CENTER
FOR
GLOBAL
DEVELOPMENT

CGD NOTE | NOVEMBER 2022

Defeating Inflation: Latin America's Most Immediate Challenge

Latin American Committee on Macroeconomic and Financial Issues Statement No. 45

I. Causes of inflation in Latin America

Inflation has become a central feature of the global economy. In Latin America (aside from idiosyncratic cases such as Argentina and Venezuela, where high inflation rates have long been the norm), inflation began to rise the first half of 2021, at the same time it did in the US. The fact that rising inflation has been a synchronized global phenomenon reflects two main causes, both directly related to the Covid-19 pandemic and the associated policy response.

Lockdowns and mobility constraints around the world generated an adverse supply shock, involving serious disruptions in global supply chains and the virtual shutdown of important economic sectors. At the same time, and most importantly **in the view of the Committee, the fiscal and monetary policy responses in the US and other economies generated an unprecedented increase in aggregate demand. The expansion of monetary aggregates triggered by the Federal Reserve in the early months of the pandemic dwarfed the monetary expansions that occurred during previous crisis episodes, including the 2008-09 global financial crisis.**

Initially, and similarly to what happened in 2008-09, the monetary expansion was not associated with inflationary pressures. Back then, the Fed expanded its balance sheet to compensate for the destruction of private liquidity that occurred after the fall of Lehman. In 2020, by contrast, there was a sharp increase in the precautionary demand for money. So, despite the 20-percentage point increase in the ratio of M2 to GDP, there was no obvious disequilibrium between the demand for and the supply of liquidity. Thus, in the early months of the pandemic, inflationary pressures did not materialize.

But when the pandemic started to recede, the situation changed drastically. The precautionary motive that had induced the sharp increase in the demand for money gradually started to reverse,

creating incipient excess liquidity in the US. In addition, the US embarked on large and reiterated fiscal expansions. The net effect was that inflationary pressures surfaced around May 2021, accelerated in early 2022, and in June peaked at nearly 9% over 12 months, the highest such figure in over four decades.

Initially, it was unclear to what extent inflation was driven by the adverse supply shocks or by the sharp increase in aggregate demand associated to the expansionary monetary and fiscal stance. Many observers tended to stress the global supply chains disruptions as the main driver of inflation, concluding that the phenomenon would likely be transitory and therefore did not require an immediate tightening of monetary policy. Moreover, after over a decade of very low inflation and even deflationary pressures, the Federal Reserve had become strongly concerned about the potential impact of policy normalization on the labor market and economic activity. The result was that monetary policy in the US and other advanced economies fell behind the curve, and the response to rapidly rising inflation was delayed, while supply constraints remained.

These developments had a negative impact on Latin America. Given the dominant role of the US dollar in the invoicing of global trade, rising US inflation translated in higher imported inflation. Moreover, international capital markets became increasingly worried about the eventual need for a sharp tightening in US monetary policy, which caused currency depreciations across the region. Weaker currencies, in turn, added to domestic inflationary pressures.

In addition to the effects of policies in the US and other advanced economies, local—and synchronized--policy actions also played a role on the path of inflation. As in most other regions, Latin American governments conducted expansionary fiscal policies to support firms and households during the pandemic, albeit with significant differentiation among countries. These expansions were not quickly reversed as consumption recovered, adding, therefore, to pressures on currency depreciations and inflation.

II. Policy response

Unlike the Federal Reserve, which was late to react to inflation and initiated its tightening cycle in March 2022, the policy response of Latin American central banks was timely. Brazil's Central Bank was the first to launch a preemptive tightening cycle in May 2021, followed by Mexico in June 2021, Chile in July 2021 and Peru in August 2021. The rapid reaction of central banks to increasing inflation had several sources. The combination of higher imported inflation and depreciating currencies prompted central banks in the region to act early and preemptively to avoid a repeat of costly past inflationary experiences. The policy tightening was also seen as an indispensable response to tightening global liquidity conditions and the resulting pressures in foreign exchange markets. Avoiding excessive depreciations can be desirable in countries with financial fragilities, in order to prevent harmful balance sheet effects and the potential shift to an inferior equilibrium.

III. Prospects of inflation in the region and risks

US inflation appears to have peaked, but significant uncertainty still exists about its persistence and the potential impact of monetary tightening on economic activity. The Federal Reserve projects to bring its monetary policy rate in the range of 4.5% to 5% in 2023. It is encouraging that inflation expectations remain well anchored, reflecting the significant credibility acquired by the Fed in recent decades, although backward-looking expectations cannot be discounted.

The Committee believes other factors may contribute to a faster-than-anticipated reduction of global inflation. First, monetary tightening is currently occurring simultaneously across regions. Second, increased risk indicators and lower prices for US Treasuries along the entire yield curve cut back on global liquidity and reduce available collateral in international capital markets. Third, quantitative tightening both in the US and Europe have complemented the increase in monetary policy rates.

In Latin America, the early tightening by central banks appears to be achieving the desired results. Inflation in Brazil has come down sharply in the last couple of months, and Brazil appears to be controlling inflation without inducing a recession so far. Moreover, in the context of elevated fiscal imbalances, the recent monetary response demonstrates the independence of many Latin American central banks from fiscal pressures.

In short, assuming a base-case scenario where no sudden stops take place, **the Committee believes that inflation in the region may start to fall more rapidly over the coming months. With luck, a hard landing scenario can be avoided. Unfortunately, countries such as Argentina and Venezuela are likely to continue to experience high inflation, reflecting idiosyncratic factors and endemic macro-policy weaknesses.**

IV. Policy implications

The global scenario remains highly uncertain. While inflation is starting to decline, it is still too early to declare victory.

Moreover, higher global interest rates increase the risk that the record-high debt levels reached during the Covid pandemic may become unsustainable. This is reflected in emerging markets high yield spreads, which remain at extremely elevated levels, only comparable to the peaks reached under the Covid pandemic and the Lehman collapse. At the same time, spreads on investment-grade emerging market assets have increased but less sharply.

In this context, **the Committee believes that central banks in Latin America need to be cautious and maintain their current tight stance until there is clear evidence that inflation is receding.** A premature loosening of monetary policy may hamper hard-earned credibility.

In the current context of significant capital outflows from emerging markets, authorities also need to prepare for the possibility of disruptive sudden stops in international capital markets. In this context, **the Committee believes that the burden of the policy preparedness cannot fall exclusively on central banks. Fiscal policy needs to play a major complementary role, since it is debt markets that may be subject to sudden volatility. Smaller structural budget deficits and larger liquidity buffers will be critical in reducing financial vulnerability.**

Moreover, it is worth keeping in mind that excess optimism could carry serious risks. The pace of monetary tightening in the US and the flight towards the USD have accelerated since the onset of the pandemic and are likely to increase global macro and financial volatility. This is already partly reflected in the large, unexpected appreciation of the USD. It faces policymakers with challenges that have no clear historical precedent—e.g., the extremely large monetary aggregates' volatility of reserve currencies since WWII—and policy proposals will unlikely meet with wide agreement across government's branches. **The Committee believes that coordination across government (e.g. the finance ministry, the central bank, state owned banks and when, applicable, the banking system regulator), well before it is needed, is highly desirable, but confidentiality is essential. Without it, the mere discussion of crisis scenarios may be self-fulling and, of course, counterproductive.**

As is by now widely appreciated, the policy response to the Covid pandemic resulted in record levels of public debt both in developed economies and in emerging and developing countries. Although liquidity levels —in particular, international reserves— are higher than in previous episodes of capital market volatility, high indebtedness poses a significant risk specially to emerging markets, as suggested by strong and ongoing outflows from these markets during 2022.

High risk levels can be particularly harmful if a credit event in one emerging market generates contagion to other economies and becomes systemic. In such circumstances, otherwise fundamentally sound economies may end up in a bad equilibrium. So far, contagion has not happened —for instance, in the case of Sri Lanka— because fundamentals in countries forced to enter a restructuring were particularly out of line and not indicative of the same situation happening elsewhere. But, as mentioned above, current market conditions and risk indictors among high/yield emerging market and developing economies are only comparable to those prevailing at the start of the Covid pandemic or at the time of the collapse of Lehman in 2008. This is a clear indication of potential vulnerability.

Financial contagion can involve an externality that requires a systemic response. **The Committee believes that the international official community should consider promoting specific actions directed at reducing debt levels in emerging and developing countries, for instance, through debt buybacks. In particular, the Committee believes that, as part of its programs and especially those requiring exceptional access, the IMF should set aside a portion of its assistance to finance exclusively debt buybacks.**

There are two important reasons why debt buybacks are efficient, on top of reducing the above/mentioned externality. Firstly, IMF programs often rely on the expectation that its catalytic role will allow countries to re access the capital market and obtain the financing necessary to repay the Fund. As shown by the Argentine program, this expectation may turn out to be overly optimistic because governments do not necessarily take the necessary actions to restore debt sustainability and have an incentive to use Fund resources in the short-term disregarding the debt burden that is passed over to future administrations. In this context, debt buybacks circumvent political myopia and address debt sustainability directly. Secondly, in the absence of an efficient mechanism for orderly debt restructuring of sovereign debt, IMF-driven debt buybacks may be an efficient tool to de facto restructure debt and avoid costly defaults and debt restructuring processes.

Finally, **the Committee believes that, now more than ever, it is essential that economic policy be supported by political authorities.** Many countries in the region are experiencing more polarized political environments and new governments are facing unusual economic challenges. Policymakers should stay the course and strive to consolidate political support from the widest possible spectrum of sectors. The ability to muster political support and stability have become essential components of investors' confidence and, hence, of financial sustainability.

The Latin American Committee on Macroeconomic and Financial Issues (CLAAF, for its acronym in Spanish) gratefully acknowledges financial support by the Center for Global Development, the Central Bank of Chile, and FLAR for funding its activities during 2022. The Committee thanks Nayke Montgomery Guzmán for his support in the production of this statement. The Committee is fully independent and autonomous in drafting its statements.

This statement was jointly produced by:

LAURA ALFARO, Warren Albert Professor, Harvard Business School, Former Minister of National Planning and Economic Policy, Costa Rica
GUILLERMO CALVO, Professor, University of Columbia; former Chief Economist, Inter-American Development Bank
JOSÉ DE GREGORIO, Professor of Economics, University of Chile. Former Governor of the Central Bank and former Minister of Economy, Mining and Energy, Chile
PABLO GUIDOTTI, Professor of the Government School, University of Torcuato di Tella; former Vice minister of Economy, Argentina
ERNESTO TALVI, Senior Fellow, Real Instituto Elcano, Madrid, former Executive Director of CERES and former Minister of Foreign Relations, Uruguay
LILIANA ROJAS-SUAREZ, president, CLAAF; Senior Fellow and Director of the Latin American Initiative, Center for Global Development; former Chief Economist for Latin America, Deutsche Bank
ANDRÉS VELASCO, Dean of the School of Public Policy, London School of Economics, UK. Former Finance Minister of Chile

This work is made available under the terms of the Creative Commons Attribution-NonCommercial 4.0 license.