Embracing uncertainty: monetary policy in Latin America

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Introduction

In 1789, Benjamin Franklin wrote to Jean-Baptiste Le Roy: "in this world, nothing can be said to be certain, except death and taxes".[2] He was referring to the US Constitution, but he may as well have referred to monetary policy, where the phrase rings true over two centuries later. The outlook for the economy is uncertain, the strength and speed of monetary policy transmission is uncertain, and even where we are today is uncertain, given measurement problems and data lags. It is therefore not surprising that uncertainty features prominently in central bankers' speeches.

Today, some indicators of uncertainty are above trend, although they fall short of previous peaks. Indeed, The Economist Intelligence Unit's World Uncertainty Index, which essentially counts mentions of the word "uncertain" and its variants, has trended upwards in the last decades (Graph 1.A). Geopolitical risk certainly rose in 2022 (Graph 1.B). On the other hand, volatility in markets – which spiked during the Covid-19 pandemic – is not much higher than historical levels (Graph 1.C).

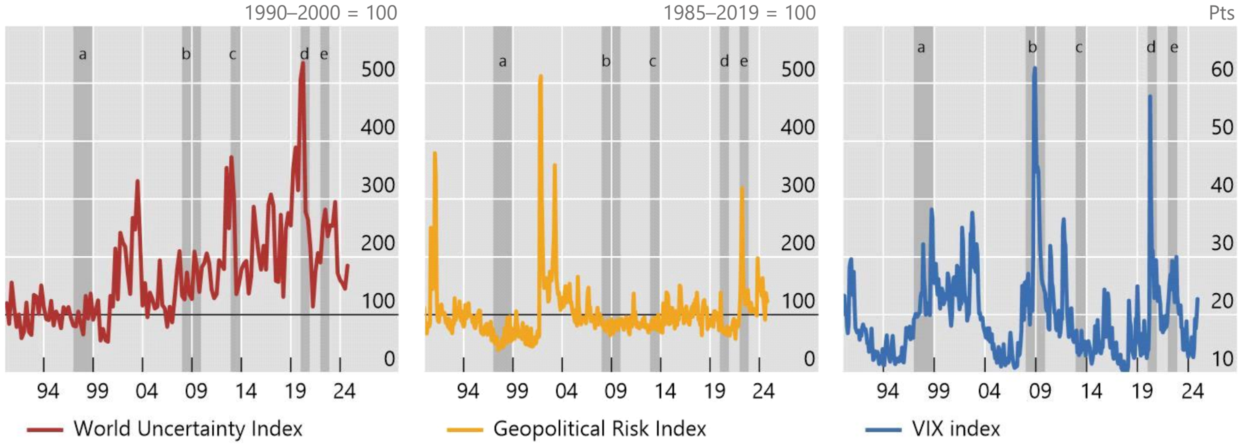
Today I will argue that there is no such a thing as a period of low uncertainty. Uncertainty is a fact of life, especially in a region like Latin America, and policymakers have to take this into account in their decisions. Luckily, policymakers have substantial experience with policymaking under uncertainty – and this holds lessons for economies around the world.

[1] The views expressed are my own and not necessarily those of the BIS. I thank Ana Aguilar, Christian Upper and Jon Frost for their input, and Alejandro Parada and Rafael Guerra for research support.

[2] Apparently, the origin of the phrase goes back to 1716 at least. See Death and taxes (idiom) - Wikipedia.

Uncertainty is currently high, albeit below previous peaks — Graph 1

A. World uncertainty has risen… | B. …due especially to geopolitical risks… | C. …while volatility is currently moderate



[a] Asian Financial Crisis. [b] Great Financial Crisis. [c] Taper Tantrum. [d] Outbreak of Covid-19. [e] Russian invasion of Ukraine.

Sources: Ahir et al (2022); Caldara and Iacoviello (2022); Bloomberg; BIS.

What is uncertainty?

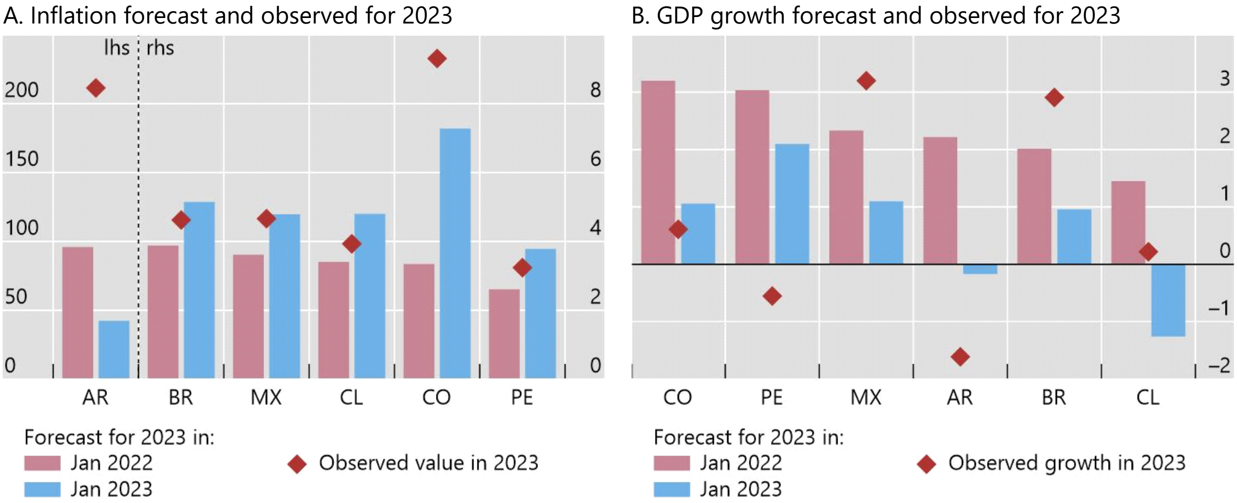
Before getting there, let's be precise and define what constitutes uncertainty. For me, it is the state of being unsure or having limited knowledge about future events, outcomes or conditions. It involves a lack of predictability and confidence in what will happen, often due to incomplete information or the inherent unpredictability of certain factors.

Let me give you a number of concrete examples of the types of uncertainty we are facing today:

- The first concerns the evolution of the economy in the aftermath of the pandemic. The recent track record of economic forecasters has been less than stellar, to say the least. Economists repeatedly underestimated inflationary pressures and the strength of the recovery (Graphs 2.A and 2.B). There are good reasons why they got it wrong. They were in uncharted territory, since the only other large pandemic and generalised lockdowns had happened over a century ago, when the economy was much less complex and more fragmented. They underestimated the impact of supply chain restrictions, the rebound in consumer spending and the tightness of the labour market.
- The second type of uncertainty is geopolitical. I don't think anybody will deny that we are living in a period of high tensions. There are at least two major international wars going on, and a series of domestic ones. The Russian invasion of Ukraine triggered massive swings in commodity prices and a loss in confidence, which in turn affected the evolution of the economy. No less important from an economic, albeit not humanitarian, point of view are trade tensions. These threaten to disrupt supply chains, affect trade flows and lead to sudden and unpredictable policy changes. Deglobalisation will also change the way the economy works, for instance by reducing the elasticity of supply and increasing the pricing power of firms and workers.

Under- and overestimation of GDP inflation and growth in 2023

In percentage points | Graph 2



Sources: IMF; Consensus Economics.

- A third uncertainty relates to climate change. It is not that we are uncertain about whether the climate is indeed changing, but more about its implications. Hurricanes, floods and wildfires ("physical risks") are becoming either more common or more extreme. These events can disrupt operations, damage infrastructure and lead to substantial economic losses. For example, a few months ago my home state of Rio Grande do Sul suffered from unprecedented floods. The impact was visible in macro variables, including inflation.
- Such physical risks are not the only channel through which climate change creates uncertainty. The various policies aimed at mitigating carbon emissions also contribute. For example, the transition to cleaner energy will involve reductions in both the supply of and the demand for fossil fuels. Since there is no reason to believe that these reductions will come at exactly the same pace, the transition is likely to lead to large swings in energy prices, depending on whether demand or supply is declining more rapidly.
- A fourth uncertainty concerns technological change. It is safe to say that changes such as automation, the adoption of artificial intelligence (AI) and digitalisation will have massive repercussions on the way we will work and produce goods and services. The big question is how these changes will unfold. For instance, there is a growing body of literature on the potential impact of AI on jobs and productivity. Some papers predict radical changes to almost all segments of the economy, while others are more guarded.
- Let me end this list with economic policy uncertainty, on which I will focus in a bit more depth. Changes in government, policy shifts and differing and in some cases arbitrary economic strategies contribute to this uncertainty. In Latin America, with several recent changes of government, we have seen a big increase in uncertainty since the pandemic, though this came down a bit in 2023 and 2024 (Graph 3.A). Higher economic policy uncertainty is associated with moves in financial markets, such as greater foreign exchange (FX) volatility and higher credit default swap (CDS) spreads (Graph 3.B and 3.C). This can raise the cost of financing for businesses and governments, and the costs of hedging cross-

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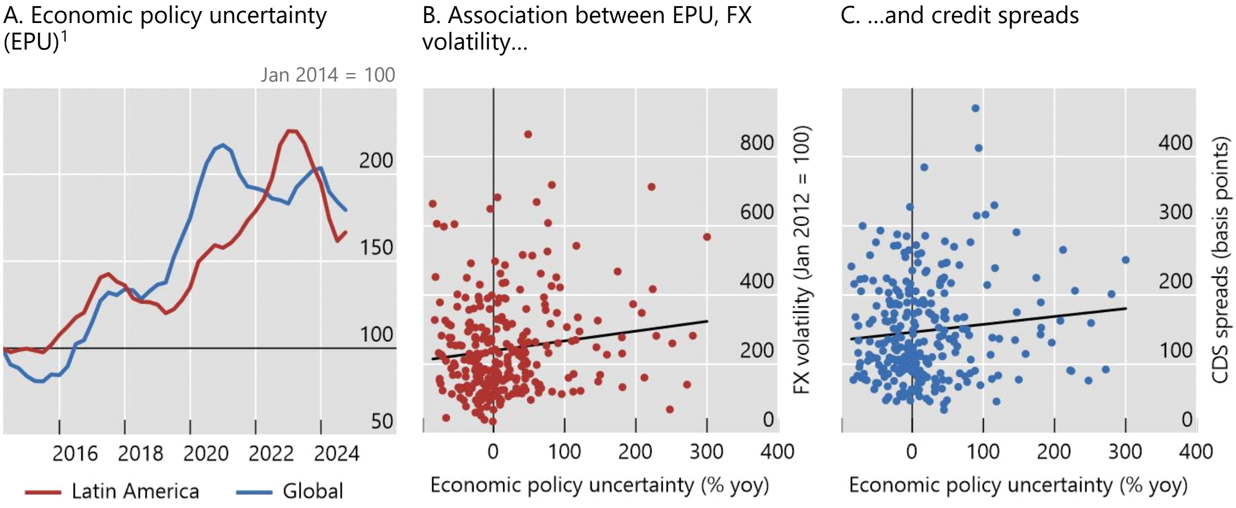
border transactions. Investors may react to new information or changing conditions with heightened sensitivity, leading to more frequent and pronounced market swings.

Higher uncertainty can weaken exchange rates and tighten financial conditions — Graph 3



[1] Data from Baker et al (2016) for BR, CL and MX and Global; data from Ahir et al (2022) for CO and PE. Latin America denotes the average figures from BR, CL, CO, MX and PE.

Sources: Ahir et al (2022); Baker et al (2016); Bloomberg; BIS.

One factor that has clearly affected the degree of uncertainty and how it influences the economy is social media. The spread of misinformation, data privacy issues and algorithmic biases on social media platforms create uncertainty, affecting decision-making and trust in institutions.

But economic policy uncertainty also has major repercussions on the actions of households, firms and policymakers, given its impact on key variables that affect each group.

- Uncertainty about future income, employment stability or prices can complicate households' financial planning. This can result in either excessive or inadequate savings.
- Firms may hesitate to invest in new projects or expand operations due to uncertainty about future demand, regulatory changes or technological advances. This can result in underinvestment in capital, research and development, and innovation.
- Governments may find it difficult to formulate effective policies due to uncertainty about economic conditions, geopolitical developments or social trends. This can lead to sub-optimal decisions and an unstable regulatory environment.

All this can reduce growth, increase real and financial volatility, and hinder innovation.

Given the importance of uncertainty around policies in some major jurisdictions in our region, I will zoom in on this fifth dimension of uncertainty, namely economic policy uncertainty. Let me narrow the topic even more to the uncertainty around policy – mainly fiscal policy – faced by monetary policymakers in this last mile of disinflation. I will mainly focus on the larger Latin American economies, ie Brazil, Colombia, Chile, Mexico and Peru. I will not discuss the case of Argentina, which is very specific.

Let me start with the impact of economic policy uncertainty on financial markets and the real economy in Latin America. I will then turn to the challenges faced by central banks in Latin America in this final stretch in the fight against inflation and conclude with my reasons for being hopeful about navigating through this uncertainty, given lessons from the past.

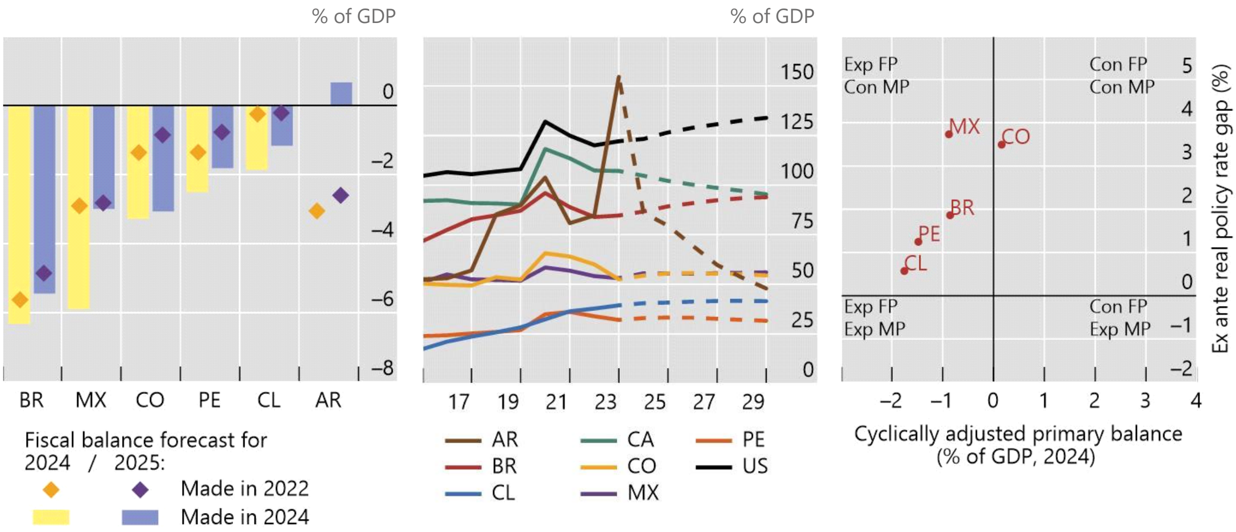
Effects of economic policy uncertainty in Latin America

Economic policy uncertainty has profound effects on financial and macroeconomic outcomes. It can affect financial markets with increased volatility and higher risk premia. It also affects the real economy, with reduced private sector confidence and lower consumption and investment. In addition, this uncertainty can diminish the effectiveness of fiscal and monetary policies in stabilising the economy and smoothing the business cycle.

One of the main sources of economy policy uncertainty in Latin America, and many other countries around the globe, is stretched fiscal positions (Graph 4.A). Debt levels in many countries were already high before the pandemic and increased further due to the expansionary policies put in place (Graph 4.B).

Fiscal and monetary policy may be working at cross purposes — Graph 4

A. Fiscal consolidation keeps getting pushed back | B. Public debt has risen[1] | C. Monetary policy is tight, but the fiscal stance is loose[2]



[1] Dashed lines denote forecasts made in 2024. [2] Exp = expansionary; con = contractionary.

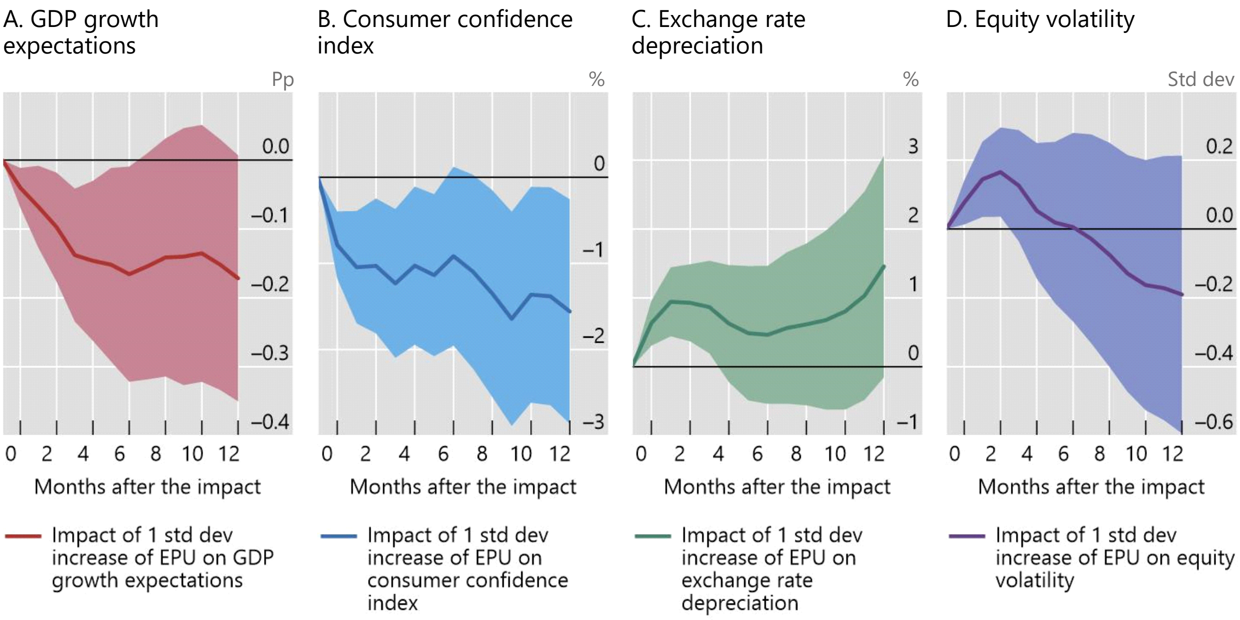
Sources: IMF; Consensus Economics; national data; BIS.

There is no question that fiscal policy needed to be expansionary during the pandemic. The issue is that it remained loose even after the economy recovered. Together with the monetary tightening in response to the surge in inflation, this led to an unbalanced policy mix (Graph 4.C). However, at some point countries need to consolidate to put fiscal positions on track. Sovereign rating downgrades are already happening and are influencing the cost of financing and other financial variables. When and how fiscal consolidation will happen is entirely open. This has led to high uncertainty, which in turn can complicate monetary policymaking and reduce growth prospects.

As noted, despite the relatively high economic policy uncertainty, financial markets exhibit moderate volatility at the moment. This paradox poses a risk because it can create a false sense of stability. When market participants are not pricing in the full extent of uncertainty, any unexpected event or new information can lead to large and abrupt adjustments.

In general, persistent uncertainty often results in greater market volatility, such as higher exchange rate volatility and an increase in the risk premium as investors demand greater compensation, raising the cost of financing for businesses and governments. Investors may react to new information or changing conditions with heightened sensitivity, leading to more frequent and pronounced market swings. Following an increase in the economic policy uncertainty index, GDP growth falls in Latin American countries (Graph 5.A). Consumer confidence also deteriorates (Graph 5.B), and currencies depreciate (Graph 5.C). Equity volatility goes up in the following two to three months (Graph 5.D) and then falls again – though the fall is not statistically significant.[3]

Economic policy uncertainty weighs on macroeconomic and financial outcomes[1] Graph 5



EPU = economic policy uncertainty.

[1] Panel local projections à la Jordà (2005) for Latin American countries with a sample from 2003 to 2024. Confidence intervals at 90%.

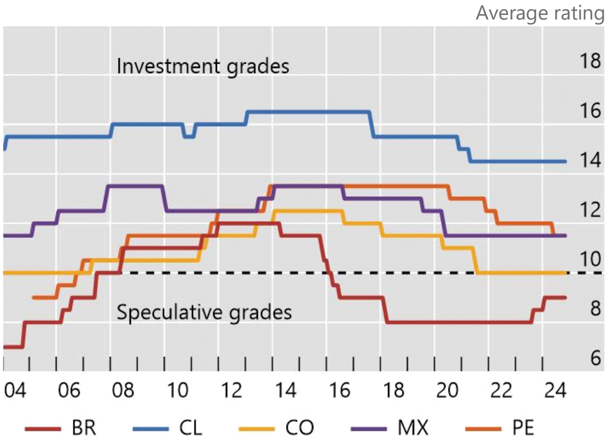
Source: Aguilar et al (forthcoming).

Uncertainty regarding fiscal consolidation can lead to perceptions of unsustainable public finances. This has been manifested in sovereign credit ratings (Graph 6.A). Latin American countries, in particular, have faced sovereign rating downgrades in the past decade. These downgrades are associated with greater FX volatility, higher costs of financing and even with lower growth expectations (Graph 6.B).

[3] Aguilar et al (forthcoming).

Sovereign rating downgrades are associated with macro-financial deterioration Graph 6

A. Sovereign ratings in Latin America[1]



B. Downgrades and macro-financial associations

Sovereign grade downgrades associated with:		
	All sample:	Rating <=10:
FX volatility (σ)	0.04***	0.23***
Long-term yields (%)	0.81***	0.81***
CDS spreads (bp)	18.9***	35.8***
Growth expectations (%)	–0.09***	–0.67***

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

[1] Average ratings from Standard & Poor's, Moody's and Fitch Ratings for long-term foreign currency debt.

Sources: Bloomberg; Consensus Economics; national data; BIS.

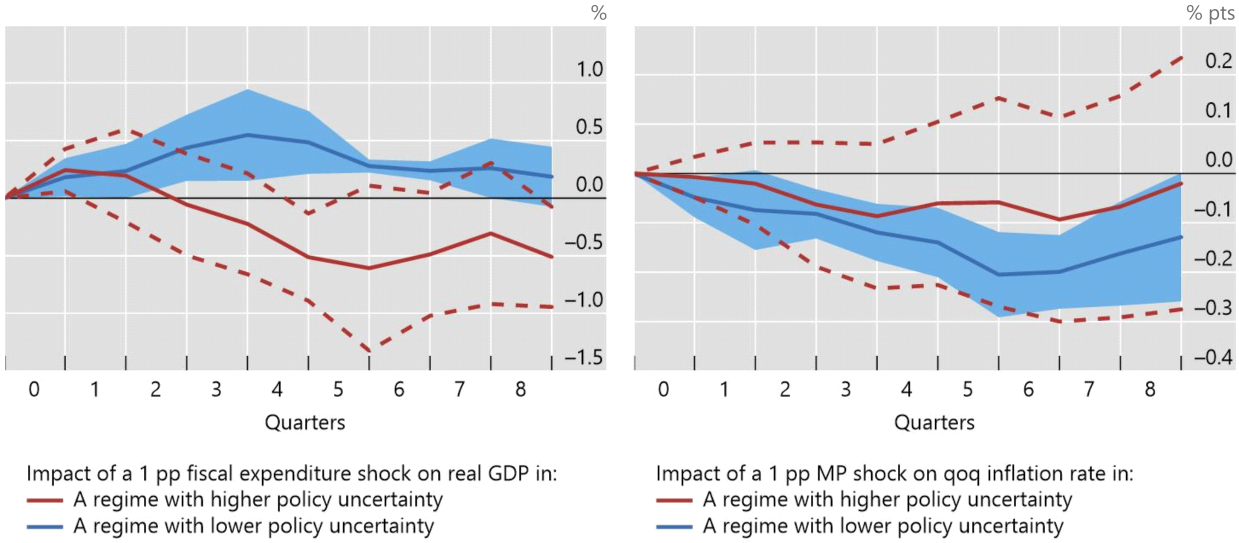
Notably, economic policy uncertainty can hinder the ability of fiscal and monetary authorities to implement countercyclical policies effectively. During downturns, it reduces the impact of fiscal stimulus measures, and during expansions, it hinders efforts to cool down the economy. That is seen in the difference in the impact of a 1 percentage point increase in government spending in higher-uncertainty and lower-uncertainty regimes (Graph 7.A). This difficulty in smoothing the business cycle can lead to more pronounced economic fluctuations and increased vulnerability to shocks. Businesses and consumers, unsure about government spending programmes or tax cuts, may not respond as expected, diminishing the intended effects of fiscal stimulus. Meanwhile, central banks rely on clear communication and predictable policy actions to influence expectations and behaviour. Yet the transmission mechanism of monetary policy can be weakened by policy uncertainty since it can undermine the credibility and predictability of monetary policy, making it more difficult for central banks to guide inflation and economic activity. The impact of a 1 percentage point interest rate shock is much weaker – and even statistically insignificant – in a higher-uncertainty regime (Graph 7.B).[4]

[4] Guerra (forthcoming).

Higher policy uncertainty can blunt the effects of fiscal and monetary policy[1] Graph 7

A. High economic policy uncertainty reduces fiscal policy effectiveness in Latin America

B. High economic policy uncertainty hinders monetary policy in reducing inflation



[1] Confidence intervals at 90%.

Source: Guerra (forthcoming).

Navigating through uncertainty in the final stretch of disinflation

The unbalanced monetary-fiscal policy mix and the uncertain prospects for fiscal consolidation are making it more difficult for central banks to navigate the final stretch of disinflation. Fiscal and monetary policies may be working at cross-purposes in Latin America, and many other countries in other regions as well. While monetary policy has tightened considerably in the past three years, fiscal policy remains quite expansive, and public debt has risen to historically high levels.

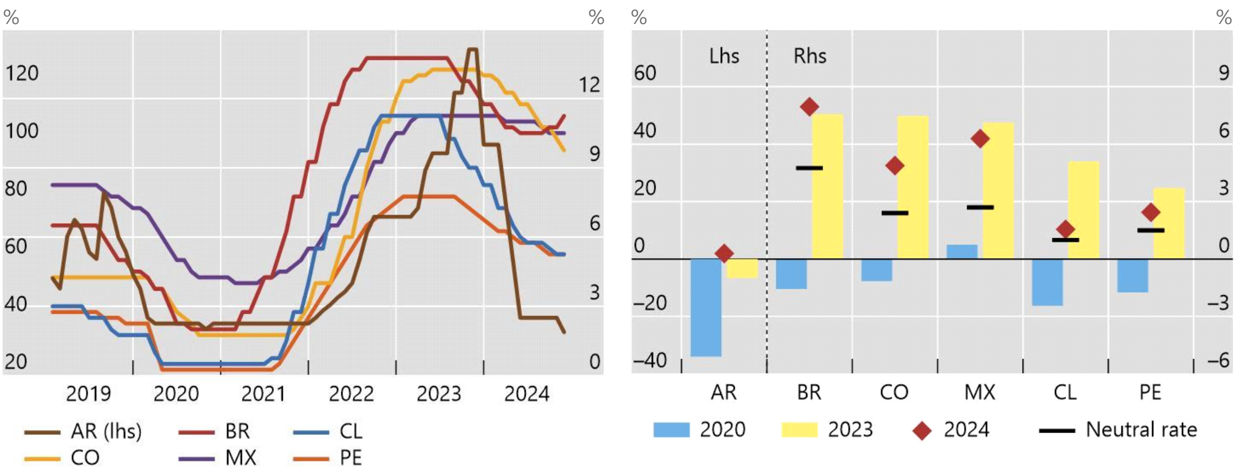
Let me take a step back and put my statement into context. During the initial stages of the pandemic, Latin American central banks reduced interest rates to record lows to weaken the blow to the economy. Fiscal policy was expansionary and levels of debt to GDP increased. However, when prices started to go up in 2021, they reversed course and swiftly began to increase policy rates, well ahead of almost all of their peers around the globe. The Central Bank of Brazil began raising rates as early as March 2021, followed by the central banks of Mexico in June, Chile in July, Peru in August and Colombia in September. Policy rates in those five Latin American economies increased by close to 10 percentage points on average, bringing them to a peak of 11.5% (Graph 8.A). This pushed ex ante real interest rates above central banks' estimates of neutral interest rates, indicating that monetary policy was well in restrictive territory. However, the fiscal stance remained loose in most economies.

Monetary easing but in restrictive territory

In per cent — Graph 8

A. Monetary policy rates have continued easing during 2024...

B. ...but are still above neutral rate estimates



Sources: Consensus Economics; Bloomberg; national data; BIS.

Why did central banks in Latin America act earlier than their global peers? I believe that the answer is quite easy: they simply did not have the luxury of waiting to confirm whether or not inflationary pressures were transitory. They had to respond to rising inflation by hiking rates early and significantly, which is what they did. This decisive action reduced uncertainty regarding their monetary policy stance.

Central banks have cut rates since 2023, but monetary policy in most of Latin America remains restrictive, despite the sharp rate cuts over the last year and a half. Ex ante real interest rates are positive and above central banks' estimates of the neutral rate (Graph 8.B). In most countries the pace of the reduction in rates is slowing. A couple of months ago, the Central Bank of Brazil even increased its policy rate in response to rising inflation. This probably reflects central banks' reluctance to call a victory before inflation has squarely returned to target. And indeed, in many countries services inflation is higher than before the pandemic, and higher than goods inflation (Graph 9.A). Wage growth, meanwhile, has outstripped price growth in all major Latin American countries except Peru (Graph 9.B). This is in part due to policy measures such as rapid increases in minimum wages. This hints at the risk – probability unknown – of new wage-price spirals.

The last mile of disinflation is thus likely to be a bumpy one, and no easier to navigate than the previous ones. I would like to highlight potential reasons for this, in particular related to uncertainty.

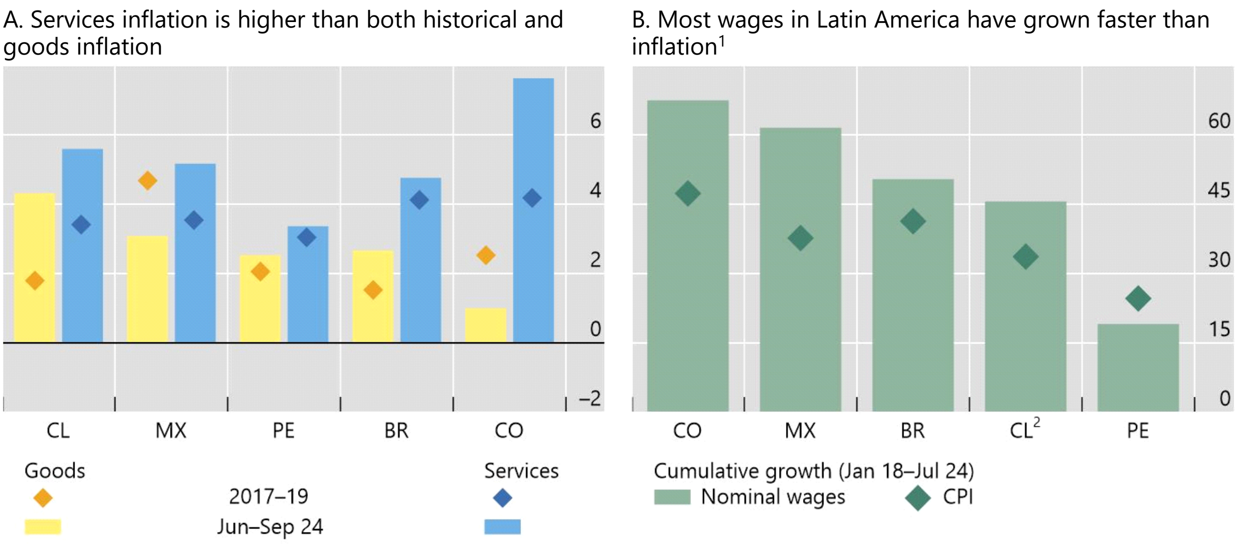
1. First of all, monetary policies are diverging more across countries, which can lead to turbulence in financial markets. The carry trade unwinding of early August is a case in point. The decline in the rate differentials between investment currencies such as the US dollar, Brazilian real and Mexican peso and funding currencies such as the yen, combined with a sharp increase in market volatility, led to an unwinding of carry trades with global repercussions. Fortunately, the turbulence in early August turned out to be short-lived and, as importantly, ended without any need for direct public intervention. But there is no

guarantee that something similar will not happen again in the period ahead. We simply do not know.

2. Second, monetary policy is becoming more data-dependent as policy rates approach their neutral level and the future path of interest rates becomes less clear. Data dependency is a good thing, but it can result in volatility if markets become oversensitive to new data points. The responses of market expectations to recent data releases, such as the US jobs report, suggest an exaggerated interpretation by market participants of what data dependency actually means. Central banks set policy in line with their outlook for growth and inflation, which obviously depends on the incoming data. It is worth stressing that this outlook depends on a large amount of data, not just individual data points like the monthly jobs report. Market participants would do well to be bear this in mind.

Services inflation is under pressure from resilient output growth and wages

In per cent | Graph 9



[1] For AR, wage rate index; for BR, nominal effective earning; for CA, average hourly earnings; for CL and CO, nominal wage index, retail commerce; for MX, average daily wage; for PE, monthly income wage; for US, average hourly earnings in non-agricultural payrolls. [2] For CL, Mar 2024.

Sources: LSEG Datastream; national data; BIS.

3. The third factor that could lead to bumps is fiscal policy. I already mentioned that fiscal and monetary policy are working at cross purposes. With fiscal balances stretched in most economies, markets are very sensitive to any news on the fiscal outlook. Uncertainty regarding fiscal consolidation may also affect risk premia and economies' financing costs.

4. A fourth factor is financial vulnerabilities. Let me highlight a few: household debt is at historical highs in some economies. Although the high margins charged by many lenders may mean that a significant increase in defaults is required to jeopardise financial stability, high household debt can still have macroeconomic repercussions by depressing consumption and economic activity. While this would lower inflation, it would also increase the risk of a hard landing.

5. A fifth factor is external shocks. While Latin American economies are much less vulnerable to such shocks today than in many periods in the past, the global landscape is complex. Geopolitical risk is exceedingly high.

Finally, as usual there could be new shocks. Navigating could be quite challenging. With inflation still a recent memory and prices at unprecedented levels, there is understandably little tolerance for further price increases. Therefore, central banks need to proceed cautiously.

In this environment, communication between central banks and the public will be crucial. The success achieved so far is valuable; we cannot let our guard down and risk excessive monetary easing. The priority remains price stability.

Conclusion

We are entering the last lap in the fight against inflation. This last lap will be bumpy. But central banks in Latin America should be able to navigate these bumps and bring inflation back to target while ensuring a soft landing in real activity.

Despite currently high global uncertainty, I am cautiously optimistic about the global outlook and the ability of Latin American central banks to fulfil their mandates. There are four reasons for this cautious optimism.

- First is historical resilience. The world has faced significant uncertainty and large shocks in the recent past, such as the Covid-19 pandemic, the Great Financial Crisis and various geopolitical events. Certainly, these episodes have tested the resilience of economies and institutions, yet we have managed to work through them together. The collaborative efforts of governments, central banks and international organisations have played a crucial role in navigating these challenges. Each of these past crises has provided valuable lessons and insights that have strengthened our ability to respond to future uncertainties.
- Second are better than expected outcomes. In the last years we have been surprised by the economic resilience in several economies. This is evident in various indicators such as GDP growth (Graph 10.A), employment rates and consumer spending. Growth for 2025 is also expected to be moderate (Graph 10.B). Economies' ability to adapt and recover from shocks has been a positive sign. In addition, inflation, which had surged in many regions due to factors like supply chain disruptions and energy price shocks, is now showing signs of moderation (Graph 11.A). While short-term expectations are above target, longer-term expectations are well anchored (Graphs 11.B and 11.C) So far, central banks' efforts to manage inflation through monetary policy adjustments are beginning to yield results, without the cost of a recession.
- Third is experience. Central banks, particularly in our region, have a long history of dealing with uncertainty.[5] They have navigated through various economic cycles, financial crises and external shocks. This experience has honed their ability to implement effective policies and maintain stability. Central banks possess a range of tools and strategies to fulfil their mandates, even in uncertain times. These include monetary policy instruments such as

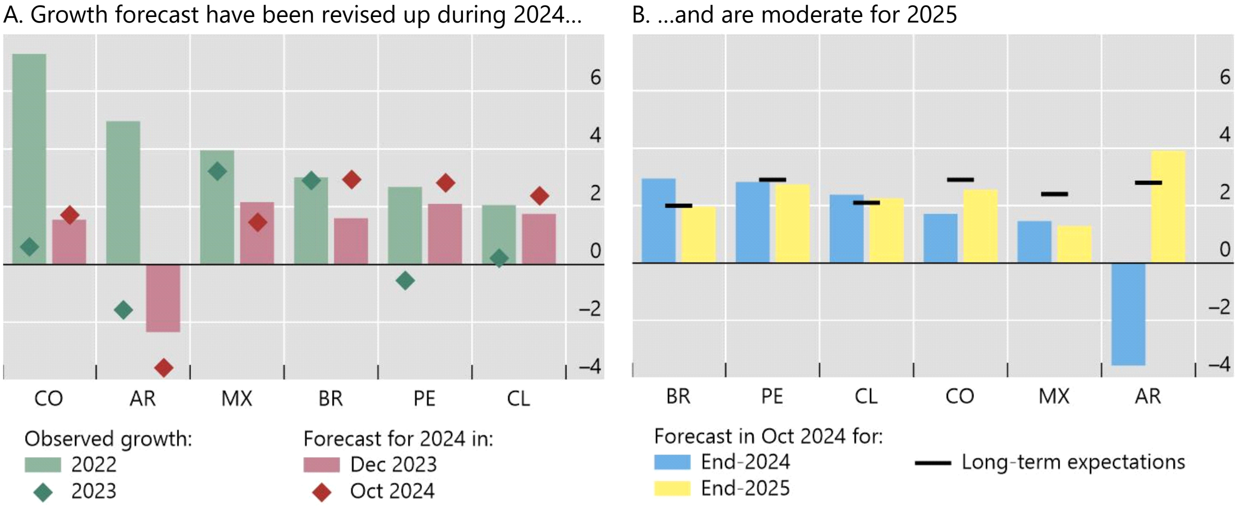
[5] Tombini et al (2023).

interest rate adjustments, open market operations and forward guidance. Additionally, central banks have developed frameworks for macroprudential regulation and financial stability that help mitigate risks and enhance resilience.

Growth remains resilient

In per cent

Graph 10



Sources: IMF; Consensus Economics; national data.

- Fourth is the global nature of many uncertainties. Geopolitical tensions and climate change necessitate international cooperation. No country can come to terms with these uncertainties by itself. Central banks and governments are increasingly collaborating through international organisations to address common challenges and coordinate policy responses. Regional partnerships play a crucial role in enhancing economic stability.

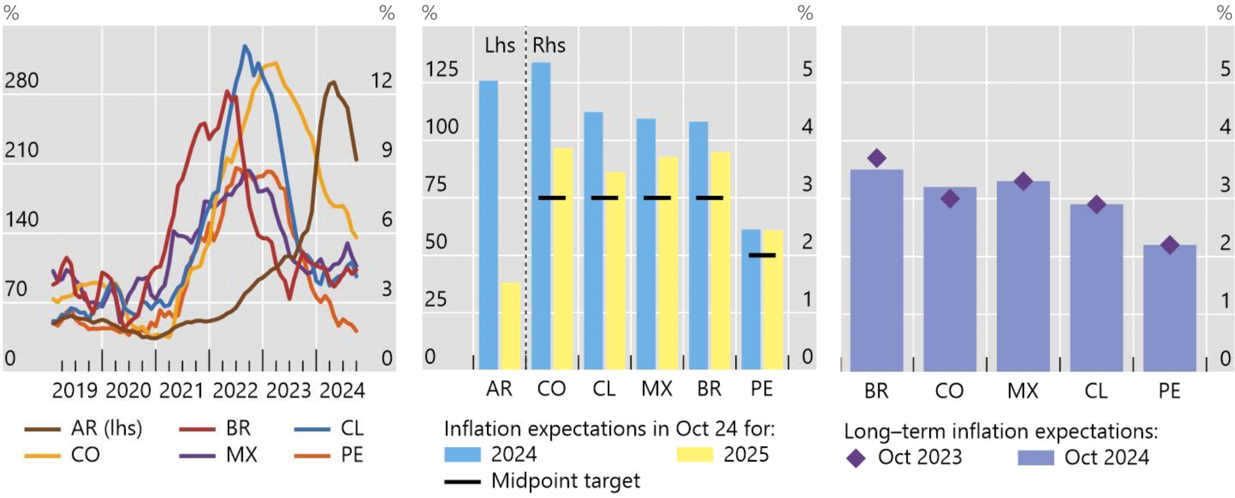
Inflation is falling and expectations are approaching target

Graph 11

A. Headline inflation slowed its fall for some countries during 2024

B. Short-term inflation expectations remain above target…

C. …but long-term ones remain anchored and close to target



Sources: Consensus Economics; national data.

Finally, let me emphasise what central banks can do to manage current uncertainty. Effective communication and transparency are universally recognised as key components of central banks' strategies. By clearly articulating their policy intentions, economic outlook and decision-making processes, central banks can help anchor expectations and reduce market volatility. For instance, central banks should highlight that their policy decisions are based on a comprehensive outlook for growth and inflation, relying on a broad range of data rather than just individual data points. Finally, periodically reviewing and updating the central bank's policy framework can help to ensure that it remains effective in a changing economic environment.

Thank you very much for your attention.

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