LatAm Central Bankers Bask in Fed Pause

BY JESSE ROGERS — JUNE 28, 2019
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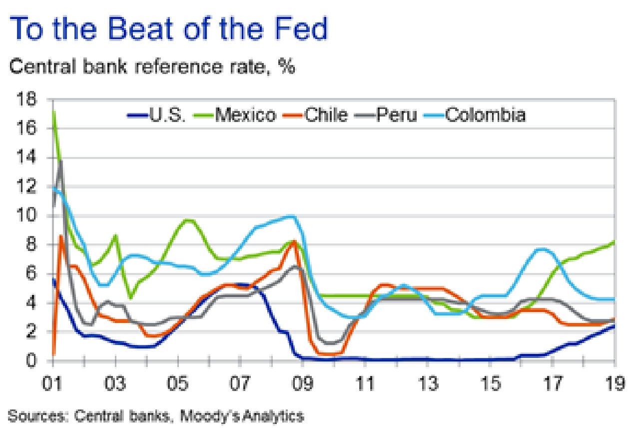
- The Fed has created breathing room for Latin America's central bankers.
- Central banks in Latin America's largest countries tend to move in concert with the Fed in the long run, but monetary policy changes in the short run are hardly synchronous.
- The divergence between local economic conditions and monetary policy stance is prominently on display in Mexico.

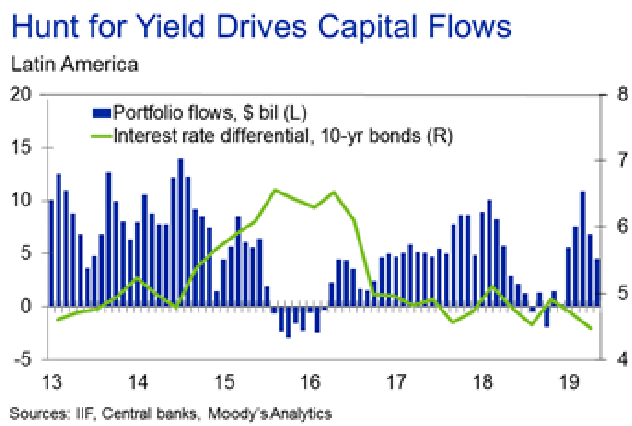
The Federal Reserve's move to step off the brake in June has created a rare bit of breathing room for Latin America's central bankers. Whether they will seize it is another matter. Higher interest rates in the U.S. cranked up the pressure on exchange rates and financial assets this time last year, sending the Argentine peso into a tizzy and bumping up borrowing costs for most sovereign and corporate issuers. The Fed's shift toward more accommodative policy lets out some of this pressure. But don't expect a shift in interest rate policy any time soon, even if rumblings of a Fed rate cut prove prescient.

Together for the long haul

Central banks in Latin America's largest countries tend to move in concert with the Fed in the long run, but monetary policy changes in the short run are hardly synchronous. This is because changes in Fed policy often coincide with moments of global uncertainty. To stem capital flight and the accompanying exchange-rate pressures that tend to accompany Fed announcements of a major policy change, emerging market central banks are obligated to raise rates even if local economic conditions argue otherwise.



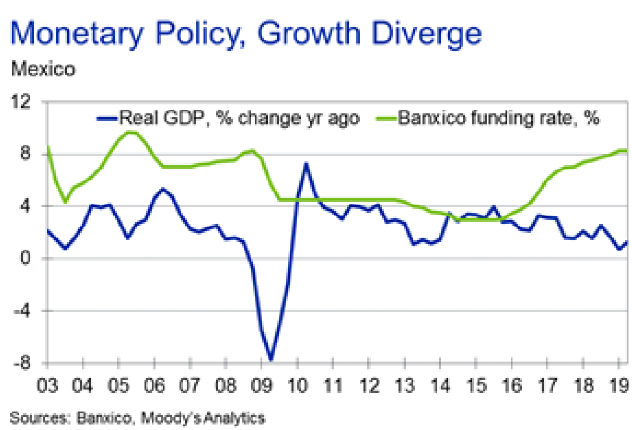
Over the latest business cycle, economic conditions in Latin America have decoupled from the U.S. This is the result of structural changes in the global economy as well as idiosyncratic developments in the region such as the recession in Argentina and the earlier downturn in Brazil. The result has been increased volatility in capital flows to the region.



When the Federal Reserve began to taper its program of quantitative easing in 2014, capital inflows to the region went into reverse. Capital flight occurred again in late in 2014 and 2015, when the commodities bust began to bite, and over the course of 2018, when the Federal Reserve began to increase rates in earnest.

A very Mexican standoff

The divergence between local economic conditions and monetary policy stance is on display across the region, but nowhere more prominently than in Mexico, where officials have tightened interest rates despite a broad slowdown in growth.

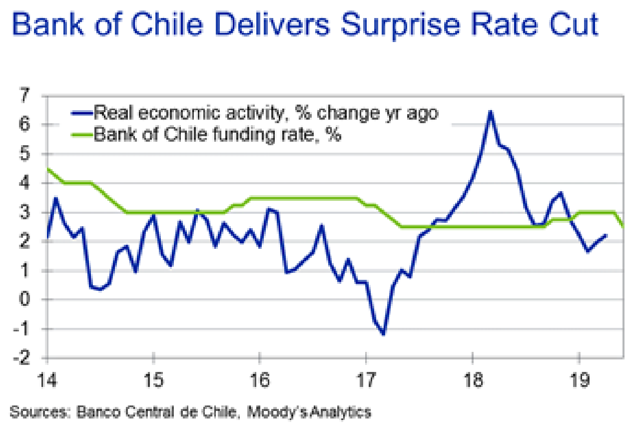


Financial jitters related to the Trump administration's policies on trade and immigration and the unorthodox policies of new President Andres Manuel Lopez Obrador have caused the exchange rate to depreciate and inflation to rise. Put simply, a cheaper peso has made imports of all kind more expensive, causing both consumer and producer prices to rise.

Although recent rate hikes by the Bank of Mexico have narrowed the interest rate differential between U.S. and Mexican assets, helping to stem capital flight and stabilize inflation, tighter economic policy in Mexico has caused growth to stammer. The Fed's decision to pull back from monetary normalization in May could end this dangerous standoff, especially if its July meeting concludes with a rate cut.

The Chilean put

Several emerging market central banks have moved to ease policy ahead of the Fed. Most of these have a far better record of managing inflation and household and business expectations than central banks in Latin America. The exception is Chile, where bank director Mario Marcel Cullell marshaled a 50-basis point cut at the bank's June meeting, the largest since 2008.



The move was partly a monetary sleight of hand. Bank directors bumped up their estimate of Chile's potential growth to justify extra stimulus. While the new estimate of potential growth has a large margin of error, the rate cut did not stem capital flight because of the bank's relative prowess in directing market expectations.

Peru's central bank could soon follow. Aided by a track record of fiscal discipline and prudent management of market expectations, central bank chief Julio Velarde laid the groundwork for extended monetary stimulus. Although the bank will leave rates unchanged for now, they remain firmly in expansionary territory.

The central bank of Colombia has used its clout with investors to move rates in an opposite direction. With the economy picking up steam, bank directors are expected to tighten the rope when they meet later this summer.

Trouble in Brazil and Argentina

Argentina's prolonged recession and Brazil's recent flirtation with very low growth cloud the outlook for rates this year. Argentine policymakers have kept policy on hold in recent months thanks to greater stability in the peso and signs that chronically high inflation has begun to cool. But capital flight ahead of October's elections could force officials into a more aggressive posture.

Brazil's central bank has kept monetary policy on hold for almost a year as inflation pressures recede. However, much is hanging on the country's landmark pension reform, and a misstep on this front could spook investors, with the resulting capital flight reigniting inflation. The worsening of the country's long-running corruption scandal calls for additional caution.

It is too soon to call reform prospects dead, and we hold to our call for monetary policy to loosen later this year. We will revise our outlook for growth and interest rates should reform prospects darken, but in the very near term, the pause by the Fed should give Brazil's monetary policymakers and Congress a little more room for maneuver.

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