The Main Challenges for Central Banking in Latin America

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During the Annual Meetings of the International Monetary Fund and World Bank, which took place in Lima in October 2015, two interesting seminars were held on the challenges facing central banks in Latin America. It is clear from the discussions during the seminars and subsequent reflection that the monetary and financial agenda for Latin American countries remains heavy and complex. The main challenges for central banking in Latin America can be divided into three groups: traditional challenges; those associated with the refinement of the inflation targeting frameworks; and the challenges generated by global cycles and the recent financial crisis.

Traditional challenges: reducing inflation and strengthening monetary independence

Inflation in Latin America has subsided significantly in recent decades. Nevertheless, the average for the region is still above that recorded in other regions of the world at similar levels of development (Chart 1). The reason for this is that the successes have not been shared by all countries and, in some cases, have been reversed. A number of economies in Latin America are still among the world’s highest-inflation countries, such as Venezuela, which has the highest inflation rate and Argentina that ranks third (Table 1).

As in the past, these high levels of inflation reflect a significant deterioration in public finances and fiscal dominance, which is expressed through government pressures on central banks to finance the fiscal deficit owing to the lack of independence of these institutions. In other economies inflation is ranging between 6 and 12 percent. There are many causes for

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this inflationary bias, from adjustments in relative prices and institutional weaknesses in central banks to fiscal policies that put pressure on the exchange rate and inflation expectations. Moreover, in some countries, indexation—particularly of wages—and the dollarization of the economy limit the effectiveness of monetary policy and thus the possibility of achieving lower inflation. Consolidating the independence of the central banks and strengthening the fiscal frameworks in high-inflation countries will help to achieve greater price stability. In highly indexed and/or dollarized countries, significantly reversing these distortions will be possible only following long periods of macroeconomic stability.

The refinement of inflation targeting regimes

Latin America faces the challenge of deepening the mechanisms for the transmission of monetary policy. In almost all economies in the region these transmission mechanisms are weaker than they are in advanced economies, most often because of smaller financial systems in these countries. This points to the importance of financial deepening and inclusion as policies that will promote potential growth and, as a byproduct, allow for more efficient implementation of monetary policy.

A second pending task in countries, such as Mexico and Peru, is to ensure that one-year inflation expectations converge with the central bank’s inflation target in order to strengthen the anchoring of those expectations. Ideally, one-year inflation expectations should fluctuate around the inflation target—as in Australia or Chile (Chart 2)—as they capture the effects of temporary supply shocks. The problem arises when deviations persist in a single direction since this suggests that there is a short-term bias in the credibility of the inflation target. Achieving greater convergence between inflation expectations and the official target probably requires an improvement in central bank communications and more systematic achievement of the official inflation target.

The reliability of the measurement of the output gap is no less important, but this is a concept that is difficult to measure. In many cases, a comparison of real-time measurements of the output gap to estimates made some years later using more complete data can even change the sign of the output gap, and its order of magnitude can vary considerably. The data available when monetary policy decisions are taken can thus lead to suboptimal results. This does not mean that central banks should abandon the use of the output gap in monetary policy decision-making, but rather that they should make an effort to improve its measurement and, above all, supplement their information with more detailed studies and indicators, especially of the country’s labor market and of capacity utilization.

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One final important aspect of the consolidation of inflation targeting regimes is the role played by the exchange rate. Countries that have transitioned to this monetary policy model have seen a significant reduction in the exchange rate pass-through to inflation. Nevertheless, an analysis of the data suggests that large exchange rate fluctuations continue to have important effects on consumer and producer confidence indices, which adversely affect consumption and investment and thus limit the expansionary effect of currency depreciation on aggregate demand (via the stimulus to net exports). This situation seems to be a reflection of the numerous episodes in the region in which currency depreciation was associated with financial crises and ultimately economic recessions. The transition to flexible exchange rates within a framework of deeper financial systems, the enhancement of the credibility of most of the central banks in the region, and improvements in financial system regulation have decreased the likelihood of financial crises considerably. Thus, with the passage of time, confidence indicators should be less influenced by fluctuations in the exchange rate.

The effect of external factors on monetary policy decisions and the role of the central bank in the stability of the financial system

Many Latin American countries have recorded lower economic growth, significant currency depreciations, inflationary pressures, and financial concerns associated with the reversal of capital flows in recent years. Two main factors are driving this economic performance. First, the economic cycle in some countries in Latin America (Argentina and Brazil—looking beyond their internal problems—but also Colombia, Chile, Paraguay, Peru and Uruguay) is to a large extent associated with China’s cycle. Therefore, the economic deceleration in China leads to a deterioration in the terms of trade and a reduction in export volumes in our countries, resulting in lower economic growth as well as currency depreciations and inflation. Second, given that the capital account in Latin American countries is linked to the economic cycle in the United States, the normalization of U.S. monetary policy has generated financial volatility and lower capital inflows, thus increasing the pressure on domestic currencies and inflation.

This combination of exogenous factors creates problems and concerns when it comes time to implement monetary policy. For example:

1. Central banks face the dilemma of whether or not to raise the policy interest rate. Increasing interest rates helps to limit capital outflows, currency depreciations and consequently inflation, but at the same time has a negative impact on economic activity. The traditional monetary policy recommendation in the face of supply shocks is that the interest rate should be determined by domestic conditions and that inflation should be allowed to reflect the direct effects of exchange rate depreciations. It is only when this direct effect contaminates other prices in the economy and inflationary expectations that monetary policy adjustments are recommended.

Unlike in the past, this time the nominal depreciations observed over the past 18 months have not resulted in significant increases in inflation and the real adjustment has taken place in an orderly fashion. Nevertheless, there is still room for concern given the size of the
exchange depreciations and their persistence, and the fact that the pass-through effect is not linear or takes place with a significant lag and ends up contaminating inflation expectations and inflation. This is occurring in Latin America, even to some extent in countries where inflation expectations have remained anchored, such as Chile and Colombia, as one-year expectations are now diverging from the central bank target (Chart 3). In this case, central banks are forced to raise interest rates to avoid the second round effects of currency depreciations—reflected, for example, in adjustments in wages and the prices of nontradable goods—even though interest rate decisions are taken at the expense of economic activity.

2. Given the magnitude of these currency depreciations and the volume of private debt denominated in foreign currencies in recent years, central banks must also monitor the negative impact on corporate balance sheets and their effect on the financial system.

3. The possibility of a prolonged and highly volatile capital outflows in a context of monetary policy normalization in the United States raises the question of the instruments available to central banks to deal with the situation. In particular, it is important to assess the role of international reserves and the effectiveness of exchange interventions—their different forms and communication—to complement fiscal and monetary policies. Similarly, combining the use of reserves with the international safety net is a topic that requires consideration.

On the other hand, Latin American central banks must define the role that they should play to preserve the stability of the financial system in their countries and the ways in which they can better coordinate monetary and macroprudential policies. The global financial crisis has shown the importance of monitoring the potential generation of vulnerabilities, not only in commercial banks but also in other financial institutions, and of the need for applying macroprudential policies to correct such vulnerabilities. In various advanced and emerging economies, central banks have largely assumed this responsibility (United States, United Kingdom, Ireland, Israel, Malaysia, etc.). In Latin America smaller changes have been made. Chile, Mexico, and Uruguay have established financial stability committees in which the central bank participates formally or informally, but the decision-making capacity of these committees is limited in practice.

Looking ahead, it is likely that central banks in the region will have to become more involved in the formulation of macroprudential policies, given the technical capacity that they have developed over time to assess the interaction between the macroeconomy and the
performance of financial systems. Moreover, central banks are in a unique position to examine the effect of monetary policy decisions on financial activity and of macroprudential measures on monetary policy and, thus, to promote an optimal combination of the two.

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