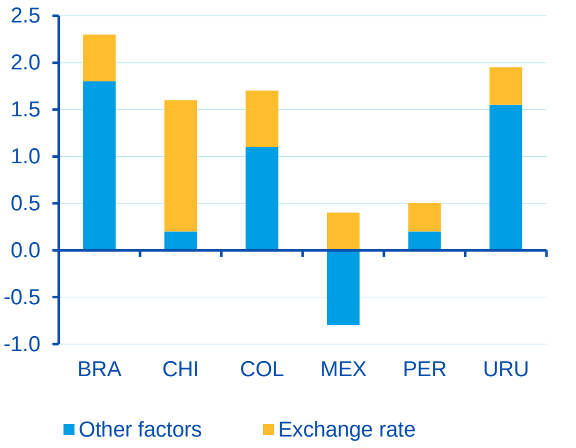
There are clear idiosyncratic factors which have contributed to the greater pressure on domestic prices in recent months: tax hikes (Chile, Brazil), the effect of supply shocks on food prices (Colombia, Peru), realignment of government-administered prices (Brazil), reforms and regulatory changes (Mexico) and inertia-related factors (Uruguay, Brazil). Nonetheless, the sharp currency depreciation generally observed in the past few months (despite the appreciation noted in recent weeks) has also been an explanatory factor behind recent deviations of inflation from prior estimates.

Figure 5.1
Observed inflation at the close of 1Q15 and that forecast for the same period both in 114Q and at the start of 1Q15 (% YoY)



Source: BBVA Research

Figure 5.2
Breakdown of explanatory factors for the difference between observed inflation at the close of 1Q15 and that forecast for the period in 114Q (pp)



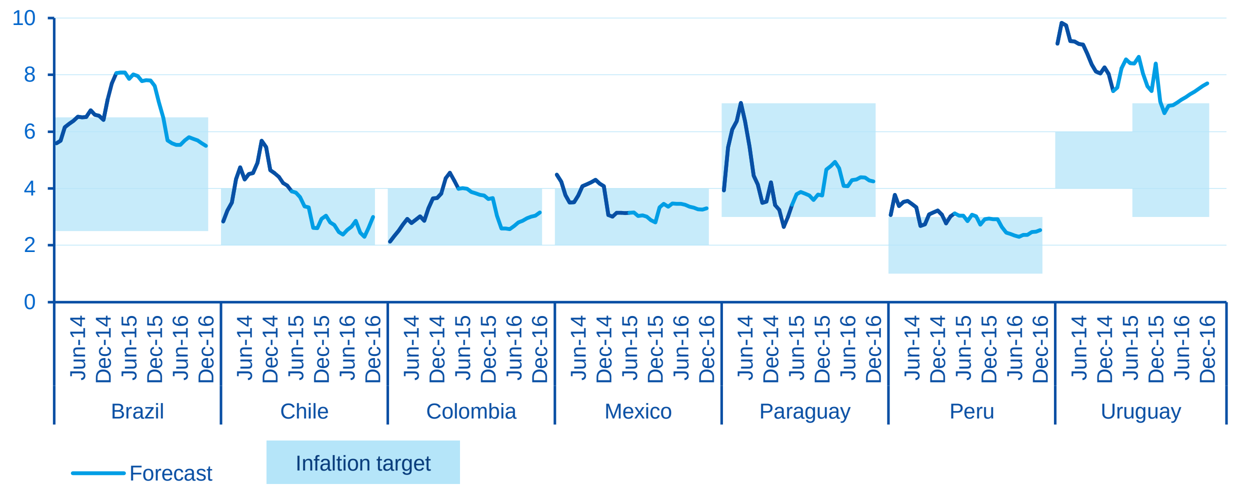
Source: BBVA Research

Our estimates suggest that the gap between inflation observed at the close of 1Q15 and that forecast in 1Q14 is in general mostly explained by idiosyncratic factors other than the exchange rate, although this is also a significant factor (Figure 5.2). Even so, in Peru, and principally in Chile, the currency depreciation by an amount above what we were predicting one year ago is the main driver behind the departure of inflation from what we were forecasting.

Similarly, following the recent surprises, inflation is very close to or above the upper limit of the target band set by each central bank (especially in the cases of Brazil and Uruguay, as can be appreciated from Figure 5.3). This is happening despite the fact that the weakness of economic activity is generally helping to keep demand pressure on prices from being very significant.

In Mexico and Paraguay inflation pressure is weaker. In Mexico inflation is close to its central target level (3%). That is due to i) the cyclical weakness ii) the effects of the reforms implemented with respect to telecoms and electricity prices iii) a smaller rise in petrol and gas prices, and iv) the more volatile among the prices within the consumption basket eased. With regard to Paraguay, inflation stands at 2% below the new target band of 2.5% to 6.5% (2014: 3% to 7%), basically because of lower food and oil prices.

Figure 5.3
LatAm: inflation (% YoY) and target band of central banks



Source: BBVA Research

Inflation will converge towards central bank targets in 2015-16.

We have revised our inflation expectations for the close of 2015 in the light of the recent surprises: upwards for most countries and downwards for Mexico and Paraguay. With respect to our 2016 forecasts, these are practically unchanged, with the exception of Peru, which we have revised upwards a touch, by 0.3pp to 2.5% due to greater anticipated currency depreciation.

We also expect inflation pressure to ease off over our forecast horizon as the impact of more moderate demand and commodity markets outweighs factors tending upwards, particularly the impact of a weaker exchange rate (Figure 5.3). This outlook is supported by the fact that most of the recent shocks mentioned earlier are of a transient nature, although the central banks will have to be watchful as regards second round effects on prices.

The greater credibility of the region's central banks and the anchoring of long-term expectations should contribute to the process of taking pressure off prices and help set inflation on course to converge towards the central value of the respective target bands.

In Brazil and Uruguay, where inflation has remained above the central target level of late, and long-term expectations are not so well-anchored, a more restrictive tone to fiscal and monetary policies will contribute to the moderation expected in the coming months, while the effect on inflation of hikes in indirect tax in Brazil is wearing off. Whatever happens, in both countries inflation will still lurk in the upper part of the target band.

DISCLAIMER

This report has been produced by the LatAm Co-ordination unit.

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