

LATIN AMERICA CENTRAL BANK WATCH

Apr. 2009



Interest rates heading for record lows

- *Growth concerns outweighing inflation fears*
- *Bulk of cuts to take place before June*
- *Only Chile has limited room to manoeuvre*

Policymakers in Latin America are becoming increasingly concerned about a sharp deterioration in the region's growth prospects. Inflation is proving sticky, particularly in Brazil and Mexico. This is partly due to weaker currencies, which are down by an average of 25% against the dollar compared with this time last year. Nonetheless, we continue to expect interest rates to be cut aggressively over the course of this year.

For a start, currencies have actually rallied over the past month. What's more, there is growing evidence that importers are absorbing more of the resulting increase in prices in their margins rather than passing them on to consumers. Most importantly, the region is heading for its deepest recession since the 1930s. As growth concerns start to outweigh those about inflation, interest rates are likely to fall to record lows.

Brazil (29th April, CE Forecast: 100bps cut)

The Brazilian Central Bank (BCB) slashed the SELIC interest rate by 150bps to 11.25% last month, in line with market expectations. According to the minutes of the meeting, the vote was unanimous. This was the second interest rate cut this year – at the BCB's last meeting in January

the SELIC rate was cut by 100bps.

The BCB's latest move was a clear response to a sharp deterioration in the real economy. Data released shortly before last month's meeting showed that GDP contracted by 3.6% q/q in the final quarter of last year. This was the sharpest fall in output since 1991.

The magnitude of the fall in Q4 clearly alarmed the monetary authorities and crushed any hopes that Brazil might remain immune to the turmoil elsewhere in the world. But there are still lingering concerns about the stickiness of inflation.

Indeed, headline inflation actually *increased* slightly to 5.9% y/y in February, from 5.8% y/y in January. While much has been made of the weaker real, the pick-up in inflation was driven by non-tradables (predominantly transport and education). More generally, concerns that a weaker currency might cause inflation to soar, as in previous downturns, are misplaced. For a start, the real has actually *rallied* in recent weeks, leaving it 0.6% stronger against the dollar compared with the start of the year. Admittedly, it is still down by 25% against the dollar on a year ago. But there are signs that importers are

TABLE 1: LATIN AMERICA'S INTEREST RATE FORECAST

	Current interest rate (%)	Latest Inflation rate (%)	Central Bank inf. target (%)	Next meeting date	CE forecast next meeting (bps)	Consensus forecast next meeting (bps)	CE forecast end year rate (%)	Market implied end year rate (%)
Brazil	11.25	5.9	4.5 +/-2.0	29 th April	-100	-50	8.0	9.0
Mexico	6.5	6.2	3.0 +/-3.0	17 th April	-75	-50*	5.5	5.65
Colombia	7.0	6.5	5.0 +/- 0.5	24 th April	-100	N/A	4.0	N/A
Chile	2.25	5.5	3.0 +/- 1.0	9 th April	-50	-25	1.0	1.05
Peru	6	5.5	2.0 +/- 1.0	9 th April	-75	-50	2.0	N/A

Sources – Thomson Datastream, Bloomberg, Capital Economics

*Cuts Expected by Junes

absorbing some of the resulting increase in their margins, in response to the weakness of domestic demand.

As the economy slides into recession, we believe that inflation will fall back to the BCB's 4.5% target by the middle of this year. Accordingly, further interest rate cuts are likely. We have pencilled in a 100 bps cut to 10.25% this month. Beyond that, the pace of easing could slow. But we still expect the rates to fall to a record low of 8% by the end of the year. By contrast, the market is currently pricing in a fall to just under 9%.

Mexico (17th April, CE Forecast: 75bps cut)

The Mexican Central Bank (BANXICO) surprised the markets by cutting interest rates by 75bps to 6.5% last month. The consensus had expected a much smaller 25bps cut.

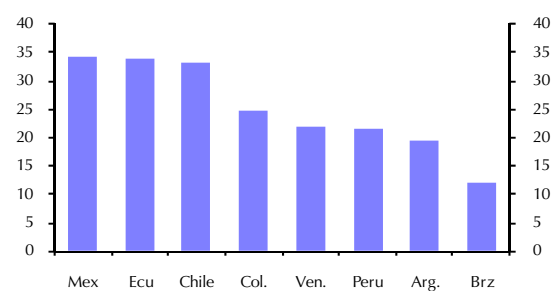
The larger than expected cut in rates was clearly motivated by the sharp deterioration in the real economy. Mexico has been hit particularly hard by a collapse in demand from north of the border (exports to the US account for 25% of GDP). As a result, industrial output is now shrinking at an annual pace of 10%. Firms have begun to cut labour and unemployment looks set to rise to close to 10% by the end of the year, from 5.3% currently.

That said, as in Brazil, inflation is proving to be stubbornly sticky. Headline CPI inflation dipped to 6.2% in February, from 6.3% in January, but remains well above BANXICO's 3% central target. However, *unlike* Brazil, this is largely due to the weaker peso, which has lost 25% against the dollar compared with a year ago. As Chart 1 shows, Mexico is the most open economy in the region. Accordingly, fluctuations in the exchange rate tend to have a much larger impact on domestic prices.

Nonetheless, three factors point to further interest rate cuts over the coming months. First, there are signs that Mexican importers are not fully passing on the resulting rise in import prices to consumers. Second, the conventional logic that a weaker

currency will prevent rates from being cut (or even require them to be *hiked*) might not apply in the current environment. After all, currency movements are currently being driven by fluctuations in global risk appetite, not interest rate differentials. In fact, rate cuts could actually cause the peso to rally if they shore up confidence in the Mexican economy.

CHART 1: IMPORTS (% OF GDP, 2007)



Sources – Thomson Datastream, Capital Economics

Finally, and most importantly, Mexico is heading for a deep recession. We expect the economy to shrink by 5% this year and by a further 1% next year. This will generate huge amounts of spare capacity in the economy. As a result, headline inflation could fall to BANXICO's 3% target by the end of the year. According to the Central Bank's statement that followed last month's rate setting meeting, 'concerns on growth now outweighed those about inflation'. Rightly so.

We have pencilled in another 75bps cut in interest rates this month, although policymakers could cut by a smaller 50bps if March's inflation numbers surprise on the upside. Either way, the bigger picture is that we expect rates to hit a record low of 5.5% by the end of the year. While this is well below consensus, it is now broadly priced into the market.

Colombia (24th April, CE Forecast: 100bps cut)

The Colombian central bank (BANREP) lowered interest rates by 100bps to 7% last month, taking the total size of rate cuts since December to 300bps. Only Chile has cut more aggressively.

BANREP's newfound dovishness contrasts with its hawkish mood just six months ago. This sudden change of heart has clearly been driven by the recent slump in the real economy. Colombia's main export partners are the US and Venezuela – both are mired in recession (although this is not reflected in official data in the latter). Accordingly, industrial output shrank by 11% y/y in January and unemployment has soared to 14.2%, the highest rate in nearly five years.

Inflation fell to 6.5% in February from 7.2% in January, but this was driven primarily by falling food prices. Key components of core inflation (housing, transport and education) actually accelerated slightly. This was probably driven by a weaker peso, which has fallen by 12% against the dollar since the start of the year and is by far the worst performing currency in the region.

Nonetheless, the same arguments that apply to Brazil and Mexico apply to Colombia – the sheer scale of the current collapse in demand is likely to cause inflation to fall back to target despite falls in the currency. Indeed, with the economy on course to contract by 4% this year, we believe inflation could fall to 4% by the end of the year, well below BANREP's 2009 target of 5%.

Accordingly, further aggressive interest rate cuts are likely. We have pencilled in another 100bps cut this month, and expect rates to hit 4% by the end of the year. This appears to be at the low end of market expectations, suggesting that bond yields have further to fall.

Chile (9th April, CE Forecast: 50bps cut)

The Central Bank of Chile (CBC) cut interest rates by a massive 250bps last month to 2.25%. As a result, borrowing costs have been lowered by a total of 600bps since January – by far the most aggressive action of any central bank Latin America.

Like the rest of the region, Chile has been hit hard by a collapse in global demand. Manufacturing output is now contracting by 10% y/y. But a much bigger concern is the sharp drop in copper prices

over the past year (copper exports accounts for 25% of GDP). As Chile's terms of trade have capitulated, the real economy has been plunged into recession. GDP shrank by 1.4% y/y In January according to the government's monthly estimates.

What's more, in contrast to the rest of the region, Chilean policymakers are not constrained by a falling currency. The peso has actually gained 10% against the dollar since the start of the year. (This partly reflects large falls last year.) As a result, last year's concerns about rising inflation have become a distant memory. Headline CPI has already fallen to 5.5% in February, from 9.9% in October. Further falls are likely – we expect inflation to hit the Bank's 3% target by the middle of this year as the recession deepens.

Governor Rebeco has hinted that further rate cuts are likely, although he acknowledged that the pace of easing could slow. This is inevitable given the aggressive action taken since the New Year. We have pencilled in a 50bps cut this month and expect rates to fall to a record low of 1% by the end of the year.

Peru (9th April, CE Forecast: 75bps cut)

The Peruvian Central Bank (BCRP) cut interest rates by 25bps to 6% last month, in line with market expectations. At the same time, it reduced reserve requirements on savings deposits to 6% from 6.5% while reserve requirements on current accounts were slashed by 50bps to 1%.

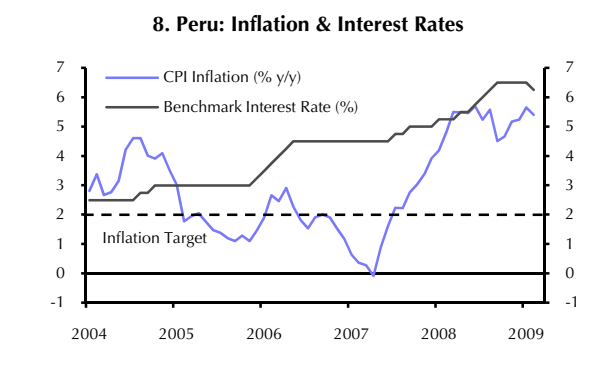
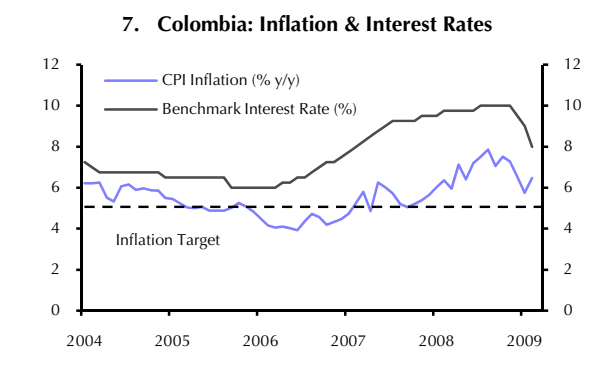
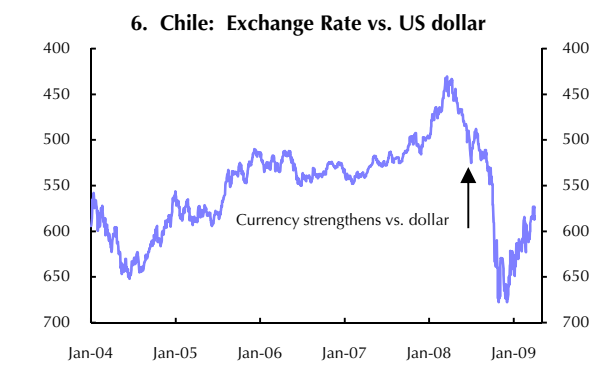
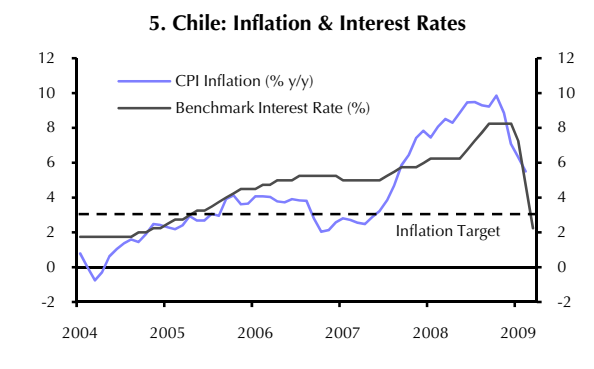
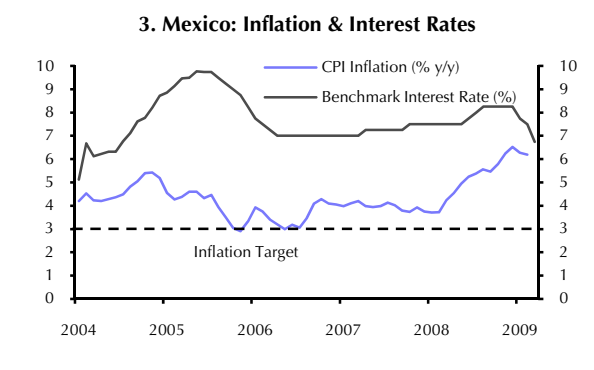
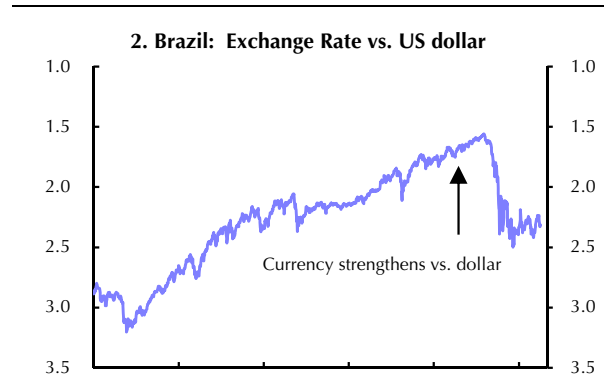
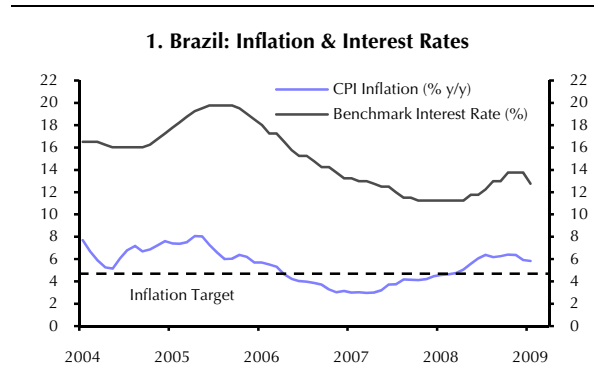
Nonetheless, the BCRP has been slower to respond to the global downturn than its counterparts elsewhere in the region. Interest rates have been cut by just 50bps in total from their peak at the end of last year. This reflects policymakers' somewhat complacent view that the Peruvian economy would sail through the current turmoil in global markets relatively unscathed. Indeed, the BCRP still expects the economy to grow by 5% this year. While Peru is undoubtedly better placed to weather the current crisis than in the past, this is still hopelessly optimistic. We have pencilled in a drop in GDP of 3% this year.

Headline inflation fell to 5.5% in February, from 6.5% in January and a peak of 6.8% in November. For the time being, this has been driven predominantly by weaker food price inflation. Core inflation is no longer accelerating, but is not yet falling. However, it is only a matter of time before core pressures start to ease. The impending collapse in demand will generate vast amounts of spare capacity. Meanwhile, the sol has been much more stable than other currencies in the region.

Of course, inflation risks still exist. With Peru's hydroelectric network operating at nearly full capacity, a reduction in rainfall could trigger a renewed rise in energy prices. Nonetheless, we expect inflation in Peru to fall close to the BCRP's target of 2% this year. While the BCRP is naturally more cautious than other Banks in the region, this could pave the way for dramatic interest rate cuts. We have pencilled in a 75bps cut to 5.25% this month (consensus 50bps cuts) and believe that interest rates could ultimately fall to 2% by the end of the year.

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Background Charts



Sources – Bloomberg, Thomson Datastream, Capital Economics

BACKGROUND INFORMATION

Brazil

Interest Rate Meetings	8 Meetings in 2009		
Inflation Target	4.5%, with +/- 2% tolerance range.		
Governor	Henrique de Campos Meirelles		
Interest Rate Meetings	Date	Outcome	Vote
	23 rd July 2008	13.00%	Unanimous
	10 th September 2008	13.75%	5-3 (Hike by 75bps –Hike by 50bps)
	29 th October 2008	13.75%	Unanimous
	10 th December 2008	13.75%	Unanimous
	21 st January 2009	12.75%	5-3 (Cut by 100bps – Cut by 50bps)
	11 th March 2009	11.25%	Unanimous

Mexico

Interest Rate Meetings	11 Meetings in 2009		
Inflation Target	3%, with +/- 1% tolerance range.		
Governor	Guillermo Ortiz		
Interest Rate Meetings	Date	Outcome	Vote
	15 th August 2008	8.00%	
	19 th September 2008	8.25%	
	17 th October 2008	8.25%	
	28 th November 2008	8.25%	Voting Breakdown Unavailable
	16 th January 2009	7.75%	
	20 th February 2009	7.25%	
	20 th March 2009	6.50%	

Colombia

Interest Rate Meetings	Once a month		
Inflation Target	5%, with +/- 0.5% tolerance range.		
Governor	José Darío Uribe Escobar		
Interest Rate Meetings	Date	Outcome	Vote
	19 th September 2008	10.00%	
	24 th October 2008	10.00%	
	21 st November 2008	10.00%	
	19 th December 2008	9.50%	Voting breakdown unavailable
	30 th January 2009	9.00%	
	27 th February 2009	8.00%	
	20 th March 2009	7.00%	

BACKGROUND INFORMATION (CONTINUED)

Chile

Interest Rate Meetings	Once a month, (on every 2 nd Thursday)		
Inflation Target	3%, with +/- 1% tolerance range.		
Governor	José De Gregorio Rebeco		
Interest Rate Meetings	Date	Outcome	Vote
	9 th October 2008	8.25%	Unanimous
	13 th November 2008	8.25%	Unanimous
	11 th December 2008	8.25%	4-1 (Hold – Cut by 25bps)
	8 th January 2009	7.25%	Unanimous
	12 th February 2009	4.75%	4-1 (Cut by 250bps – Cut by 200bps)
	12 th March 2009	2.25%	

Peru

Interest Rate Meetings	Once a month		
Inflation Target	2%, with +/- 1% tolerance range.		
Governor	Julio Velarde		
Interest Rate Meetings	Date	Outcome	Vote
	9 th October 2008	6.50%	
	13 th November 2008	6.50%	
	10 th December 2008	6.50%	
	8 th January 2009	6.50%	Voting breakdown unavailable
	5 th February 2009	6.25%	
	5 th March 2009	6.00%	

Source – National Central Banks