Latin America: inflation in times of deceleration

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The Latin American economy contacted 0.4% in 2015 and the region's GDP will probably fall again this year, compared to average growth of around 4% in previous years.

Despite the sharp drop in economic activity, inflation is still high: Argentina close 40%, around 10% in Brazil, Colombia and Uruguay and nearly 4% in Chile and Peru. Likewise, despite the disparate figures practically all the countries in the region have inflation that surpasses the targets set by the respective monetary authorities. The main exception is Mexico, where inflation remains below 3%, largely due to the positive impact from the reforms approved in the last few years on the price of services such as telecommunications.

However, why is inflation so high in most of the countries if domestic demand is still weak? Forex depreciation of late, mainly due to its effect on the prices of tradeable products has had a significant impact on inflation. In many cases, negative weather impacts - mainly from “El Niño”- has driven food prices higher. Furthermore, in countries like Argentina, Brazil and Uruguay, a necessary adjustment in government regulated prices has pushed inflation higher recently. Lastly, tax adjustments have also resulted in inflationary pressure in countries like Chile.

In any case, in the last few months we have seen clear signs of moderation in Brazil, Chile and Peru. This downward trend will most likely spread to other countries and, over the rest of 2016 and into 2017, inflation should converge with monetary policy targets. The prospects that currencies will stop depreciating as sharply as they have in the recent past (in effect, we have already seen this in the last few months) supports a scenario of slowing inflation. Furthermore, it is also likely that internal prices will benefit from better weather conditions, smaller increases in regulated prices after the latest adjustments, domestic demand that will remain relatively weak and cautious monetary policy in most of the region's countries.

In any case, the speed at which inflation will converge with monetary policy targets will depend on how persistent price increases are in each country. Therefore, if monetary policy has traditionally been tolerant of inflation and if price indexation mechanisms don't play very relevant role, inflation won't be very persistent and it will fall more quickly. If the opposite occurs, inflation will slow more gradually.

A recent study by BBVA Research (‘Persistent inflation in Latin America’) shows that inflationary inertia is relative high in Argentina, but also in Brazil, Colombia and Uruguay. On the other hand, said analysis reveals that persistence will be a less relevant problem in the future inflation scenarios of Chile, Peru and Mexico.

These results are in line with the forecast calling for inflation to remain under control in Mexico, which will ly hover in the target range in Chile and Peru and later in Brazil and in Colombia, and will remain above the targets set in Argentina and Uruguay.

Likewise, the strengthening of monetary institutions (like the implementation of a target system in Argentina), economic reforms that increase competition (like the ones recently adopted in Mexico) and changes in the indexation mechanisms, for example, would help curb the degree of inertia in internal price dynamics and, therefore, reduce the cost of lowering inflation, mainly in those countries in which persistent inflation is a major problem.