Monetary Policy and External Shocks in Latin America: Global Inflation Pressures, Monetary Tightening and Liquidity

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Pablo García Silva, Vice Governor, Banco Central de Chile

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The traditional view on the global financial/liquidity cycle:

The global financial/liquidity cycle is driven by monetary policy by the Federal Reserve.

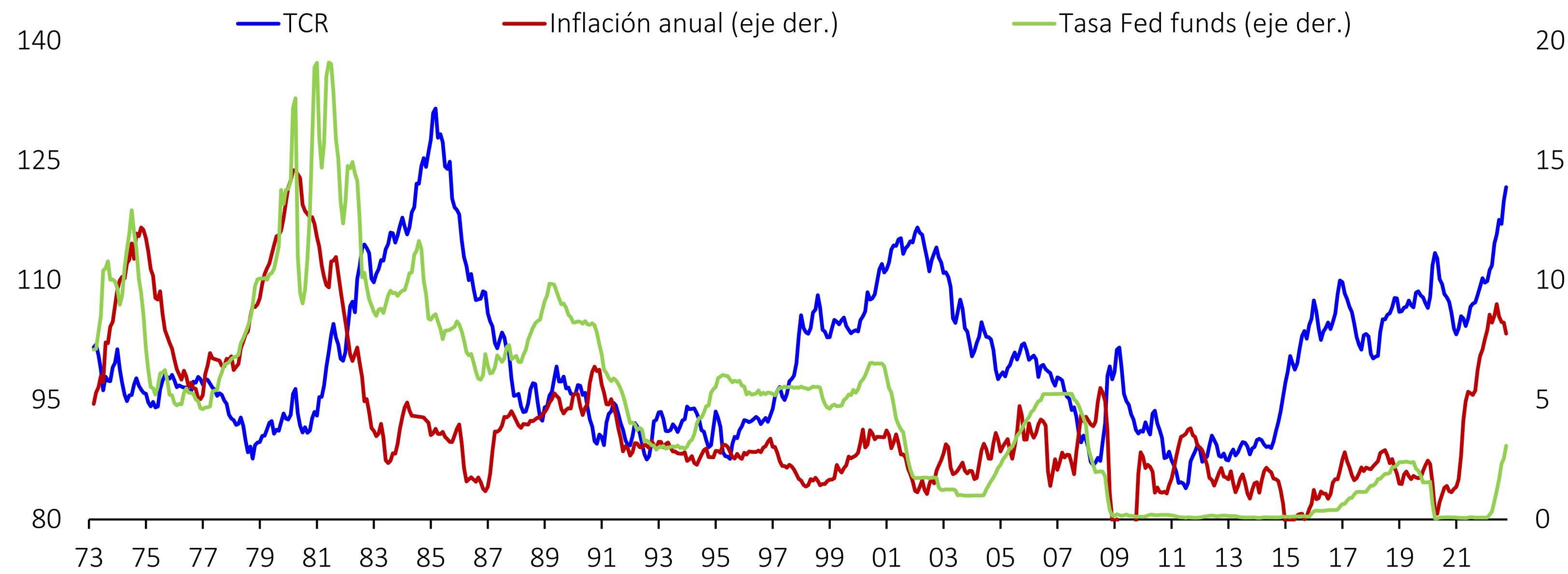
These cycles lead to volatile capital flows and swings in exchange rates (when the US sneezes we get a cold in EMEs).

A tightening cycle by the Fed coupled with USD strength is a harbinger that something is going to break in Emerging Economies.

The USD cycle is apparent from history. Its relationship with inflation and monetary policy is les clear cut.

Inflation, Monetary Policy and the USD Real Exchange Rate cycles

(jan 2006 = 100; percent)



Fuente: Reserva Federal.

Maybe things could be different this time? (not necessarily better, but different)

The dollar cycle has been a lagging indicator of financial stress. (Volcker shock in 1980, Asian crisis, dotcom, and commodites plus Latam in 2001).

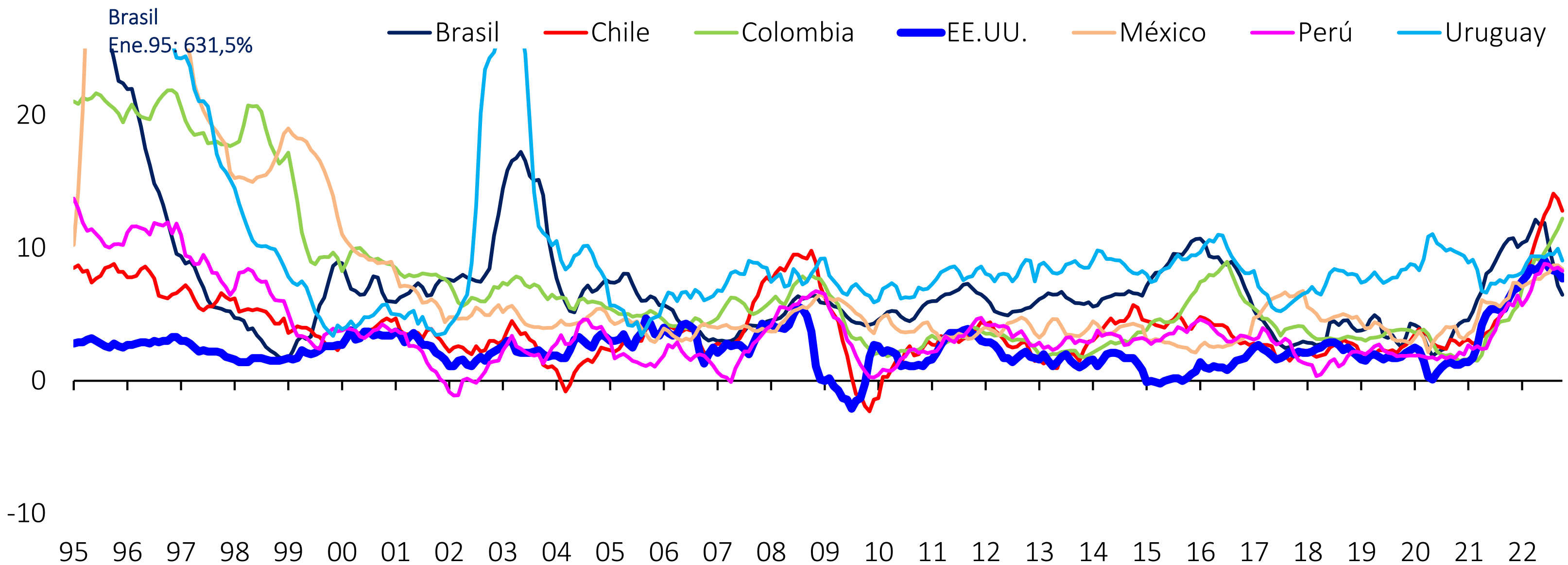
Is it lagging the COVID shock and the worst is behind us? Or is there more stress and dollar strength in the pipeline?

The effect of the FFR on financial markets. Is it stronger today? We are witnessing a mayor adjustment in housing activity and a tightening of credit conditions globally.

There is a big downshift in expected inflation in the US.

The post COVID inflation surge in Latin America in perspective is informative

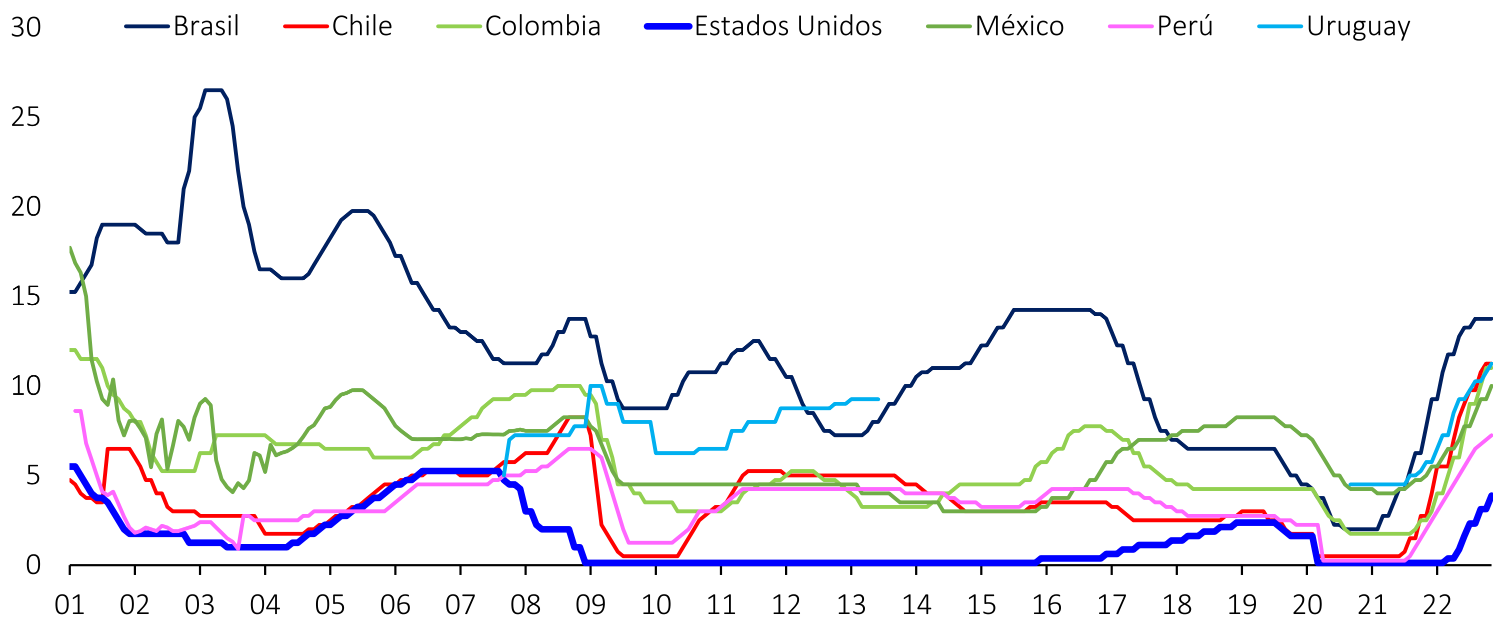
Headline Inflation
(percent)



Fuentes: Banco Central de Chile y Bloomberg.

Monetary policy tightening in LATAM started early in the post COVID inflation surge

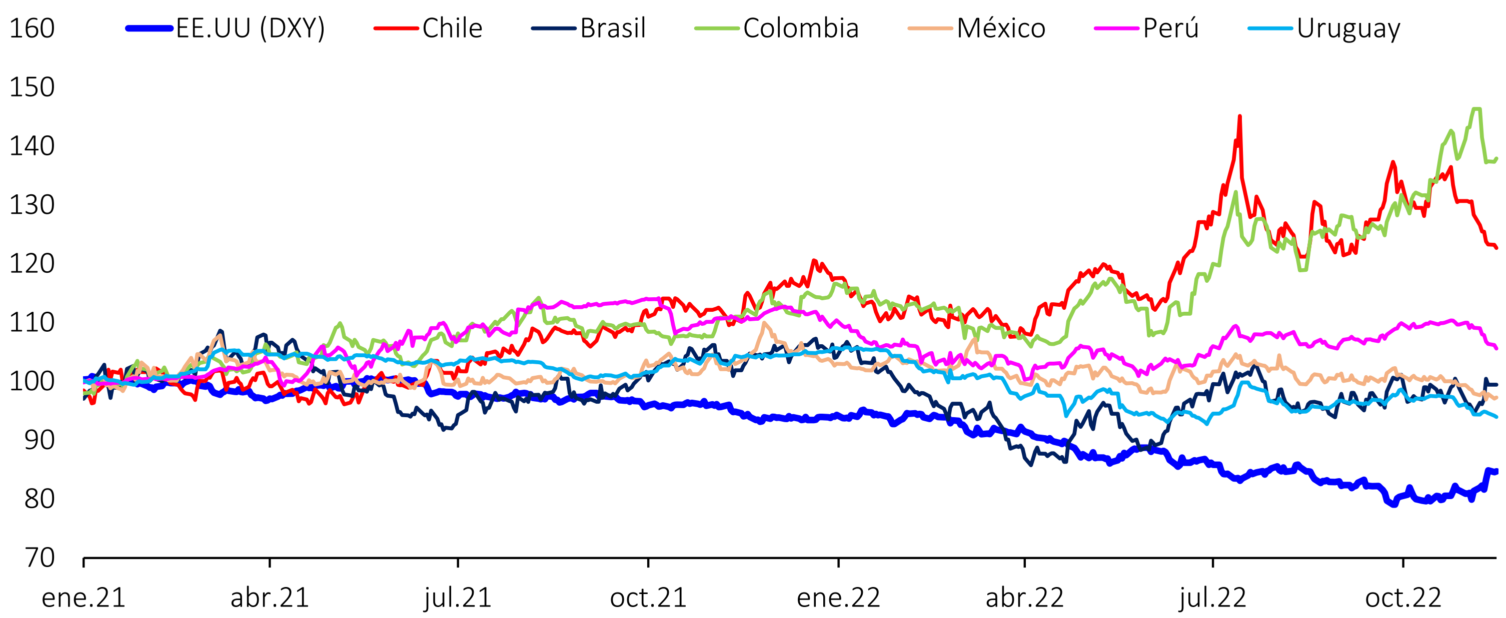
Monetary Policy Rate
(percent)



Sources: Banco Central de Chile and Bloomberg.

The exchange rate response to global USD strength has been relatively muted, except in Chile and Colombia (local factors?)

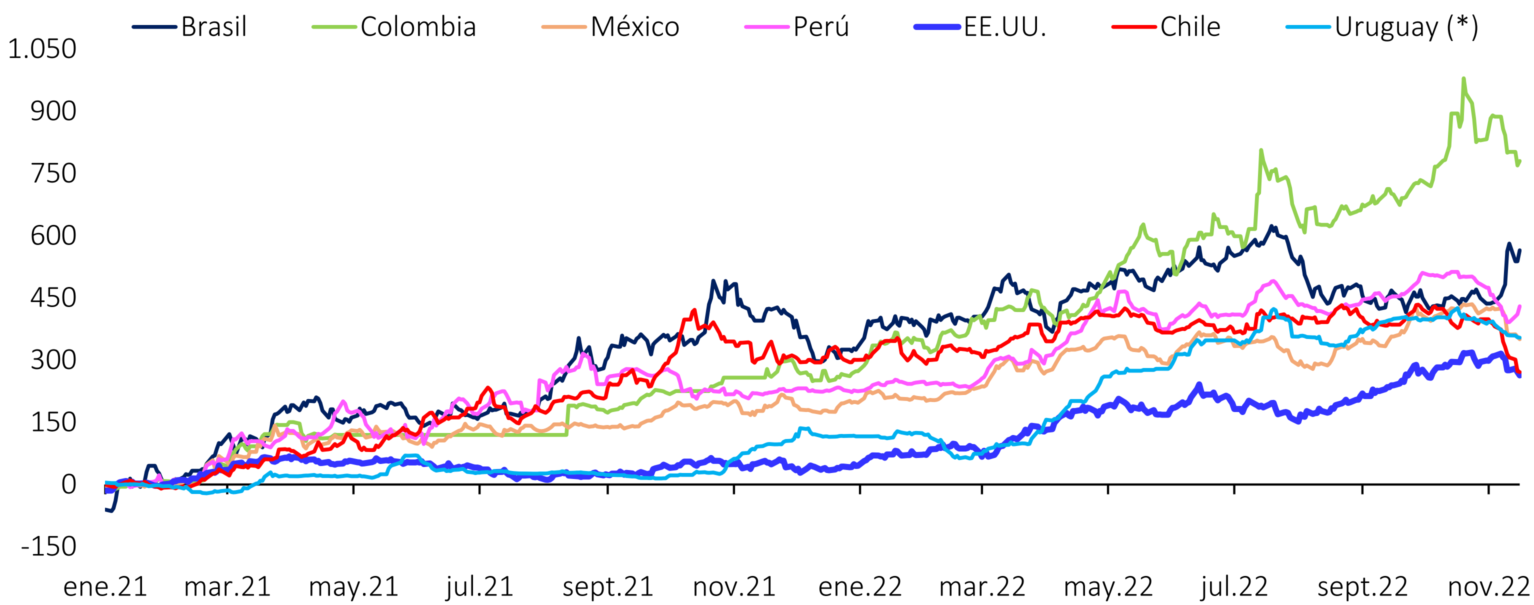
Nominal Exchange Rate
(Index January 2021 = 100)



Fuente: Bloomberg.

Local fixed income markets in Latin America have not reacted very significantly to the latest (2022) increase in US yields. Idionsyncratic factors are also at play.

10 year local currency bond yields
(differnce from January 2021, basis points)



(*) Empalme de las series de los bonos a 2028 y 2031, en pesos uruguayos.
Fuente: Bloomberg.

Still mayor concerns going forward

Fiscal policy globally did not consolidate fast enough post-COVID, leaving little space for income support in the coming downturn.

Fiscal balances will remain under stress with the risk of spillovers to fixed-income markets, especially if inflation does not consolidate a downward shift.

Monetary/exchange rate frameworks in AE are also under tension.

Geopolitical concerns will probably continue to weigh in sentiment.

Domestic political uncertainty will linger in LATAM.

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