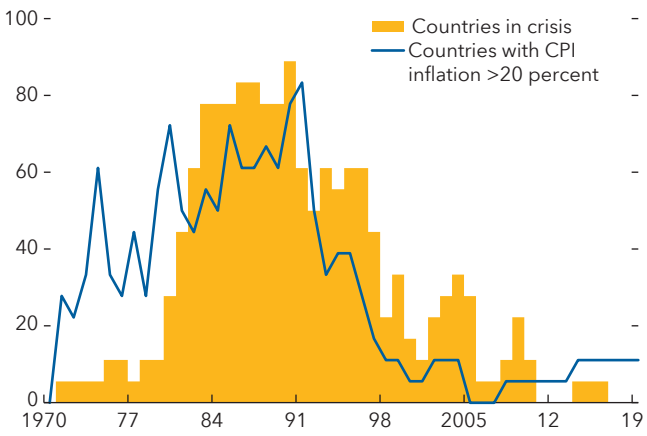
3. Preserving Hard-Won Monetary Policy Gains amid Persistent Fiscal Risks[1]

By the early 2000s, countries in Latin America and the Caribbean had achieved price stability supported by sweeping reforms that enhanced central bank independence and strengthened monetary policy frameworks. These advances helped anchor inflation expectations and enabled effective monetary transmission. However, fiscal frameworks and policies raise challenges, particularly associated with high debt levels and interest costs, which can amplify the fiscal impact of monetary policy and hinder monetary policy transmission. Evidence in this chapter shows that low public debt and appropriate fiscal stances aid monetary policy in achieving inflation targets. It also shows that there is scope to further improve monetary policy frameworks. To safeguard price stability, countries in the region must focus on advancing fiscal consolidation, improving fiscal policy frameworks, and continuing reforms to further strengthen central bank independence.

3.1. Introduction

Figure 3.1. LAC Countries with High Inflation and in Crisis
(Percent share)



Sources: Ha and others (2023); and Harvard Business School (Behavioral Finance and Financial Stability), Global Crises database.
Note: A country is considered in crisis if it is classified in either banking, sovereign debt or currency crisis. CPI = consumer price index; LAC = Latin America and the Caribbean.

After a long history of battling with high inflation and crises, many countries in Latin America and the Caribbean (LAC) implemented extensive institutional reforms in the 1990s and early 2000s (Figure 3.1). A pivotal aspect was new legislation that granted independence to central banks. Notably, these reforms restricted central banks' financing of public deficits—a major contributor to high inflation in the region—while governments concurrently took steps to reduce these deficits. These changes not only alleviated inflationary pressures but also enabled central banks to implement countercyclical policies during shocks, such as the Global Financial Crisis and the COVID-19 pandemic.

Notwithstanding this progress, a key concern moving forward is whether heightened fiscal pressures may hinder monetary policy effectiveness in managing inflation (Figure 3.2). Challenges associated with the fiscal stance, particularly in the context of expansionary or procyclical fiscal policies and overly timid fiscal consolidation plans, can impose significant pressures on monetary policy by stimulating demand when inflation is above the target. Similarly, unfavorable debt dynamics can increase risk premiums and weaken the local currency, further complicating inflation dynamics. Related to these challenges, as debt and debt-servicing needs climb, the fiscal costs of high real interest rates—necessary for stabilizing inflation—can also increase. These dynamics underscore policy interaction challenges that might undermine the effectiveness of monetary policy.

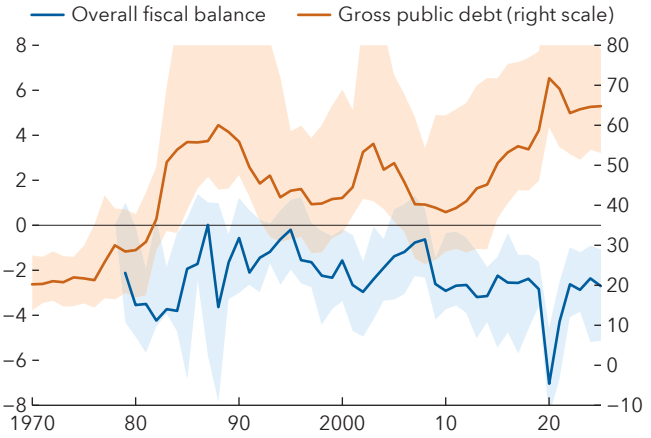
In this context, this chapter explores the following questions: (1) how did Latin America enhance central bank independence and what were the effects of these reforms?; (2) how fiscal policy may affect the channels of transmission of monetary policy?; and (3) does fiscal policy, via high debt levels and sustained deficits, affect the credibility of central banks and the ability to achieve inflation targets?

[1] Prepared by Agnese Carella, Dimitris Drakopoulos (co-lead), Juan Passadore (co-lead), and Genevieve Lindow.

3.2. Central Bank Reforms

During the 1990s, most countries in the region undertook substantial reforms to bolster the autonomy of their central banks (Figure 3.3, panel 1). According to well-known indices, central bank independence (CBI) saw a marked improvement,[2] especially in restricting monetary financing of the budget and prioritizing price stability. Some central banks have achieved scores that placed them at the top of emerging market (EM) peers and close to the average of the Organisation for Economic Co-operation and Development (OECD) countries (Figure 3.3, panel 2). Even though there were some reversals in just a few countries in the 2000s, overall progress has been substantial. The reforms took place across several areas, and the following are the most notable ones:

Figure 3.2. LAC: Overall Fiscal Balance and Government Debt
(Percent of GDP)



Sources: IMF, Historical Public Debt database; IMF, World Economic Outlook database; and IMF staff calculations.
Note: Aggregates are medians. Shaded areas refer to the interquartile ranges. LAC = Latin America and the Caribbean.

Monetary financing. A cornerstone reform was the restriction of central bank financing to the government. This reflected the consensus that monetary financing was the main cause of chronic inflation in the region (Kehoe and Nicolini 2022). These restrictions were both codified and largely respected in practice,[3] resulting in a substantial reduction in central bank claims against the public sector (Figure 3.3, panel 3). Notably, during the pandemic, amid fiscal pressures, central banks largely refrained from direct monetary financing.

Price stability. Price stability became the primary objective for most central banks, often alongside other non-conflicting goals such as ensuring the stability of the payment system (Figure 3.3, panel 4). This marks a significant shift from the 1980s—when a small number of central banks prioritized price stability—to the current situation in which around three quarters do so.

Political influence in decision making. Governance reforms made significant strides across the region, although progress generally lags OECD countries (Figure 3.3, panel 5). Notable achievements were the introduction of longer and staggered terms for board members—to reduce alignment with electoral cycles—and stricter conditions for their removal by the executive branch.[4] There was also progress in reducing government representation on central bank boards, although in some cases the minister of finance has retained a seat—typically without voting rights.[5]

Financial independence. Financial independence reforms have been less pronounced compared to other areas (Figure 3.3, panel 6), with some reforms happening more recently, most notably in Brazil, the Bahamas, and Jamaica. Crucially even though some countries have automatic government recapitalization rules, others either

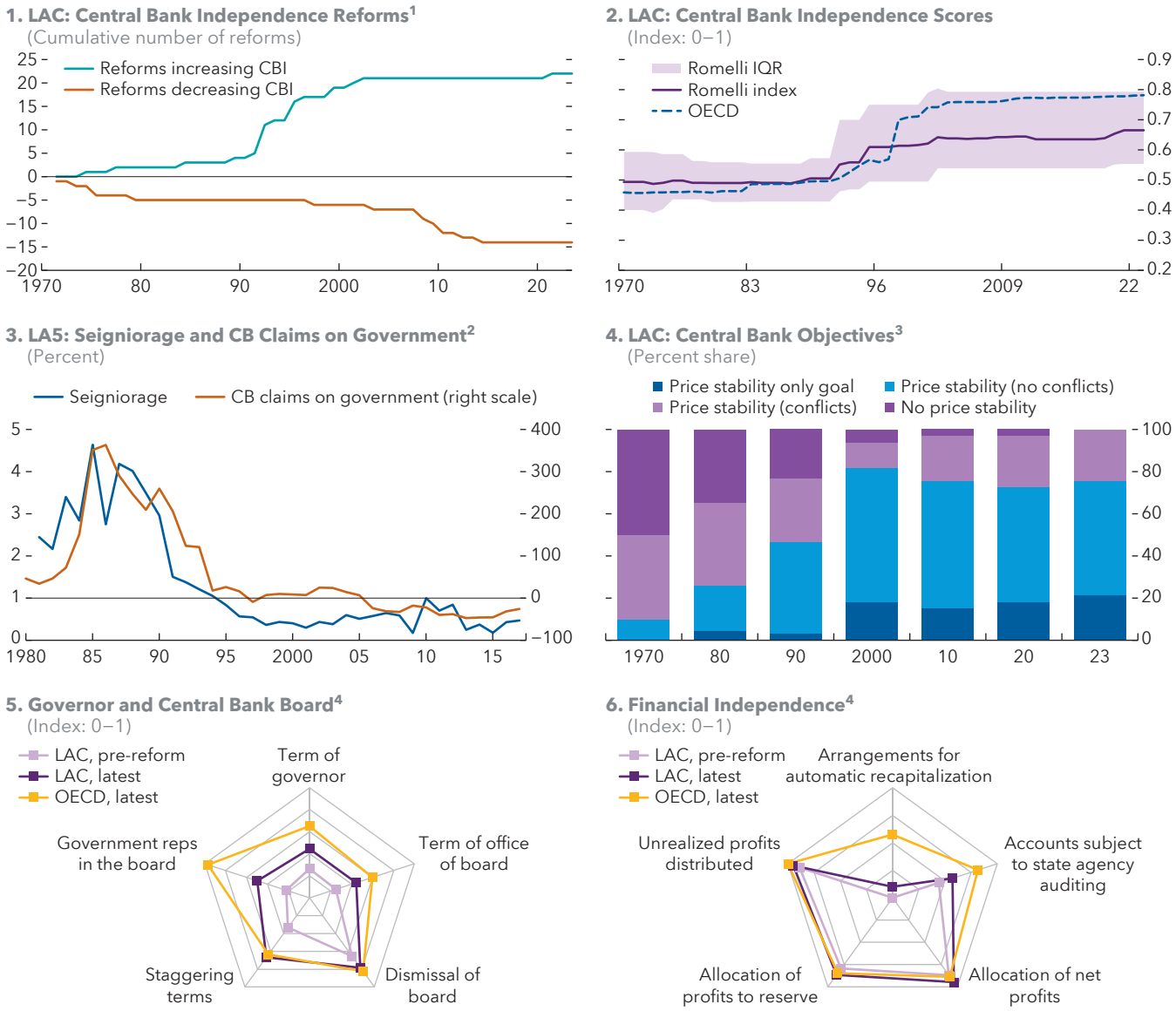
[2] De jure indices are based on interpretation of legal texts, which can lead to inconsistent readings among different authors. Central banks may struggle to maintain their independence from political pressure, and some laws may be subject to interpretation and contain gaps. For instance, Unsal and Papageorgiou (2023) observe that profit distribution rules are not always observed in practice and that members of monetary policy committees may be dismissed prematurely, contrary to their legally defined terms.

[3] Some exceptions include Argentina, Bolivia, and Venezuela.

[4] Exceptions remain in countries such as Peru and Uruguay, where board terms align with political cycles. Brazil implemented staggered terms in 2021.

[5] Colombia is an exception, since the minister of finance participates as a full voting member.

Figure 3.3. Central Bank Reforms



Sources: Garriga (2025); IMF, International Financial Statistics database; Kehoe and Nicolini (2022); Romelli (2024); and IMF staff calculations.
Note: CB = central bank; CBI = central bank independence; IQR = interquartile range; LAC = Latin America and the Caribbean; LA5 = Latin America 5 (Brazil, Chile, Colombia, Mexico, Peru); OECD = Organisation for Economic Co-operation and Development.
[1]Legal reform is a country passing a central bank reform in a year, increasing (decreasing) the CBI index.
[2]Seigniorage is calculated as $m_{t-1}[1-\frac{1}{(1+g_t)(1+\pi_t)}]$ where m_{t-1} is the monetary base as a fraction of nominal GDP, g_t is the growth, and π_t is the inflation. CB claims on government in percent of monetary base.
[3]"Price stability only goal" also includes cases where the central bank has the final authority in determining the objective in case of conflict; "Price stability (no conflicts)" is defined as price stability along with other objectives that do not seem to conflict with the former; "Price stability (conflicts)" is defined as price stability along with other objectives of potentially conflicting goals (for example, full employment).
[4]Pre-reform index is the level before the first reform since 1985. Aggregates are simple averages. OECD sample excludes LAC countries.

have discretionary arrangements that are not implemented in practice or lack them entirely. All in all, several central banks in the region still show inadequate capitalization, awaiting a recapitalization agreement with the government.[6] Another key aspect is the ability of the central bank to determine its own budget, including staff

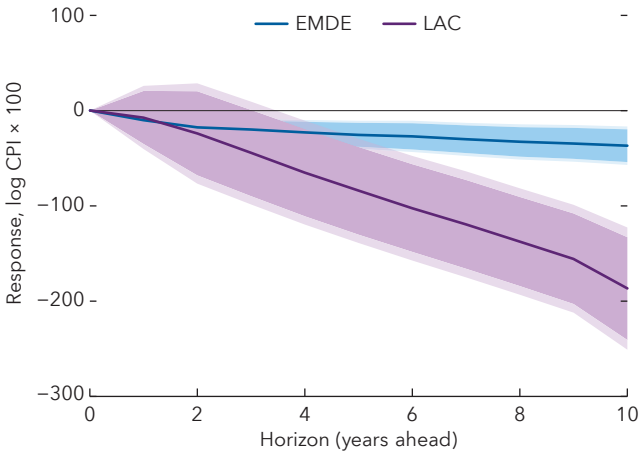
[6] Negative capital is not inherently problematic. Chile and Mexico are among the most prominent examples globally of central banks that have successfully fulfilled their mandates while operating with negative equity in some years.

compensation. Although on average the region is comparable to OECD, some key exceptions remain.[7]

Impact of Reforms

Reforms to strengthen CBI were associated with improvements in inflation outcomes (see Online Annex 3 for more details). To capture the dynamic effects of these reforms, the local projections method of Jordà (2005) is applied. The specification controls for key macroeconomic and external factors, including lagged output gap, inflation, exchange rate regime, and fiscal factors. Empirical evidence from a sample over the period of 1980–2023 indicates that increased independence was associated with lower long-term inflation levels in LAC compared to other emerging market and developing economies (EMDEs) (Figure 3.4), which reflects to some extent LAC's historically high inflation levels. Quantile techniques are applied to uncover how the association varies across different segments of the inflation distribution (Figure 3.5). The coefficients on the CBI index consistently decline across quantiles, becoming notably more negative at higher inflation levels. The relationship is again consistently larger in LAC countries than in EMDEs.

Figure 3.4. Response of Inflation to Changes in CBI
(Cumulative change of 100 × log CPI)



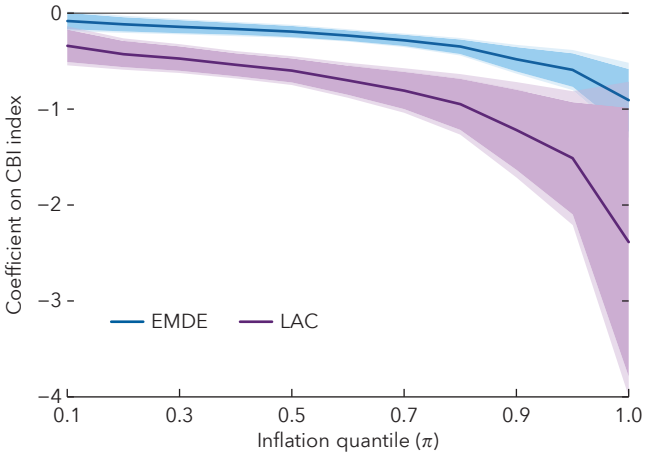
Sources: Romelli (2024); and IMF staff calculations.
Note: Local projection of cumulative change of 100 times the log of CPI in country *i* between year *t+h* and year *t* on CBI index, over a 10-year horizon. Control variables are one lag of output gap, transformed CPI inflation, exchange rate regime, general government gross debt, a fiscal rule indicator, and US inflation. Solid line is the point estimate; dark and light-shaded areas are the 90 and 95 percent confidence bands, respectively. CBI = central bank independence; CPI = consumer price index; EMDE = emerging market and developing economies; LAC = Latin America and the Caribbean.

These reforms have also paved the way for better inflation anchoring, greater monetary policy effectiveness, lower sacrifice ratios, and an increase in resilience (as highlighted in IMF 2025a). The credibility of Latin America 5 (LA5) monetary policy frameworks has strengthened over the years as central banks demonstrated their commitment to their mandates and inflation rates generally remained within the target range.[8] This increased credibility is evident among the more mature inflation targeting regimes in LA5, as seen in the improved anchoring of inflation expectations since the mid-2000s (Figure 3.6). Analysis using a time-varying vector autoregression model across LA5 also indicates that the transmission of monetary policy to inflation has been strong, even when compared to advanced economies (see IMF 2024g and Online Annex 3 for more details). All in all, the combination of enhanced credibility and stronger anchoring has helped to mitigate the costs traditionally associated with bringing down inflation, leading to a better sacrifice ratio (Forbes, Ha, and Kose 2025).

[7] At the time of writing, a constitutional amendment granting financial autonomy to the Central Bak of Brazil is under discussion in congress.

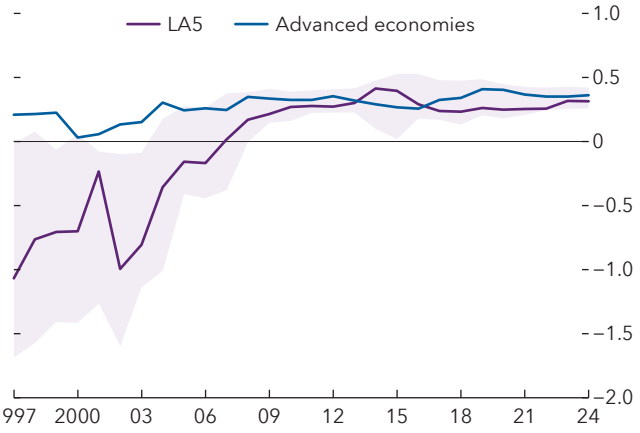
[8] The transformation of monetary policy frameworks happened sequentially following the legal reforms of the 1990s. Initially, central banks continued to rely on the exchange rate as their primary monetary policy tool. By the early 2000s, countries started to transition toward more flexible exchange rate regimes, which facilitated the adoption of comprehensive inflation-targeting frameworks (see Carrière-Swallow and others 2016).

Figure 3.5. CBI Index across the Inflation Distribution
(Δπ per CBI unit; re-scaled CPI; CBI index: 0–1)



Sources: Romelli (2024); and IMF staff calculations.
Note: Quantile regression of transformed inflation on CBI index. The solid line is the point estimate; the dark and light-shaded areas are the 90 and 95 percent confidence bands, respectively. CBI = central bank independence; CPI = consumer price index; EMDE = emerging market and developing economies; LAC = Latin America and the Caribbean.

Figure 3.6. Index of Inflation Expectations Anchoring
(Index)



Source: Bems and others (2018).
Note: Shaded area refers to the minimum–maximum range. LA5 = Latin America 5 (Brazil, Chile, Colombia, Mexico, Peru).

3.3. Interactions between Monetary and Fiscal Policy

Monetary and fiscal policies interact through several channels. Adding to the standard aggregate demand channel, fiscal policy may also have an impact through the effects of debt levels and the fiscal stance on local currency bond spreads, inflation expectations, and the exchange rate risk premium. High debt also amplifies aggregate demand through wealth effects[9] and raises the risk that central banks accommodate fiscal needs.

Debt Levels and Monetary Policy

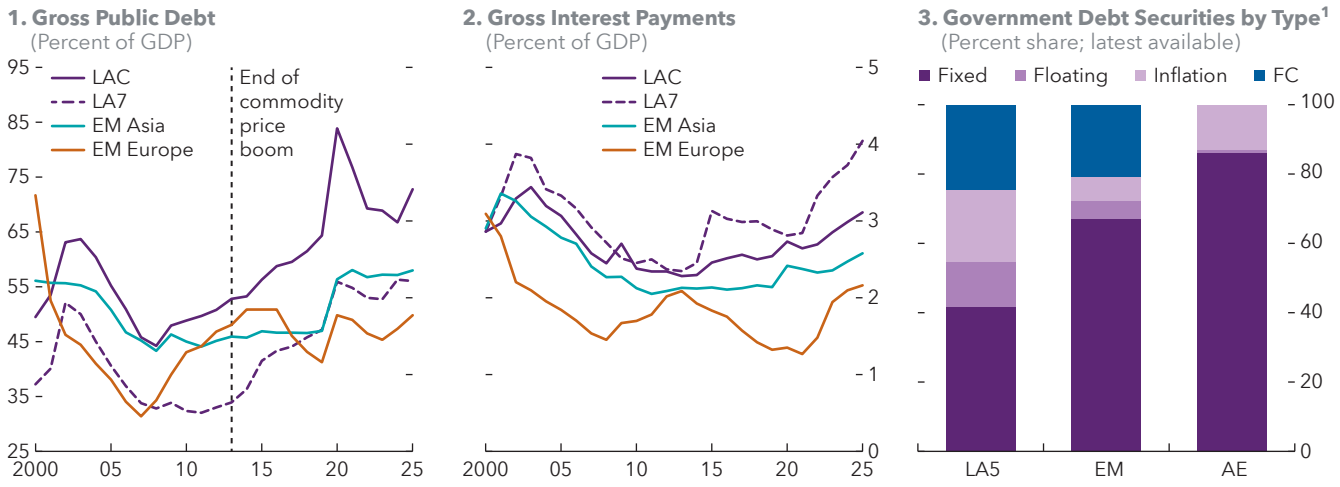
Monetary policy decisions have a fiscal impact through financing costs, especially if debt is high and its maturity is short. This is relevant for the region, as current debt levels and interest payments are high compared to both other regions and historical standards (Figure 3.7, panels 1 and 2). In addition, although the region has achieved significant improvements in debt composition by reducing foreign currency debt and extending the average maturity, the amount of floating and indexed rate debt in some countries remains substantial.[10] This results in a more immediate pass-through from monetary policy decisions to debt-servicing costs compared to advanced economies (Figure 3.7, panel 3).

High debt levels may compromise the achievement of inflation targets. Estimates of local projections using monetary policy shocks as computed by Checo, Grigoli, and Sandri (2024) show that in EMs with low debt levels, monetary policy is effective in reducing inflation. Monetary policy tightening leads to an exchange rate appreciation and lower short-term inflation expectations, aiding the convergence of inflation to the target

[9] There is large literature that emphasizes the impact of increases in nominal wealth and their implications for inflation. See among others Leeper (1991); Cochrane (2001); Sims (1994); Woodford (1995); Bianchi and Melosi (2022); Bianchi, Faccini, and Melosi (2023); Caramp and Silva (2023).

[10] The maturity structure of debt shapes the fiscal impact of monetary policy as the debt service on long-maturity bonds is fixed at issuance. Moreover, as emphasized by Cochrane (2001) and Caramp and Silva (2023), increases in interest rates lower the market value of long-term debt, leading to a negative revaluation of these assets and, through this channel, reducing aggregate nominal demand. Because of data limitations, the econometric exercises focus on debt levels and not on the maturity structure of debt.

Figure 3.7. Debt, Interest Payments, and Financing Costs



Sources: Bank for International Settlements; Haver Analytics; IMF, World Economic Outlook database; national authorities; and IMF staff calculations.
Note: Aggregates are simple averages. Advanced economies = Germany, Japan, United Kingdom, the United States; EM = emerging markets; EM Asia = India, Indonesia, Malaysia, Philippines, Thailand, Vietnam; EM Europe = Bosnia and Herzegovina, Bulgaria, Hungary, Poland, Romania, Serbia; FC = foreign currency; LAC = Latin America and the Caribbean; LA5 = Latin America 5 (Brazil, Chile, Colombia, Mexico, Peru); LA7 = Latin America 7 (Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay).
[1]AE sample excludes Japan. EM sample includes Hungary, Indonesia, Malaysia, Philippines, Saudi Arabia, South Africa, Thailand, and Türkiye.

(Figure 3.8).[11] Concurrently, it lowers long-term yields, pointing to a reduction in risk premium that alleviates the impact of monetary policy on the fiscal accounts (see Online Annex 3 for technical details). In contrast, monetary policy likely faces more challenges to reduce inflation in EMs with high debt levels, defined as having current debt levels higher than the 80th percentile in the past 20 years. In high-debt environments, monetary policy shocks have no significant impact on exchange rates, short-term inflation expectations, and long-term yields (Figure 3.8).[12]

High debt may also raise concerns about central banks' implementation of an appropriate interest rate policy. Estimates of the Taylor rules in EMs show that the policy rate responds more to inflation in low-debt economies compared to high-debt economies (Figure 3.9). This weaker response suggests that elevated debt levels may limit the willingness or ability of central banks to tighten policy, potentially undermining confidence in their commitment to controlling inflation.

Monetary and Fiscal Policy Mix

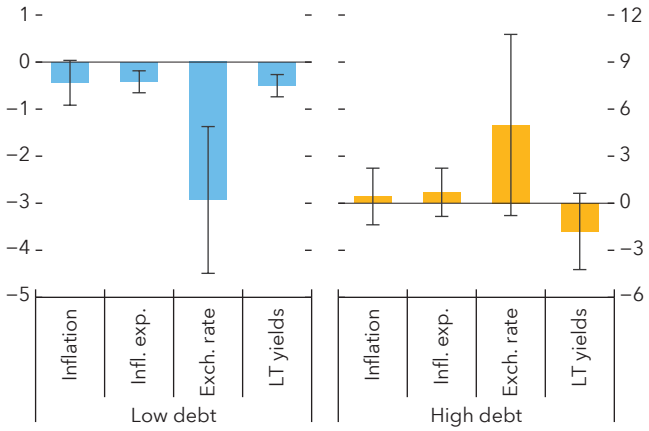
Beyond debt levels, fiscal stance can also influence the effectiveness of monetary policy in achieving its inflation target. This issue is particularly relevant in Latin America. At the onset of the pandemic, both monetary and fiscal policies were expansionary. However, although monetary policy was tightened significantly in 2021 and 2022—contributing to a rapid decline in inflation after the COVID-19 shocks—needed fiscal consolidations have been delayed (Figure 3.10, panel 1). Hence, although several countries continue to experience inflation above the target and monetary policy remains restrictive, fiscal policy has stayed expansionary in recent years, creating a policy mix that might have slowed the disinflation process (Figure 3.10, panel 2).

The policy mix may pose challenges, particularly by influencing aggregate demand. In fact, estimates of local projections for selected EMDEs suggest that a surprise increase in structural primary deficits—defined as the difference between actual and the October *World Economic Outlook* (WEO) projection of the year—pushes

[11] Even in cases in which inflation expectations remain anchored, lower short-term inflation expectations facilitate convergence in cases in which inflation is above the central bank target.
[12] These results are in line with those of Caramp and Feilich (2024).

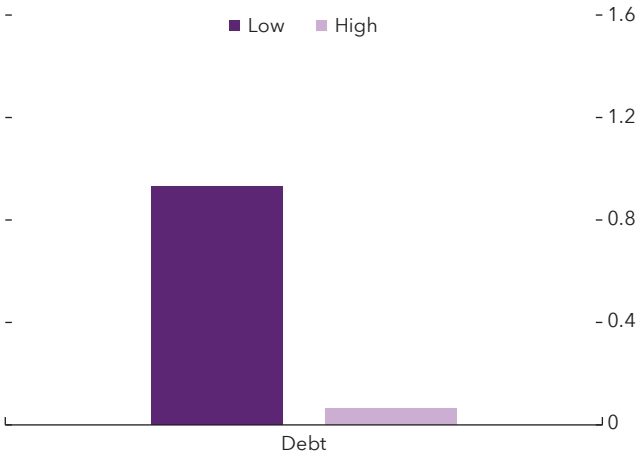
Figure 3.8. Response to a 100-Basis-Point Monetary Policy Tightening Shock at 18-Month Horizon

(Percent)



Source: IMF staff calculations.
Note: Change in the level of each of the variables at 18-month horizon from a local projection into monetary policy shocks from Checo, Grigoli, and Sandri (2024). Local projections specification is calculated as follows: $Y_{c,t+h} - Y_{c,t} = \alpha_c^h + \delta_t^h + \beta_I^h I_t + \gamma_I^h Interaction_{it} \times I_t + u_{it}$. Interaction is an indicator for each country that debt is higher than the 80th percentile. Plots depict the response to a 100-basis point shock. Left panel: β_I^h. Right panel: $\beta_I^h + \gamma_I^h$. Inflation, inflation expectations, and LT yields, denote change in level of the variable (measured in percent). Exchange rates are measured in logs, and an increase denotes depreciation. Monthly frequency. Sample: Brazil, Chile, Colombia, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Nigeria, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Türkiye. Exch. = exchange; Infl. exp. = inflation expectations; LT = long term.

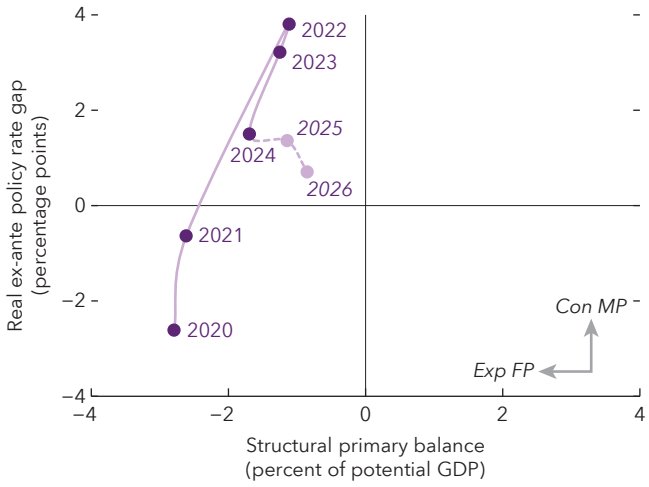
Figure 3.9. Estimated Taylor Rule Coefficient on Inflation by Subsamples of High and Low Debt



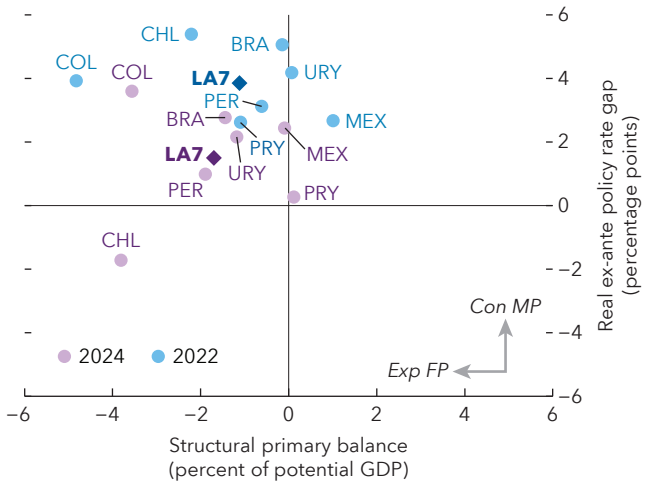
Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: The Taylor rule estimation is as follows: $i_{i,t} = \alpha i_{i,t-1} + \beta_1 \pi_{i,t} + \beta_2 \pi_{i,t} Interaction_{it} + \gamma_i x_{i,t} + \epsilon_{i,t}$. Interaction is an indicator for each country that debt is higher than the 80th percentile. The bars depict $\frac{\beta_1}{1-\alpha}$ and $\frac{\beta_1+\beta_2}{1-\alpha}$, respectively. Notation: i, nominal rate; x, output gap; π, inflation. Quarterly frequency. Sample: Brazil, Chile, Colombia, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Nigeria, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Türkiye.

Figure 3.10. Monetary and Fiscal Policies

1. LA7



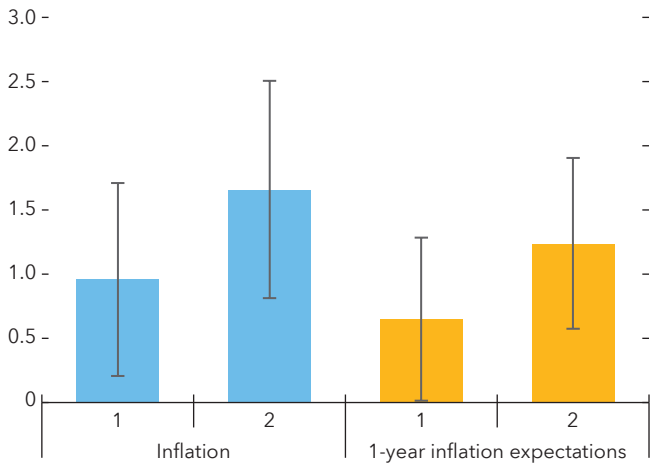
2. 2022 versus 2024



Sources: Calderon, Dhungana, and Wales (forthcoming); Consensus Economics; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: LA7 is simple average. Chile refers to the central government's structural non-mining primary balance. Colombia refers to the consolidated public sector's structural non-oil primary balance. Peru refers to the nonfinancial public sector's structural primary balance. Real ex-ante policy rate gap is the current level of the real rate minus the neutral rate computed in Calderon, Dhungana, and Wales (forthcoming). Con = contractionary; Exp = expansionary; FP = fiscal policy; LA7 = Latin America 7 (Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay); MP = monetary policy.

inflation and inflation expectations up at both one- and two-year horizons (Figure 3.11). Debt levels may also compound the impact of fiscal shocks on inflation; Arizala and others (forthcoming) show that fiscal consolidations prompt a reduction in inflation that is larger in countries with high debt.

Figure 3.11. Impact of Fiscal Deficit Shocks: Headline Inflation
(Percent)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Local projections is calculated as follows: $\mathbf{Y}_{c,t+h} - \mathbf{Y}_{c,t} = \alpha_c^h + \delta_t^h + \beta_I^h FP_t + \Sigma_{k=0}^{1} \gamma^h \text{Controls}_{c,t-k} + u_{it}$, where $\mathbf{Y}_{c,t}$ is the outcome variable for country c in time t, α_c^h, δ_t^h are country and time fixed effects for each horizon h, FP_t is the fiscal deficit shock, and $\text{Controls}_{c,t-k}$ are a vector of control variables for country c in time $t-k$. Annual frequency. Fiscal deficit shocks are computed from *World Economic Outlook* forecast errors on structural primary balance. Controls include current and lagged real GDP growth and debt to GDP. Sample: Brazil, Chile, Colombia, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Nigeria, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Türkiye.

3.4. Policies for Preserving Hard-Won Gains

Since the 1990s, reforms enhancing CBI and improving monetary policy frameworks have led to lower inflation levels, better anchoring of expectations, stronger monetary policy transmission, and greater resilience.

Sound fiscal frameworks and policies are instrumental to preserving the hard-won gains associated with monetary policy reforms. This chapter shows that high public debt and an inappropriate policy mix may introduce friction to the convergence of inflation to targets. Securing price stability requires maintaining public debt levels that do not undermine monetary policy transmission through its impact on expectations and asset prices, preserving the ability of central banks to implement appropriate interest rate policy. In the current regional context, credible fiscal consolidation, supported by stronger fiscal rules and policy frameworks and the introduction in some cases of well-calibrated debt anchors (see IMF 2024a), remains critical and is required not only to stabilize debt and create fiscal space but also to keep monetary policy effective.

There is also scope for further strengthening of CBI. Building on the effective reforms over the past decades—which involved critical steps to reduce monetary financing of the budget and to improve central bank mandates and governance—there is room in some countries to enhance the governance of central bank boards and bolster financial independence, including through budgetary autonomy and proper capitalization.