6 The window of opportunity for cutting interest rates in LatAm is closing

Despite the cyclical weakness, the window of opportunity for cutting interest rates is closing due to the persistence of inflation (and in Peru, because of exchange rate volatility)

The recent inflation-related surprises discussed in the previous section have ended up shaping tougher-than-forecast monetary policy in several of the region's countries. Thus, instead of interest rate cuts in the Andean countries, which we were expecting to see three months ago, the most likely scenario is that interest rates will be held at current levels, i.e. 3.25% in Peru, 3% in Chile and 4.5% in Colombia, for a long time, at least until mid-2016 (Figure 6.1), when the lift-off of economic activity will call for an upward shift.

In Peru, besides the greater inflation pressure, the decision not to cut interest rates arises from concern that a more expansive monetary policy could put more pressure on the exchange rate to depreciate in a highly dollarised economy. In Colombia, aside from the inflation pressure and in spite of a slowdown in activity, the decision not to cut interest rates is also based on the high current account deficit, good progress being made in credit portfolio growth and the risk of high inflation tainting expectations. In Chile, the monetary authorities remain focussed on inflation pressures and the persistence of them, and they have ruled out a monetary policy rate cut within the "foreseeable future". They have also hinted at a small upward adjustment at the end of the year, which is something that we do not believe will ultimately happen, due to inflation remitting as we go forward.

In Brazil, inflation surprises (as well as the need to restore credibility for its economic policy) are forcing a bigger-than-expected hike in interest rates. Instead of concluding the process of toughening monetary policy with a Selic rate of 12.50%, the Brazilian monetary authorities raised rates to 13.25% in April and should hike them to 13.75% at their next meeting in June, which is a level at which they ought to remain until 1Q16, when falling inflation warrants some degree of monetary loosening.

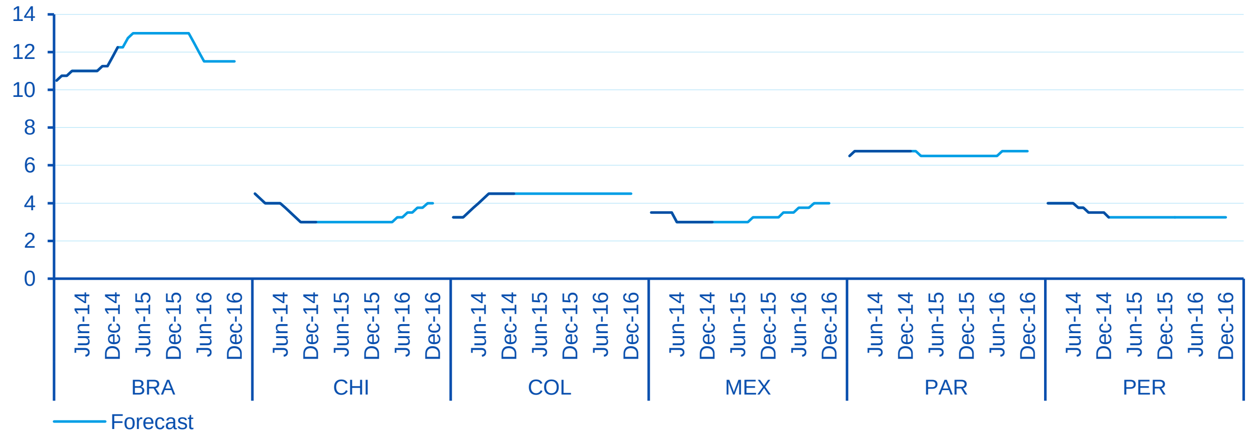
In Mexico and Paraguay, the recent inflation surprises were in a downward direction, which leaves the central banks with room to manoeuvre. In this regard, statements from Mexico's central bank show a willingness to synchronise their monetary adjustment cycle with that of the United States. We therefore expect rates in Mexico to begin rising in September and to reach 3.25% and 4.0% by year-end 2015 and 2016, respectively.

In Paraguay, the central bank has lowered the policy rate to 6.25% in recent months instead of holding it at 6.75% as expected. As with other countries in the region, we are not expecting further cuts ahead since inflation should start to rise and growth will remain relatively robust. We forecast that rates will stay at their current level until mid-2016.

Thus, given the widespread view that the problems experienced by businesses which are associated with a currency mismatch are limited[8], the most likely course of events is that monetary policy will uncouple from the Fed, at least in the short term. The main exception is likely to be Mexico, which should remain in step with US monetary policy due to the fact that its economy is closely intertwined with that of its northern neighbour.

8: See the box on this subject in our Latin America Economic Outlook, 1Q15.

Figure 6.1
LatAm: Monetary Policy Rate, %



Source: BBVA Research

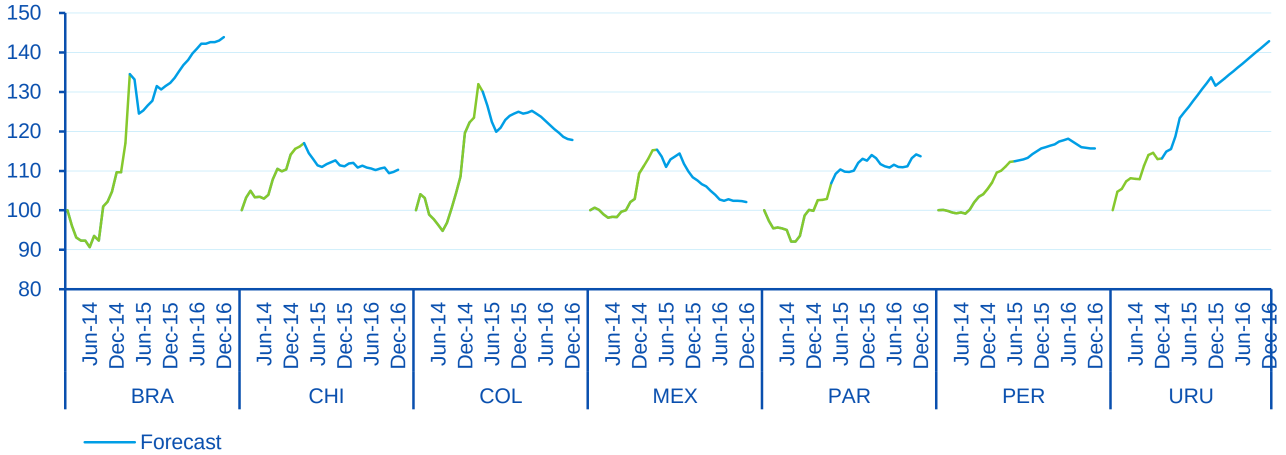
Curencies will remain under depreciation pressure due to central banks uncoupling from the Fed rate hike and still-hefty external deficits

As was examined in Section 3, the appreciation of LatAm currencies since mid-March has wiped out a portion (albeit a small one) of the depreciation that had been observed previously. In all of the region's countries the currency is palpably weaker than it has been in the past two years (Figures 3.6 and 6.2). In certain cases this has arisen in spite of exchange rate intervention by the monetary authorities. This is what has happened in Peru, and to a lesser extent Brazil, where the central bank broke off from its programme of daily injections of dollar liquidity using currency swaps at the end of March.

From now on movements on FX markets will be very much dictated by the Fed's normalisation strategy as well as commodity price trends, which suggests to us that fresh bouts of volatility are highly likely. Moreover, the uncoupling of monetary policy of most countries in the region from that in the United States will imply pressure on their currencies to depreciate. Lastly, unwieldy current account deficits and the prospects of a slackening of capital inflows into the region should also contribute to currencies remaining at relatively weakened levels (for further details see Section 7 and our forecasts concerning how capital inflows to the region will behave in Section 3).

In spite of one or two minor downscaling revisions for certain countries, primarily Chile and Colombia, partly due to greater support from copper and oil, in many cases the currency depreciation will continue over our forecast horizon, particularly in Brazil, Peru and Paraguay (Figure 6.2).

Figure 6.2
LatAm: Exchange rate (January 2012=100*)



* Local currency to the dollar.
Source: BBVA Research

DISCLAIMER

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

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