International Commentary — August 3, 2023

Chile and Brazil Cut Rates (Too?) Quickly

Summary

Policymakers at the Central Bank of Chile and Brazilian Central Bank cut interest rates more aggressively than financial markets expected at their latest meetings, meaning downside risks to our Chilean peso and Brazilian real forecasts are materializing. In the coming weeks, we will update our currency forecasts; however, we are using this publication to flag the likelihood of more short-term currency depreciation in Chile and Brazil than we currently expect, as well as the possibility of a slower pace of longer-term appreciation against the U.S. dollar.

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CLP and BRL Downside Risks Take Shape

In a report published about a month ago, we highlighted how most central banks across the emerging markets had accumulated monetary policy space to begin cutting interest rates. With inflation converging toward central bank target ranges, economic slowdowns/recessions forming, and local currencies stable, we noted how the need for as restrictive monetary policy was likely no longer justified in many countries across the emerging world. Our monetary policy space framework identified central banks in Latin America as fitting this narrative quite well and that regional institutions had accumulated the most space to begin cutting interest rates. To that point, disinflation is most apparent in South America, economic activity is softening across the continent, and regional currencies have strengthened considerably over the course of the last few years. Within Latin America, our policy space framework identified institutions such as the Chilean Central Bank (BCCh), Brazilian Central Bank (BCB) and Central Bank of Colombia (BanRep) as most likely to be among the first to initiate easing cycles. Over the last two weeks, all three of these Latam central banks met to assess monetary policy, and while BanRep kept rates on hold, policymakers in Chile and Brazil took advantage of their policy space and began easing cycles.

In Chile, BCCh policymakers cut rates 100 bps at the July meeting, more easing than we forecast and a more aggressive reduction than financial markets were priced. The official statement indicated softening growth and inflation dynamics as the primary rationale for easing, but also cited a more robust disinflation process than initially expected as the foundation for the sizable rate cut. As far as forward guidance, policymakers hinted that similar size reductions to the overnight rate target would be likely at future meetings. Brazilian Central Bank policymakers also moved forward with a more aggressive rate cut than we, as well as consensus economists, expected. According to the BCB August statement, policymakers were split 5-4 in their decision to cut the Selic rate 50 bps. Underpinning the more aggressive rate cut was a strong disinflation process as well as reduced fiscal risks associated with the Lula administration, which in the view of BCB policymakers, should keep inflation and inflation expectations anchored. Forward guidance indicated BCB cuts of a similar magnitude are likely going forward. Thematically, we believed that while Latin American central banks would start easing cycles well ahead of the Federal Reserve, policymakers would take a more measured approach to interest rate cuts and ease monetary policy gradually to protect against another round of inflationary pressures transmitted through FX depreciation. But given the BCCh and BCB decisions, policymakers in Chile and Brazil seemingly feel comfortable enough easing monetary policy aggressively. As a result, we are revising our Chilean Central Bank policy rate forecast lower to reflect policymakers' stance, and **we now believe the Chilean overnight rate target can fall to 7.25% by the end of this year.** We are also revising our Brazilian Central Bank forecast, and **we now believe the BCB will lower the Selic rate to 11.75% by year-end 2023**.

Our currency forecast profiles for the Chilean peso and Brazilian real included gradual rate cuts that started in Q3, and that easing ahead of the Federal Reserve would lead to modest currency weakness through the end of this year. However, with policymakers easing more aggressively than we expected, the short-term outlook for both currencies has worsened. In our July International Economic Outlook we forecast the USD/CLP exchange rate to reach CLP840 by year-end and for the Brazilian real to weaken to BRL4.80 before experiencing a modest recovery by the end of this year. Given policymaker forward guidance and our revised BCCh and BCB forecasts, **clear downside risks to our CLP and BRL forecasts have materialized**. We will introduce updated currency forecasts in our August outlook publication; however, we are using this report to flag the likelihood of more CLP and BRL depreciation when those forecasts are finalized in a few weeks. In addition, while we will still forecast longer-term strength for each currency, a more gradual pace of appreciation relative to the U.S. dollar is also possible.

Recent decisions from the BCCh and BCB may also be watched closely by policymakers across Latin America. Regional central banks in Colombia, Peru and Mexico—institutions our framework identifies as having policy space to cut rates this year—will likely take notice of how financial markets react to BCCh and BCB aggressive rate cuts. Markets have not necessarily digested initial rate cuts well as the Chilean peso and Brazilian real have underperformed in response to their respective monetary policy decisions. If market participants apply sharp depreciation pressure to the Chilean peso and Brazilian real, regional peer central banks could choose to take the more gradual approach to rate cuts in the coming months. Outside of Chile and Brazil, we believe BanRep as well as policymakers at the Central Bank of Peru and Banxico will indeed choose a more cautious pace of interest rate cuts; however, the evolution of local currencies and local currency performance could become the driving force of monetary policy decisions in the short-term.

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