International Commentary — July 31, 2024

Latin America Central Bank Preview

Summary

Many Latin American central banks will decide monetary policy over the next two weeks. While near-term rate decisions should be straight-forward in Brazil, Colombia and Chile, longer-term outlooks for each central bank are less certain. But in our view, Brazilian central bankers will keep rates unchanged for the foreseeable future as fiscal policy dominates monetary policy, BanRep policymakers in Colombia are likely to keep the current pace of easing well into 2025, while the Chilean Central Bank is approaching the end of the easing cycle. Mexico's central bank is where monetary policy views arguably diverge the most. For now, we believe peso depreciation and renewed inflationary pressures will keep Banxico on hold in August. In addition, local and external political uncertainties should contribute an extra layer of caution for policymakers considering resuming the easing cycle.

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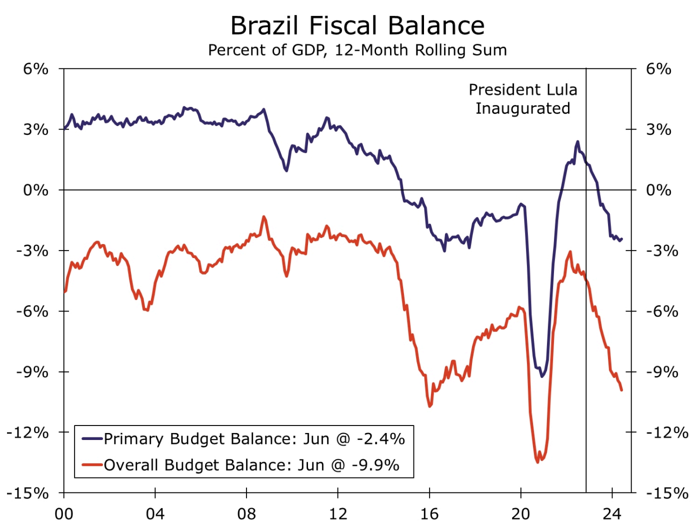
Fiscal Dominance Creates Selic Rate Uncertainties in Brazil

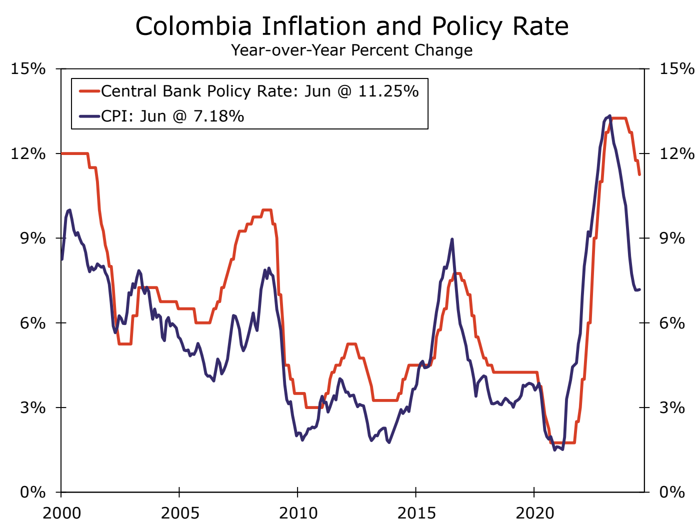
Brazilian Central Bank (BCB) policymakers are in a difficult position. Real interest rates are elevated, which despite activity remaining resilient, are contributing to restrained growth across Brazil's economy. At the same time, inflationary pressures are starting to rebuild as fiscal responsibility remains elusive under the Lula administration (Figure 1). As a result, a fiscal dominance scenario is starting to materialize, which is also generating depreciation pressures on Brazil's currency given the already precarious state of government finances. Imported inflation via FX depreciation is now a risk, and a risk that, in combination with looser fiscal policy, is contributing to upward pressure on local inflation expectations. Against this backdrop, BCB policymakers will meet this week to decide monetary policy. In our view, rising inflation expectations are likely to outweigh sluggish growth prospects, and we expect the Brazilian Central Bank to hold interest rates steady at 10.50%. Our outlook for the BCB's July meeting is not out of consensus or different from financial market pricing; however, the longer-term view for Brazilian policy rates is where more diverging views are found. To that point, we believe BCB policymakers will keep interest rates steady at 10.50% through the end of 2025, select peer economists believe a restarting the easing cycle will be delivered early next year, while at the same time, financial markets are priced for the BCB to raise rates in the near future. This kind of divergence makes forward guidance the most critical component of the July BCB meeting. Last meeting, policymakers communicated a relatively hawkish stance, but with recent inflation data firming as well as Lula suggesting a wider budget deficit than originally anticipated, BCB language could shift more hawkish at the upcoming meeting. Despite an expectation for more hawkish language, at this time we do not believe policymakers will restart the tightening cycle. We will, however, be focused on how concerned policymakers are in regard to new budget forecasts and whether additional upward pressure on inflation is now expected.

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

BanRep's Rate Cut Rythm is Unchanged

Looser fiscal policy and inflation are also challenges for Colombia's central bank (BanRep); however, not necessarily challenges that will prevent BanRep policymakers from easing monetary policy this week. In that sense, we believe Colombia's central bank will lower policy rates another 50 bps at its upcoming meeting. A 50 bps cut would take Colombia's Overnight Lending Rate to 10.75%. Policymakers have been in easing mode for some time (Figure 2), although internal divisions regarding the pace of rate cuts have persisted for most of the cycle. For the last few meetings, BanRep voters have been split on whether to cuts rates by 50 or 75 bps. Ultimately, 50 bps cuts were delivered by majority decision, and in July, we expect a similar divided vote. In our view, policymakers have a bias to ease quicker; however, the combination of fiscal loosening under President Petro and persistent currency volatility/ depreciation act as roadblocks to speeding up rate cuts. BanRep official statements have not offered much in terms of forward guidance, which we interpret as policymakers indicating they are data dependent and approaching interest rate decisions on a meeting-by-meeting basis. For the time being, we believe the 50 bps tempo will be maintained into next year as inflation concerns linger. Speeding up the pace of rate cuts at the current juncture, or in 2025, risks additional currency depreciation and renewed inflationary pressures, a dynamic policymakers likely want to avoid. With this in mind, we believe BanRep policy rates will be lowered 50 bps at each remaining meeting this year, and end 2024 with a policy rate of 9.25%.

This week's regional monetary policy decisions extend to Chile and the Chilean Central Bank (BCCh). BCCh policymakers embarked on one of the most aggressive easing cycles in Latin America; however, in June, policymakers slowed the pace of easing and lowered the main policy rate by only 25 bps. The June BCCh statement suggested 25 bps rate cuts were likely to be the pace of easing for the next few meetings, and in our view, BCCh policymakers will indeed deliver another 25 bps rate reduction in July. Recent growth and inflation data indicate Chile's economy is contracting, while disinflation has stalled. With inflation hovering around the upper bound of the BCCh inflation target, Chile's central bank may be running out of policy space for further easing. For now, we believe the focus will be on returning to economic growth, but with inflation still elevated and real rate differentials relative to the United States compressed, the runway to lower interest rates is closing. For now, we believe BCCh policymakers will deliver 25 bps rate cuts in July, September and October, and Chile's policy rate will end 2024 at 5.00%. We would note, however, that the balance of risk is tilted toward a higher terminal rate than we currently forecast. With inflation ticking higher recently and the peso volatile, policymakers could choose to end the easing cycle earlier than we expect. We will be paying attention to clues on the future direction of rates this week, and if we interpret language as leaning less dovish or outright hawkish, we will adjust our BCCh forecast appropriately.

Election Hangover and Political Risks To Keep Banxico Cautious

Not this week but the following week, Mexico's central bank (Banxico) will also assess monetary policy. Economists and market participants are somewhat split on the outlook for monetary policy in Mexico following local elections and the subsequent peso selloff. Select economists forecast Banxico to cut rates in August, while others believe the easing cycle will restart later in the year. We are on the later side of the forecast spectrum, and believe Banxico policymakers will keep rates on hold at the August meeting. Prior to the election, policymakers demonstrated a degree of caution related to elevated inflation. The recent peso selloff has already started to generate new inflation pressures via FX pass through, which we believe should be enough to continue warranting caution and keep Banxico voting members on hold. Granted, at their last meeting in June Banxico policymakers did express a willingness to possibly start cutting rates again in the near future as growth softened. However, that dovish commentary was offered before June inflation and July bi-weekly inflation both surprised to the upside. In addition, the peso remains under pressure due to a broad unwind of the Latin America carry trade. In our view, currency weakness and new inflationary pressures are enough rationale for Banxico policymakers to keep monetary policy settings unchanged in August. In fact, we believe Banxico will keep rates unchanged until December. FX volatility and inflation should keep policymakers cautious, while we also believe uncertainties related to Mexico's local political backdrop as well as the U.S. election will keep policymakers on the defensive as well. A potential domestic environment of constitutional amendments and an erosion of institutional strengths, combined with uncertainties around U.S. trade and immigration policy, may not be the most conducive environment to lower interest rates and erode carry associated with the peso. In that sense, we believe Banxico will deliver another 25 bps rate cut once the local and external political arena crystallizes a bit more, and as the peso eventually stabilizes. As of now, we forecast the Banxico policy rate to end 2024 at 10.75%.

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