CAPITAL ECONOMICS

LATIN AMERICA ECONOMICS UPDATE

Tight monetary policy despite peak inflation

- **Inflation across most of Latin America has peaked, but this is mainly an energy story – core price pressures are proving much more persistent. And underlying price pressures are likely to ease only gradually over the coming months, which will keep inflation high – and higher than most expect this year. As a result, while the region's central banks will turn to interest rate cuts over the coming quarters, we think they will tread more cautiously than most analysts are anticipating.**
- The batch of inflation data for January out of Latin America will have spooked central bankers. In Colombia, the headline rate surged to a multi-decade high of 13.3% in January, making it one of the few EMs where inflation has not yet peaked. Elsewhere, inflation in Chile surprised to the upside last month (12.3%) while headline rates in Mexico and Peru edged up again in January (to 7.9% and 8.7%).
- **Colombia aside, inflation in the major economies across the region has now passed its peak**. But, with the exception of Brazil, inflation has been slow to come down – in Mexico, Chile and Peru, the headline rate is less than 2%-pts lower than its recent peak. **And, more worryingly, these falls have been driven largely by easing food and energy inflation, not core inflation.**
- In Chart 1, we have broken down the contributions to the change in headline inflation from its peak into consistent measures of food, energy and core inflation. This shows that most of the decline has been driven by energy inflation. This is especially the case for Brazil, where energy inflation has shaved off more than 6%-pts off the headline rate since April 2022. (Recall that Brazil had an energy crisis in 2021 due to droughts, which reduced hydropower output and led to a rise in electricity tariffs. This has now unwound.)
- **In contrast, core inflation is proving a lot more persistent**. In Brazil and Mexico, our core inflation measure is broadly unchanged (at 8.8% y/y and 6.2% y/y respectively) over the time periods shown in Chart 1, while the core rate has *risen* in Peru, to 6%. (See Chart 1 again). And even in Chile, the country in the region where core inflation has fallen, core inflation is still extremely high at over 8% y/y.
- Further large falls in food and energy inflation should drag down headline rates across the region over the coming months. Underlying price pressures should ease too as growth slows, economic slack is created and goods shortages ease. Indeed, there are already some signs of the latter playing out – goods inflation has peaked in most countries (although it remains very high).
- **That said, core inflation is likely to ease only gradually, and we think this will keep headline inflation higher this year than most other analysts are expecting.** (See Chart 2.) This is especially the case in in Brazil and in Colombia. In the former, that's due to a combination of strong wage growth and looser fiscal policy under the Lula administration. And in Colombia, we expect the economy to continue to operate above potential over the next few quarters, which will keep core inflation high.
- This means that, while tightening cycles are at (or close to) an end, policymakers in most countries will only feel comfortable cutting interest rates from the second half of the year when there are more pronounced signs of disinflation. And **even once central banks ease off the brakes, we think they will do so more gradually than most other analysts are expecting.**

Chart 1: Contribution to Change in Headline Inflation (Since Peak*, %-pts)

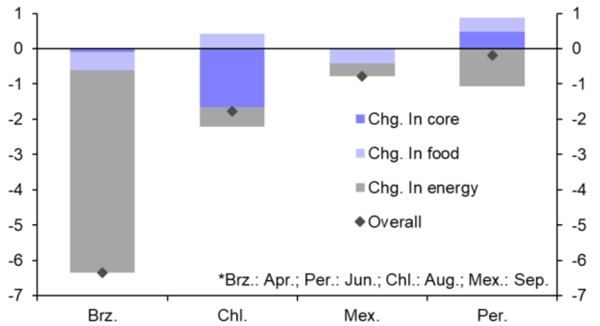
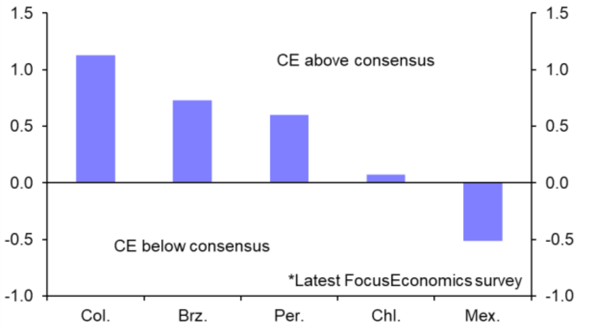


Chart 2: CE vs. Consensus* Inflation Forecasts (End-2023, %)



Sources: Refinitiv, Focus Economics, Capital Economics

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