6 Further tightening of monetary policy in Latin America

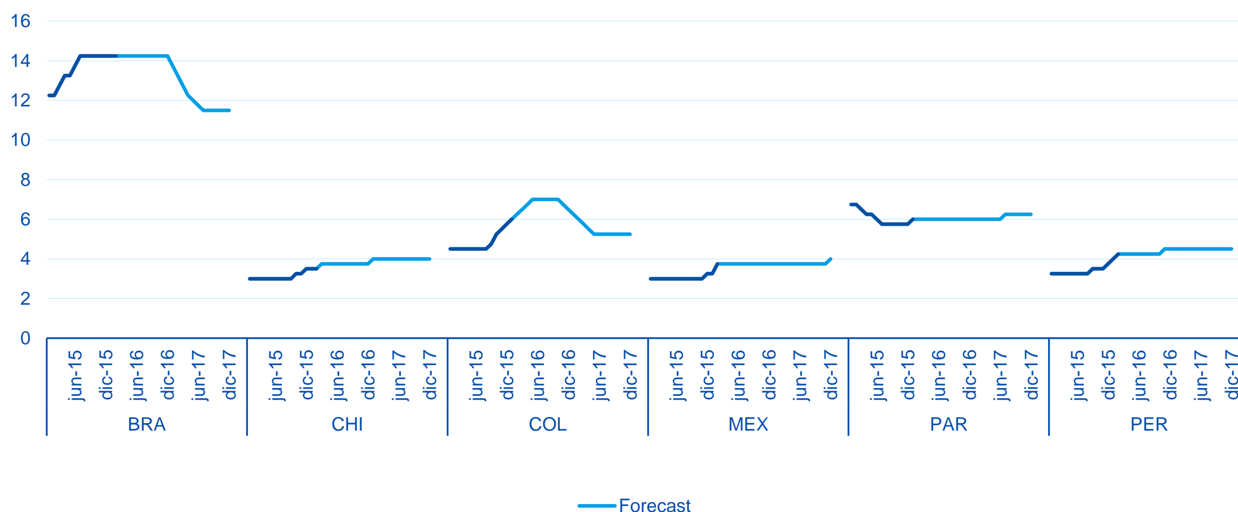
Pacific Alliance countries have been forced to tighten their monetary policy in the light of worse outlook for inflation and interest rate hikes by the Fed

The higher inflation and the risk of inflation expectations being unanchored prompted further tightening of monetary conditions in the three Andean countries in recent months (Chart 6.1). Specifically, reference interest rates for Chile, Colombia and Peru recently reached 3.50%, 6.0% and 4.25% respectively, levels which are 50, 150 and 100 basis points above the rates observed a year ago.

The direction of monetary policy has been swayed by the 25 basis point interest rate hike in the US and pressures on exchange rates in the three Andean states and in Paraguay, where, following months of stability, interest rates were raised 25 bp in January to 6.0%. Banxico also adjusted its overnight interest rate by 50 bp on 17 February, faced with pressure on the exchange rate and a possible pass-through to inflation; this came after it had reacted to the Fed's first interest rate hike with a 25 bp increase. This is the Mexican central bank's way of attempting to temper risks of greater financial volatility.

In the end, Brazil's central bank decided to keep interest rates stable at 14.25% (200 and 700 bp higher respectively than one year and three years ago) in its last meeting; this decision is in line with our forecast, but not with consensus, which expected a new upward cycle in the wake of further decline in inflation in recent months. Amidst political pressures, the ultimate fear was that fresh increases in the Selic interest rate might trigger an even deeper recession, mainly taking into account the growing doubts about global growth and recent financial turmoil.

Chart 6.1
Monetary policy rate in countries with inflation targets systems (%)



Source: BBVA Research

Also, despite the adjustments announced in recent months, interest rates in most Latin American countries are still below their long term equilibrium levels (in fact, in some cases interest rates are below current inflation or even expected inflation). This is the not the case, however, in Brazil, where the central bank is compelled to maintain a restrictive monetary policy despite the recession because of the inflationary pressures and fiscal decline.

Further interest rate hikes are expected in 2016 in Andean countries, along with stability in Mexico and Brazil

The tightening of monetary policies in the three Andean countries is not over yet. The tightening will almost certainly continue, offsetting the risks of inflationary drifting and decoupling with the US monetary cycle, reducing the expansionary tone of monetary policy in these three countries throughout the year. Specifically, we are expecting a further adjustment of 25 bp in the coming months in Chile and Peru and of four 25 bp hikes in upcoming monetary policy meetings in Colombia.

In Mexico, following the unexpected adjustment of 50 bp in February, the central bank will have to keep a stable overnight rate of 3.75% throughout the year.

Furthermore, after interest rates were increased at the close of 2015 and throughout 2016, we expect further adjustments in 2017 in Chile (+25 bp), and, towards the end of the year, in Mexico (+25 bp). In Peru, the most likely scenario is that reference interest rates will be unchanged at 4.50% in 2017.

In Colombia, the monetary tightening cycle would come to an end in the first half of 2016, with interest rates at 7.0%. The expected slowdown in inflation would create extra room for manoeuvre in order for the central bank to make interest rates converge at 6.5% in the last quarter of 2016 and towards 5.25% in 2017.

In Brazil, the central bank is not expected to implement further interest rate hikes because of its major concerns about the domestic recession and the international setting. Although inflation would be expected to ease off from February onwards, potential interest rate cuts would only be made from 2017 onwards because inflationary expectations are not firmly anchored.

It is also interesting to note that certain central banks in the region, such as Brazil's, interpret the international setting in a more dovish light, due to the supposed negative impact on activity, while others, such as Mexico's, have a more hawkish reading of the state of the world economy, mainly due to the possible impact of further exchange rate devaluation. This shows the complexity of the current setting, and suggests that changes in the global scenario could imply adjustments in monetary policy strategies across Latin America.

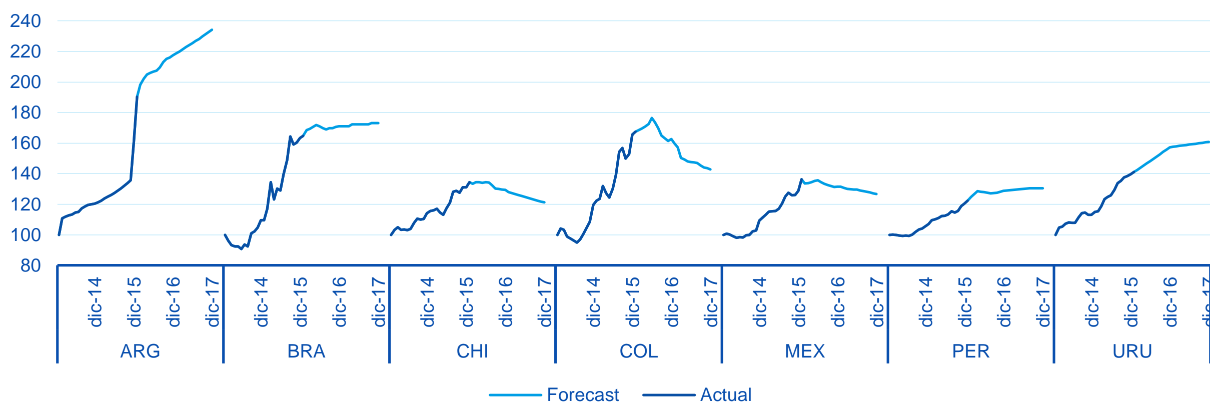
Exchange rates should remain at relatively low levels as a result of the Fed's increase in interest rates and a less favourable international setting

As we stated above, in section 3, the most likely scenario is that market volatility will persist due to uncertainty over China and about US monetary policy. Taking all these factors into account, if our base scenario occurs, including a “soft landing” in China, steady recovery in the US economy and moderate increases in commodity prices from the second half of 2016 onwards, then, looking ahead, further depreciations as strong as those recorded last year would be unlikely (Chart 6.2 and forecasts table in section 9).

That said, we expect further exchange rate devaluation, albeit to a lesser extent, in Brazil, Uruguay, Peru and Paraguay. In the first two countries, the high domestic inflation levels are a factor which would help depreciations further down the line.

We expect the currencies of Chile, Colombia and Mexico to appreciate to a certain degree from mid-2016 on, as these countries' fundamentals are bolstered and the decline in commodity prices is halted. The Chilean peso should be shored up to some degree by the copper price from the second half of 2016 onwards, while the relative rise in value of the Colombian and Mexican peso would be underpinned by recovery in oil prices (for further details on patterns in commodity prices, refer to Chart 3.8 and the forecasts table in section 9).

Chart 6.2
Exchange rate: observed and expected (local currency / US dollar) (January 2014 = 100) *



* Increases indicate depreciations.
Source: BBVA Research

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