Seeking Stability and Responses to Shocks in Latin America

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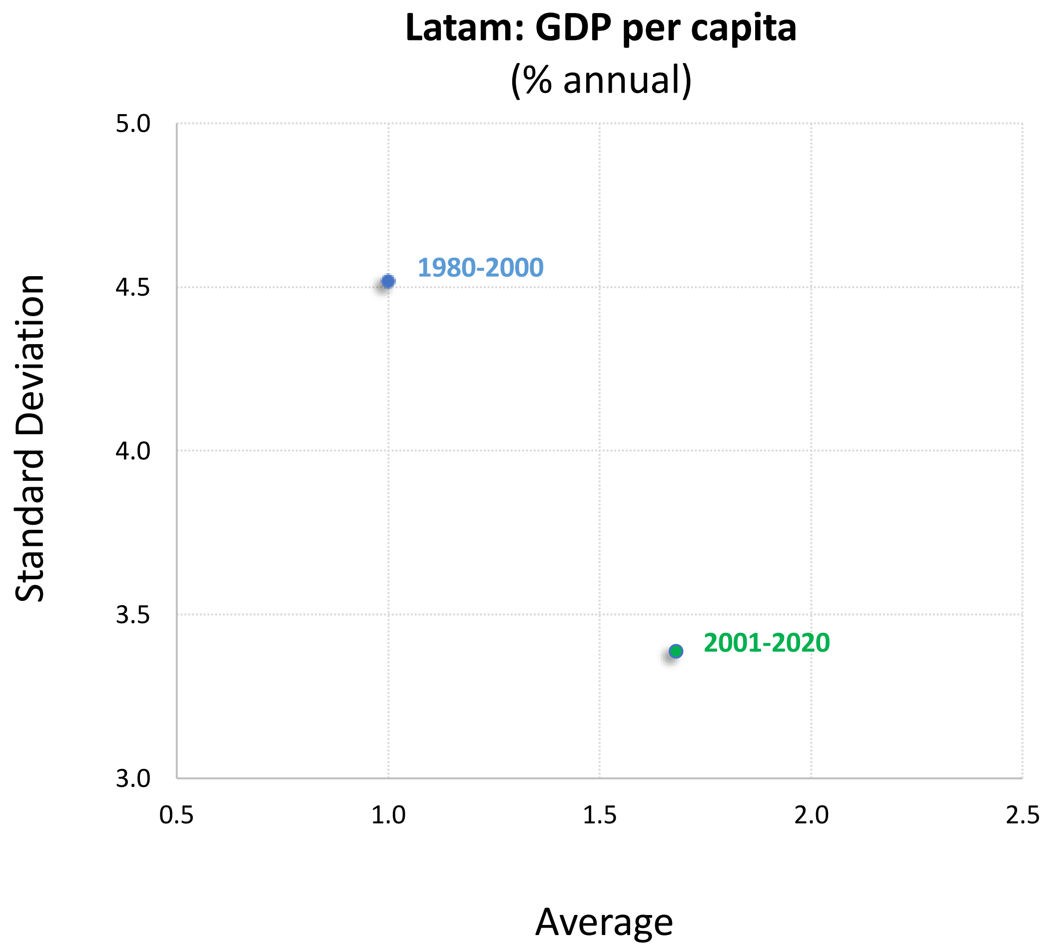
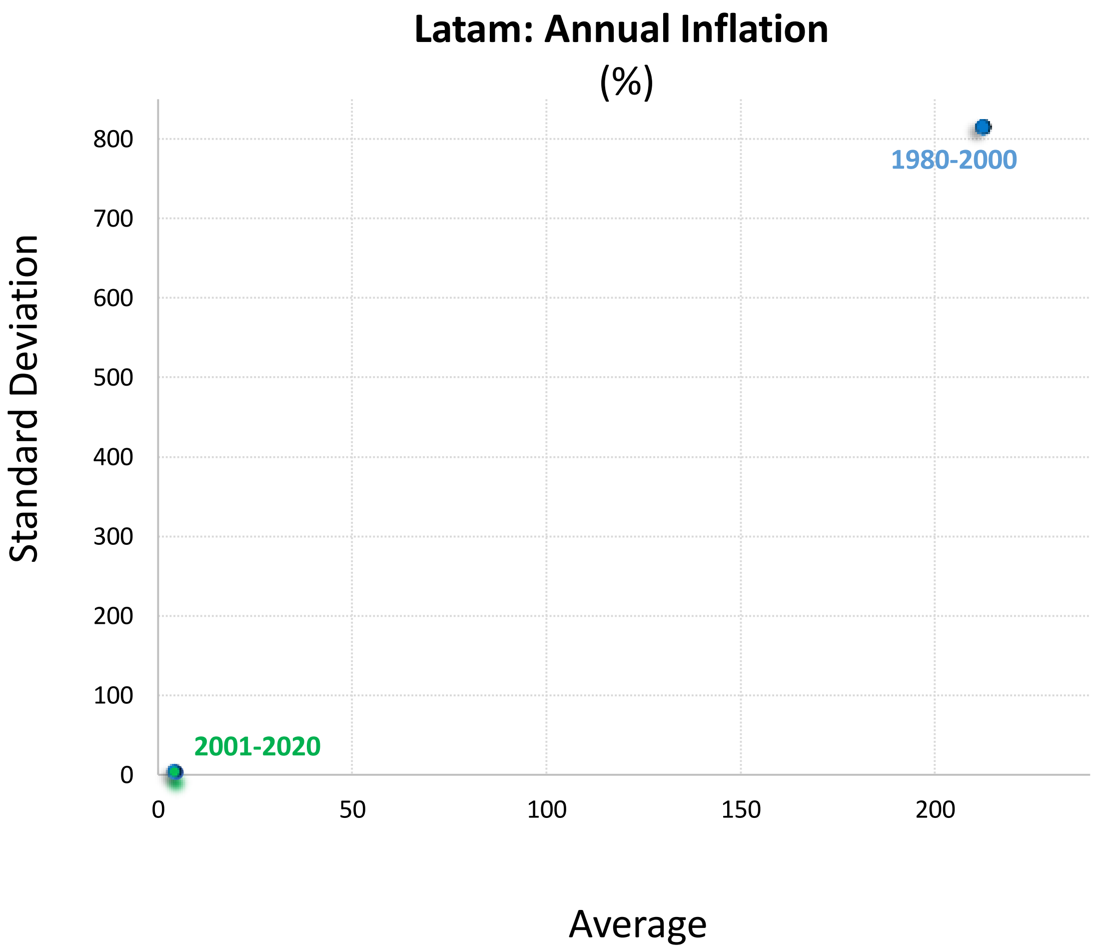
25 Years of Inflation Targeting: Lessons for the Future

Key Characteristics of Latin American IT Economies

- Emerging and developing economies
- Small (semi) open economies
- Predominantly commodity exporters
- Integrated (partially) into global financial markets
- Underdeveloped domestic financial markets
- High exposure to global economic cycles
- Low productivity growth (e.g., high informality)

During the last quarter of the 20th century, LA experienced recurrent financial and currency crises with strong effect on growth and inflation volatility (blue points)



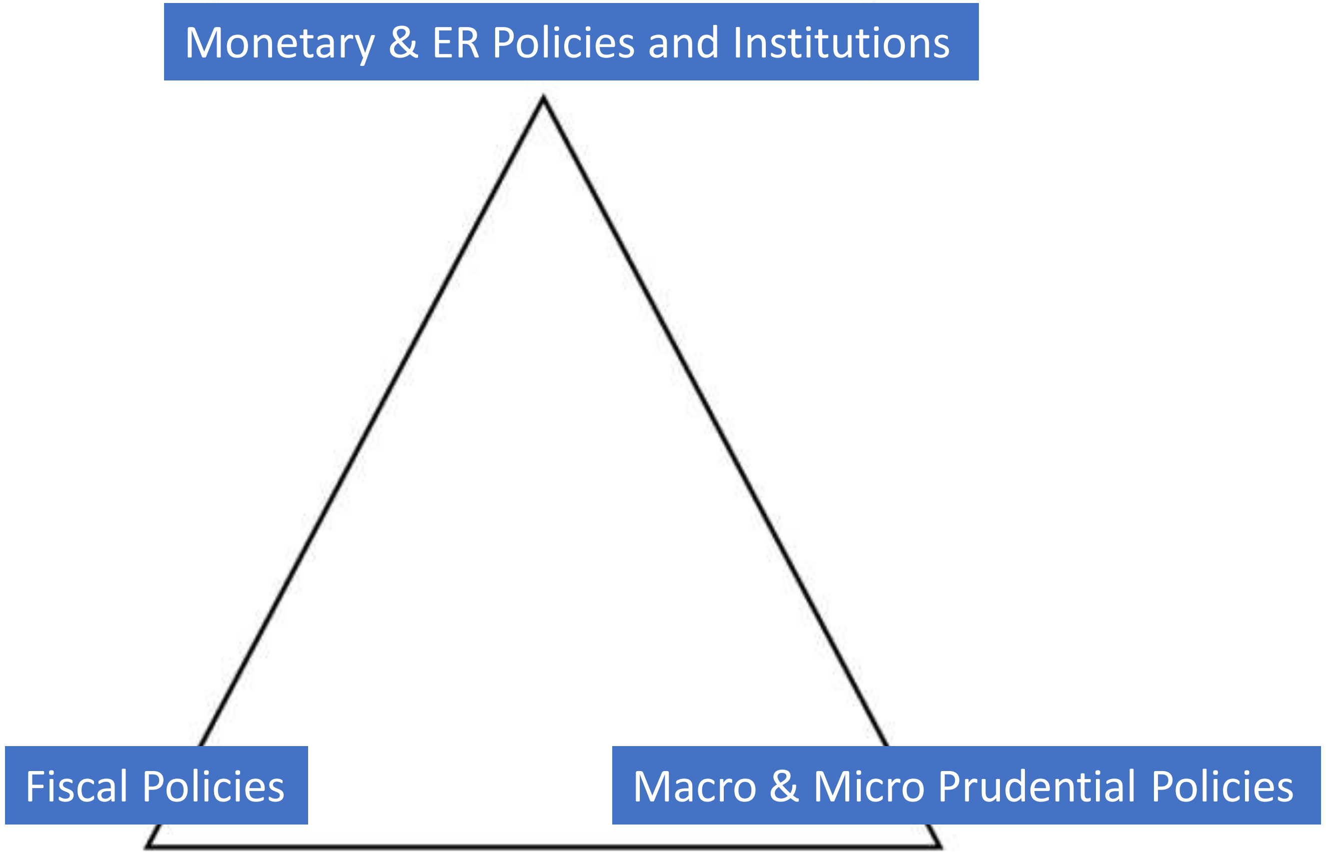


* Latam: Brazil, Chile, Colombia, Costa Rica, Mexico, and Peru.
Source: Penn World Tables, IMF-WEO. Own calculations.

Key Drivers of Financial and Currency Crises

- Terms of trade shocks
- Sudden Stops in capital flows
- Unsustainable fiscal policies
- Fiscal dominance of monetary policies
- Unsustainable exchange rate regimes

The substantial costs of financial and currency crises highlighted the need to enhance institutions and policies to strengthen macroeconomic and financial resilience



Monetary and Exchange Rate Policies and Institutions

- Central bank independence
- Flexible inflation targeting
- (Managed) floating exchange rate regimes
- Enhanced comunication, transparency and accountability
- Restrictions on direct financing to the government

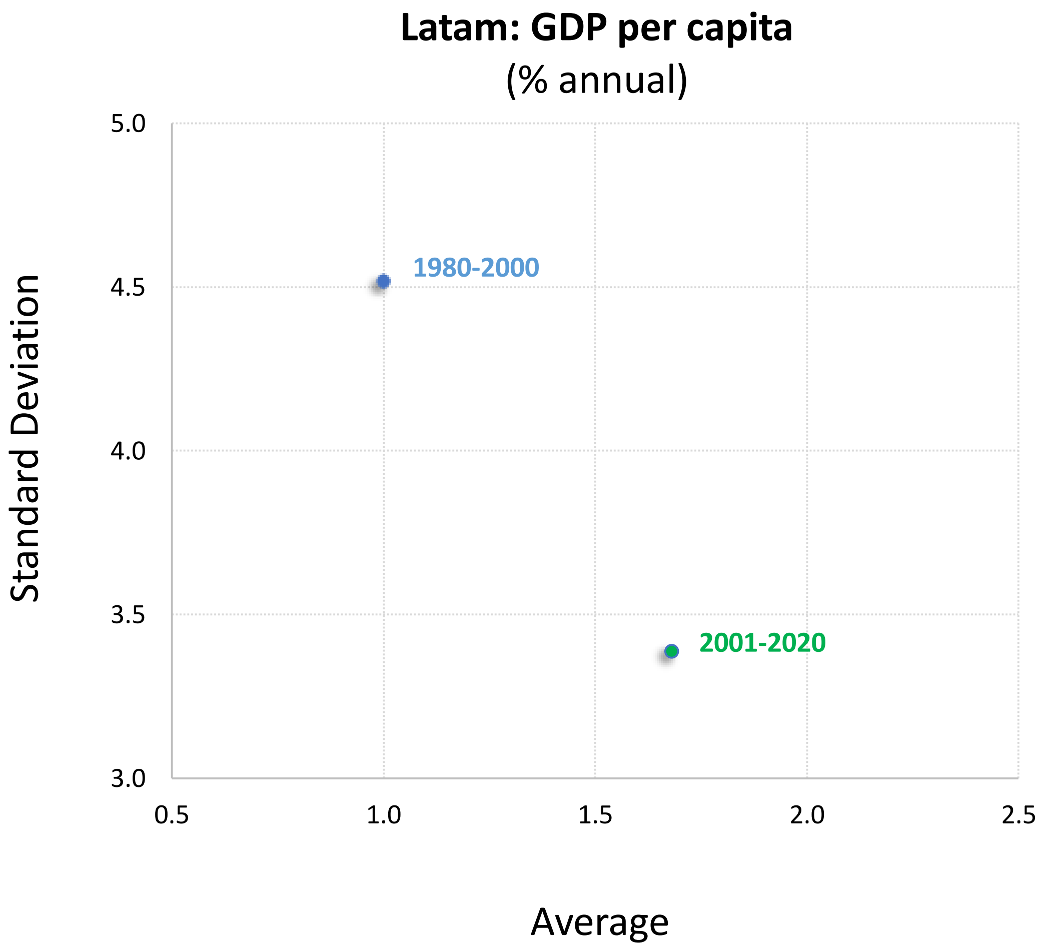
Fiscal policies (more heterogenous)

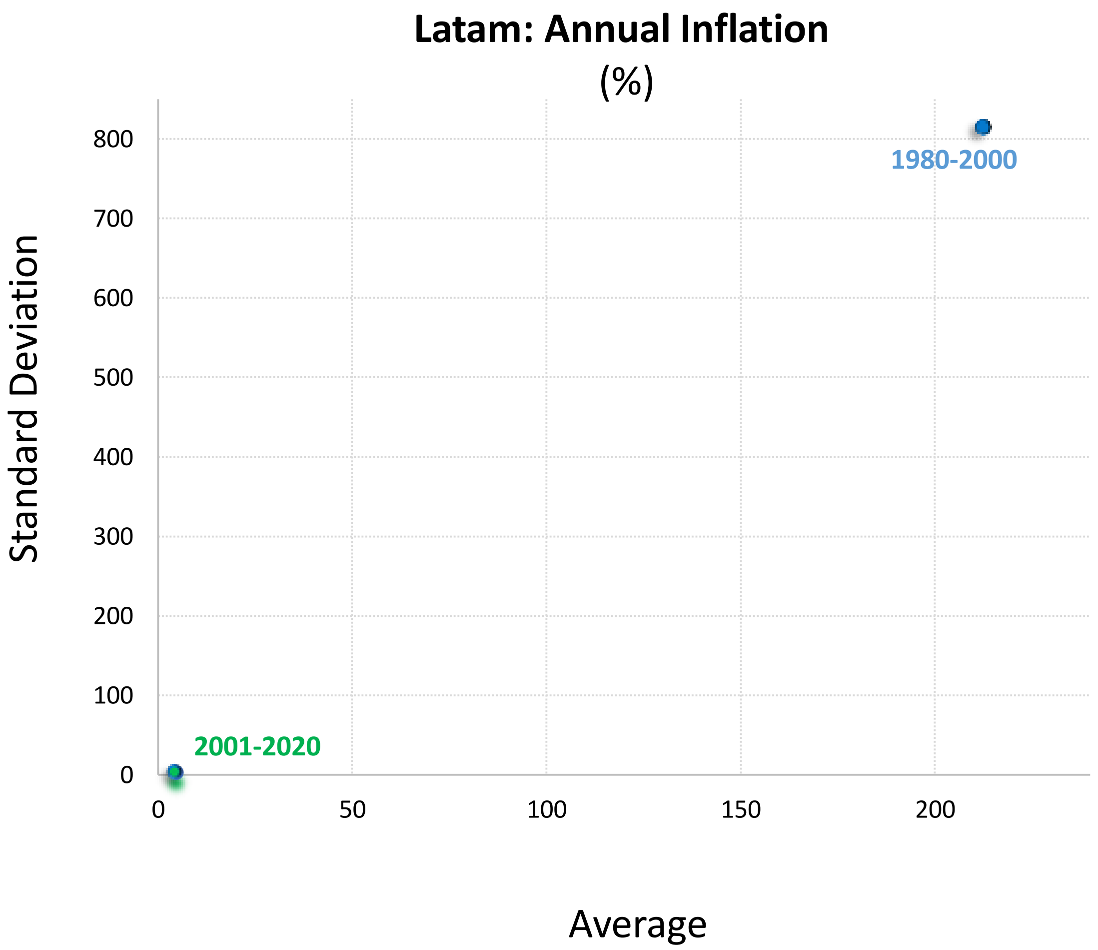
- Adoption of fiscal rules
- Establishment of independent fiscal councils
- Medium-term fiscal frameworks (MTFF)
- Fiscal responsibility laws

Macro and micro prudential policies

- Capital flow management measures
- Countercyclical capital requirements
- Foreign exchange position limits
- Leverage limits
- Liquidity Coverage Ratio (LCR)

With the strengthening of institutions and macro-financial policies, the region experienced lower volatility and greater resilience (green points)





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The new macro-financial framework proved effective in addressing multiple external shocks

- Global Financial Crisis
- Taper Tantrum
- Terms of Trade Shocks
- COVID-19 Pandemic (Supply, Demand, and Financial Shocks)
- War in Ukraine (Terms of Trade and Supply Shocks)
- Sharp and unexpected surge in Inflation
- Rapid Increase in external interest rates

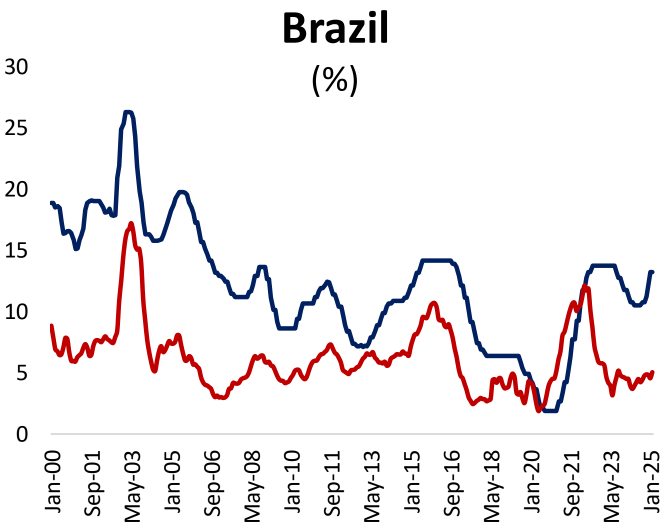
Inflation Targeting (IT) and exchange rate flexibility were key pillars of the new macro-financial policy framework

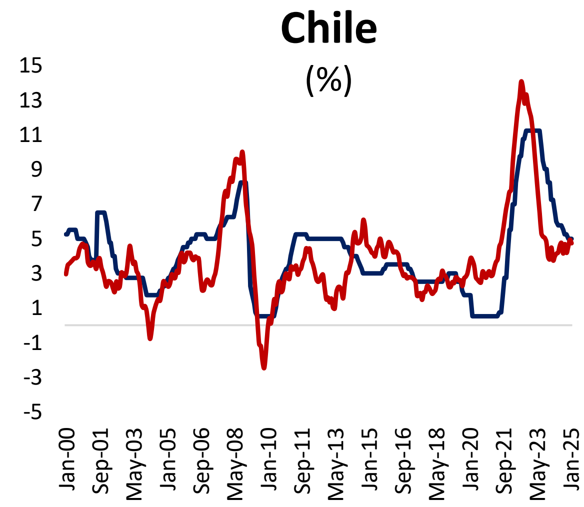
The combination of IT and exchange rate flexibility enabled Latin American economies to adopt countercyclical monetary policies:

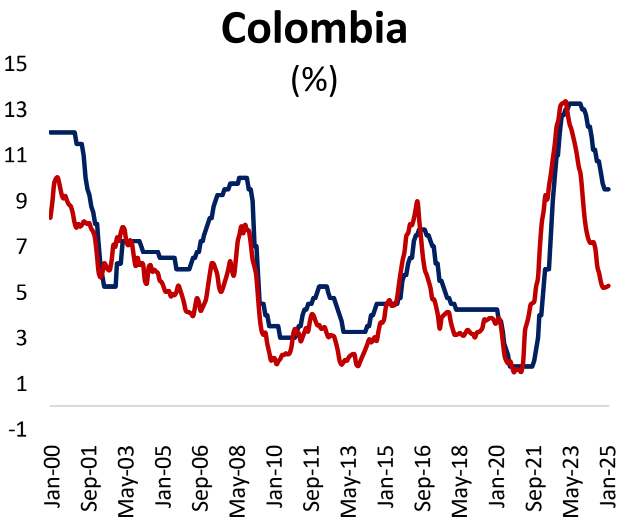
- IT credibility anchored inflation expectations, allowing central banks to adjust interest rates in response to economic fluctuations without fueling inflationary pressures

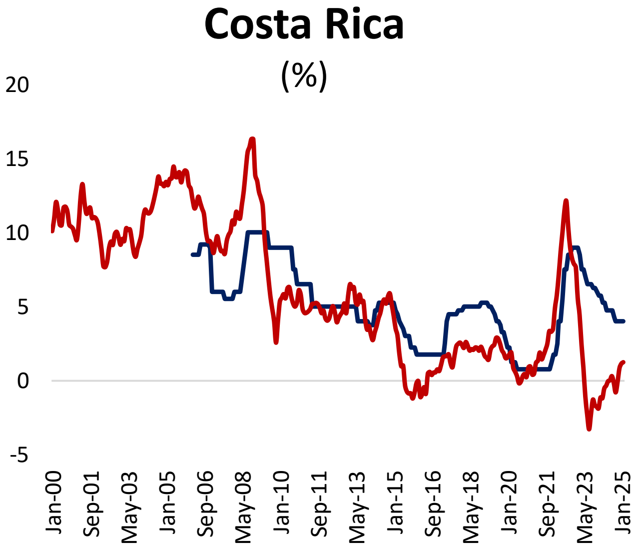
- Exchange rate flexibility acted as a shock absorber, reducing the need for monetary interventions that might otherwise be procyclical

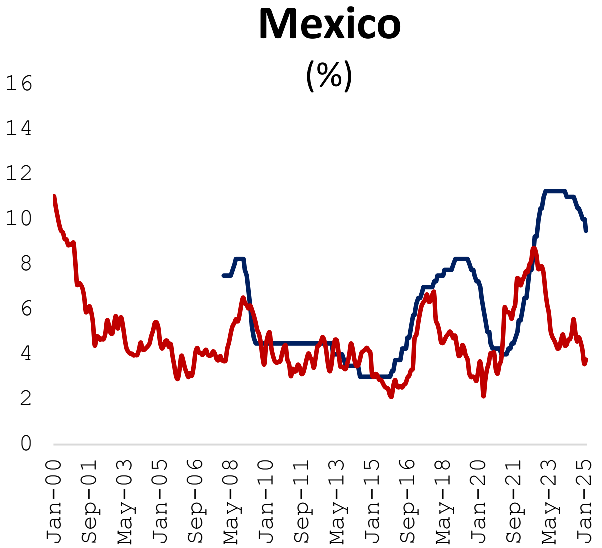
Monetary policy rate counter-cyclical action: 2000-2025

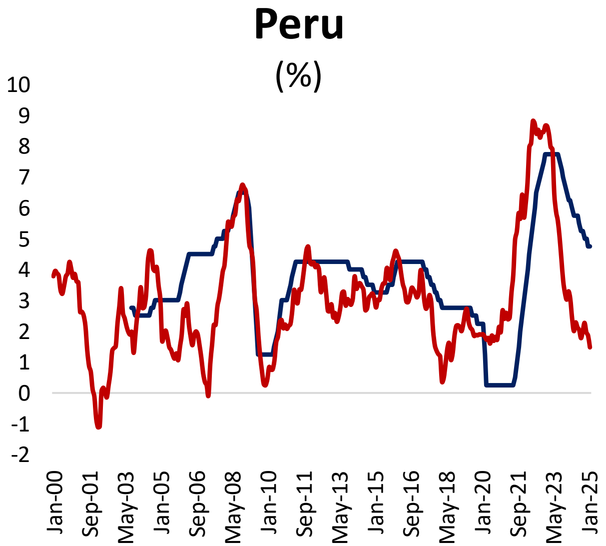












Monetary policy rate — Inflation

While sound macroeconomic and financial policies are necessary, they might not be sufficient to prevent financial and external liquidity crises. For example:

- Capital flows are highly volatile, leading to external liquidity crises that may escalate into solvency crises

- Market and coordination failures in global financial markets contribute to sudden stops, capital reversals, and contagion

Additionally, the global environment remains highly uncertain, and risks of new shocks persist:

- Escalation of geopolitical conflicts and economic fragmentation
- Increasing climate-related events
- Higher volatility in global financial markets

(What if the U.S. economy and the Federal Reserve are not affected by the crisis, unlike the Global Financial Crisis and the COVID-19 pandemic?)

These risks underscore the need to strengthen the Global Financial Safety Net (GFSN), which includes:

- Global (IMF)
- Regional (regional financing arrangements like FLAR)
- Bilateral (Central Bank swap lines)
- National (International reserve accumulation)

In Latin America, the financial safety net heavily relies on international reserves and the IMF. However:

- International reserves are costly, unequally distributed, and low in some countries, creating a ‘fear of using them’

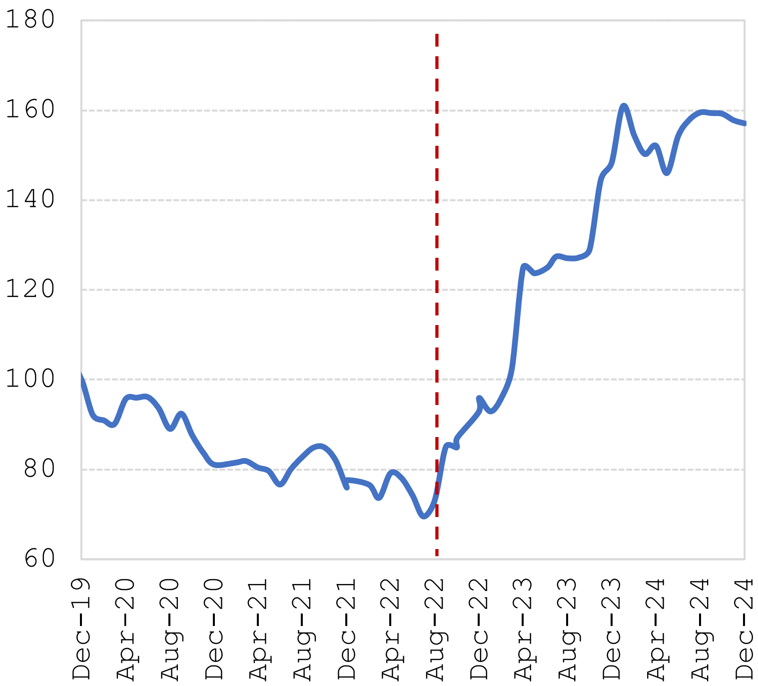
- IMF resources are insufficient for systemic crises, require lengthy negotiations, and some countries are reluctant to use them due to stigma

This highlights the importance of regional financing arrangements like FLAR, which currently has nine member countries: Bolivia, Chile, Colombia, Costa Rica, Ecuador, Paraguay, Peru, Uruguay, and Venezuela

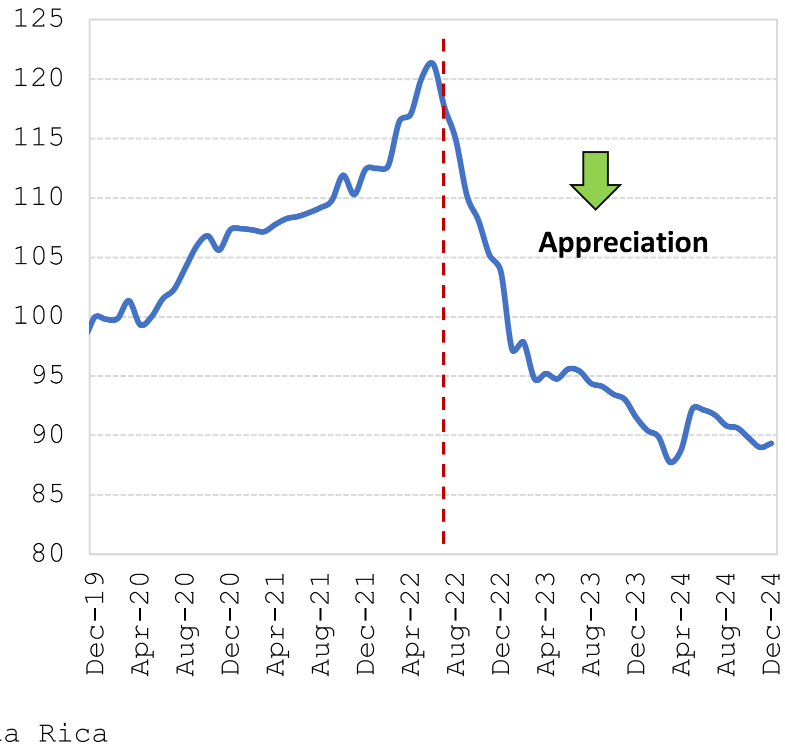
- **Primary Objective:** Support the balance of payments

Example: BoP loan to Central Bank of Costa Rica in 2022 by 1.1 billion

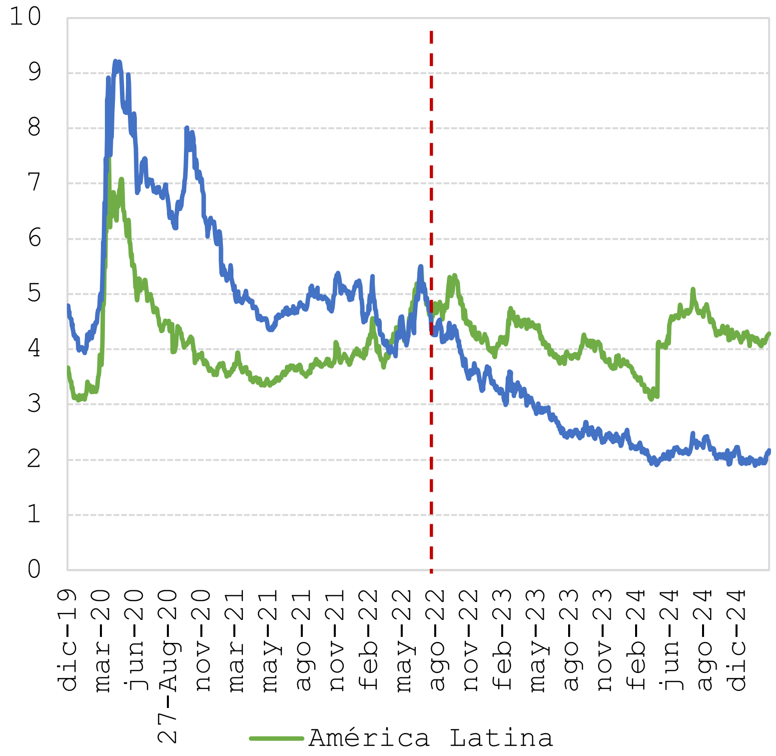
Central Bank of Costa Rica:
International Reserves
(Dec-19 = 100)



Nominal Exchange Rate Index
(dec-19 = 100)



Embig *spread*
(Daily, basis points)



This credit operation strengthened confidence in the macroeconomic adjustment process implemented by the authorities, at a critical moment for exchange rate and price stability.

Conclusion: Preparing for Future Shocks

The evolution of macro-financial policies in Latin America has been a success story

- **Improved Stability and Resilience:** The decline in both GDP and inflation volatility reflects enhanced macroeconomic resilience to external shocks
- **More Effective Monetary Policy:** The adoption of countercyclical monetary policy enabled central banks to lower interest rates during downturns and tighten policy in response to inflationary pressures
- **Strengthened Fiscal and Financial Frameworks**: Advances in fiscal and financial policies have played an important role in fostering macroeconomic stability

Remaining challenges

- **Ongoing Institutional Strengthening:** Further reinforcement of macro-financial frameworks is critical to sustaining stability
- **Enhancing Financial Resilience:** Strengthening financial safety nets will improve the system's capacity to absorb shocks
- **Readiness for Future Shocks:** Proactive policy measures are essential to mitigate the impact of potential global disruptions

Thank you!