



Representative Office
for the Americas



Fiscal and monetary policy uncertainty in the Americas

XVIII IMF Regional conference on Central America, Panama and the Dominican Republic

Session III: Monetary and exchange rate policy in an uncertain environment.

Jon Frost, Head of Economics for the Americas, 29-30 July, 2024*

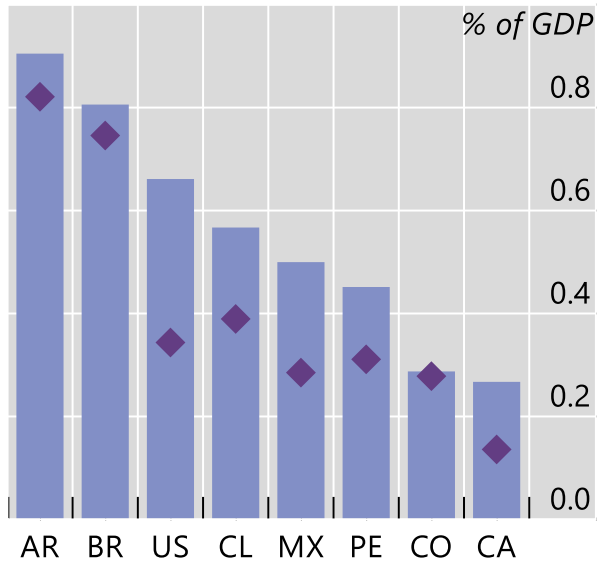
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Fiscal and monetary policy uncertainty in the Americas

- Two current features to consider for fiscal and monetary policy in the region:
 - High levels of policy uncertainty
 - Expansionary fiscal policy and contractionary monetary policy
- Which are the challenges that this configuration brings?

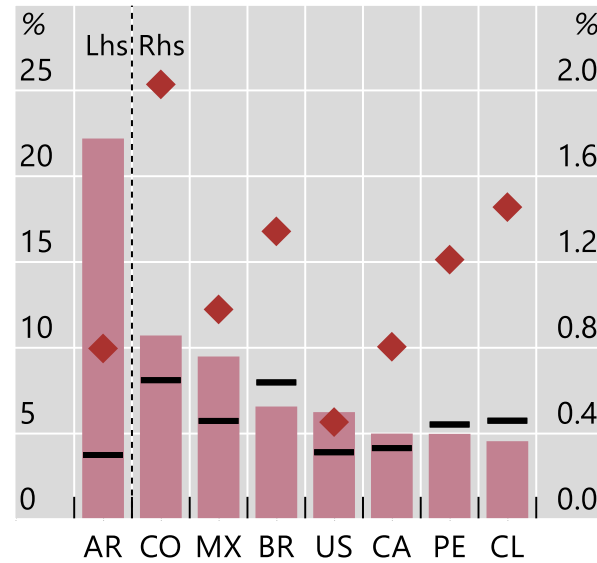
High levels of policy uncertainty

Fiscal forecast error dispersion is above historical means



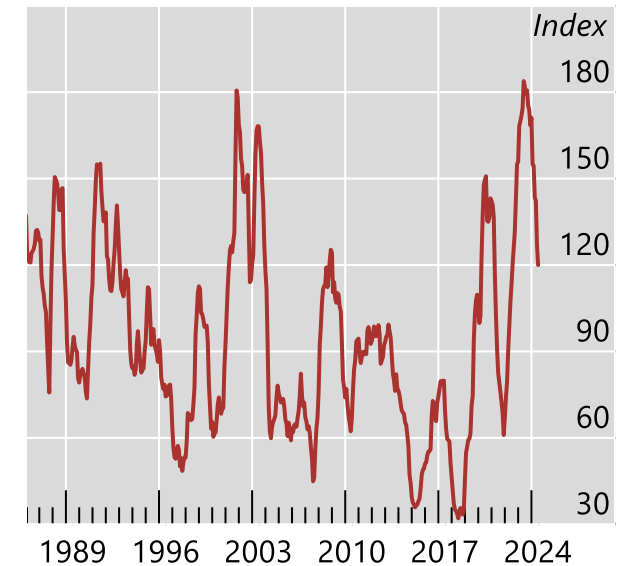
Dispersion across private analysts:
 ◆ Average 2016–19
 ■ January 2024

Forecast dispersion for monetary policy rates is also high



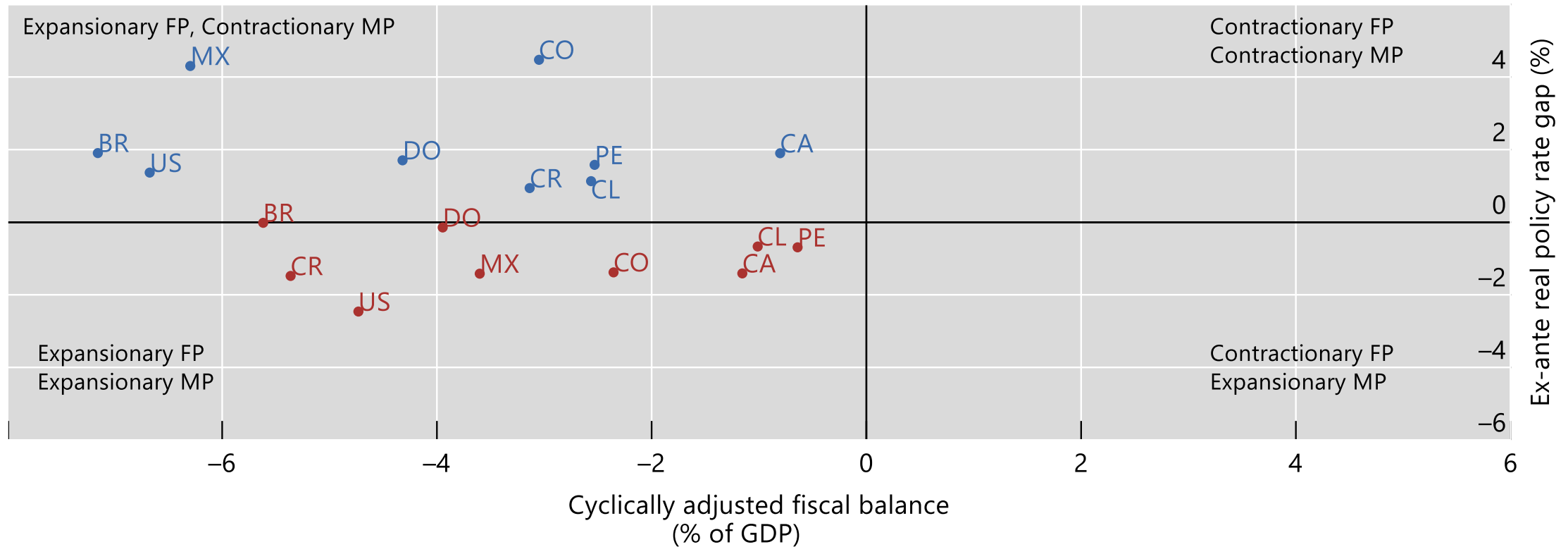
Dispersion across private analysts on on policy rate forecast:
 ■ Feb 24 ◆ Feb 23
 — Average since 2005

Uncertainty around US monetary policy is still high



Sources: Baker et al (2016); Consensus Economics; BIS.

Expansionary fiscal policy and contractionary monetary policy



● Average 2010-19 ● 2024

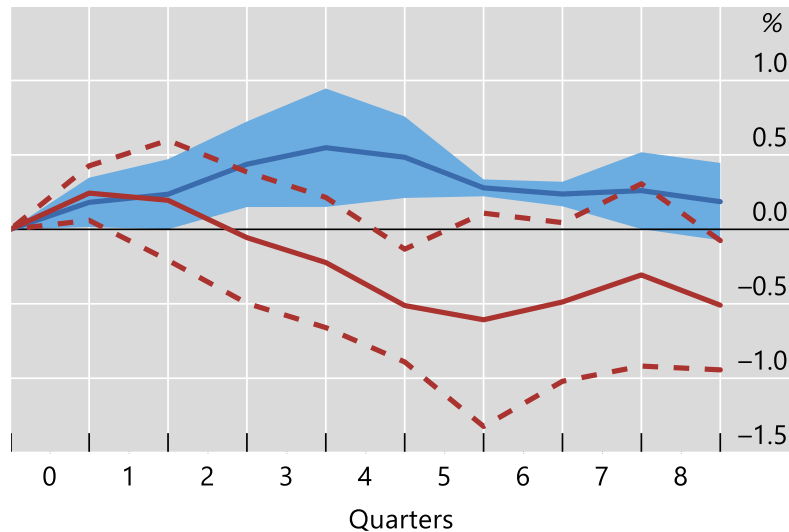
BR = Brazil; CA = Canada; CL = Chile; CR = Costa Rica; CO = Colombia; DO = Dominican Republic; MX = Mexico; PE = Peru; US = United States.

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

What are the challenges that this configuration brings?

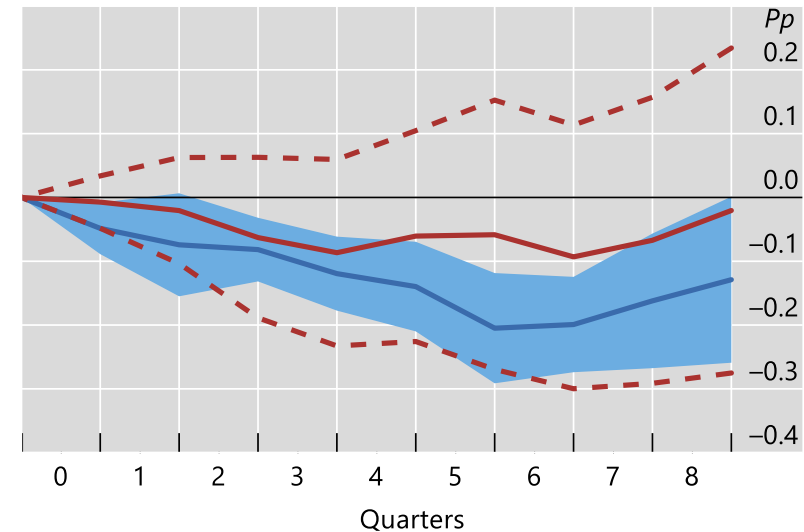
- High uncertainty by itself can weaken exchange rates and tighten financial conditions, but what could be the effects of higher uncertainty on fiscal and monetary policy?

High policy uncertainty reduces fiscal policy effectiveness in Latin America



Impact of 1% of government spending on real GDP during:
 — a high policy uncertainty regime
 — a low policy uncertainty regime

High policy uncertainty hinders monetary policy in reducing inflation



Impact of 1% of MP shock on QoQ inflation rate in during:
 — a high policy uncertainty regime
 — a low policy uncertainty regime

Confidence intervals at 90%.

Source: R Guerra (forthcoming): "How does economic policy uncertainty affect fiscal and monetary policy in Latin America?", *BIS Working Paper*.

Policy implications and conclusions

- Even during low uncertainty periods, a lack of fiscal consolidation efforts can push up prices and trigger exchange rate depreciation
- But in a high uncertainty environment, the reduction of effectiveness of fiscal and monetary policy could put upward pressures on risk premia and inflation expectations – and thus drive further inflation and exchange rate pressure
- The current fiscal and monetary policy mix in the region may bring important risks, particularly considering the high level of external uncertainty

Thank you!
¡Gracias!

References

- Aguilar, A, C Cantú and R Guerra (2023): "Fiscal and monetary policy in emerging market economies: what are the risks and policy trade-offs?", *BIS Bulletin*, no 71, March.
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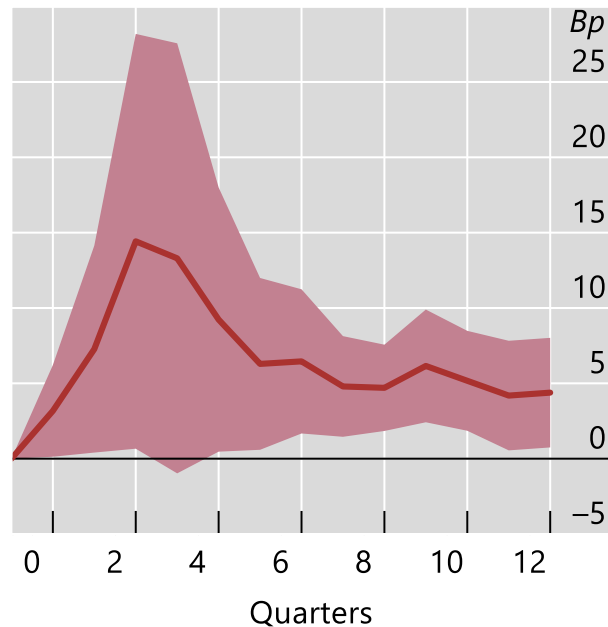
What are the challenges that this configuration brings?

- Empirical evidence for Latin America:
 - Risk premia channel in Latin America is higher than in other emerging market economies (EMEs) (Aguilar et al (2023))
 - Latin American yields are highly responsive to fiscal news (see next slide)
- Broad evidence for EMEs and advanced economies (AEs):
 - Higher deficits raise the risk of inflation more in EMEs than in AEs (Banerjee et al (2023))
 - Higher debt levels increase the risk of capital flow reversals in EMEs (Aguilar et al (forthcoming))

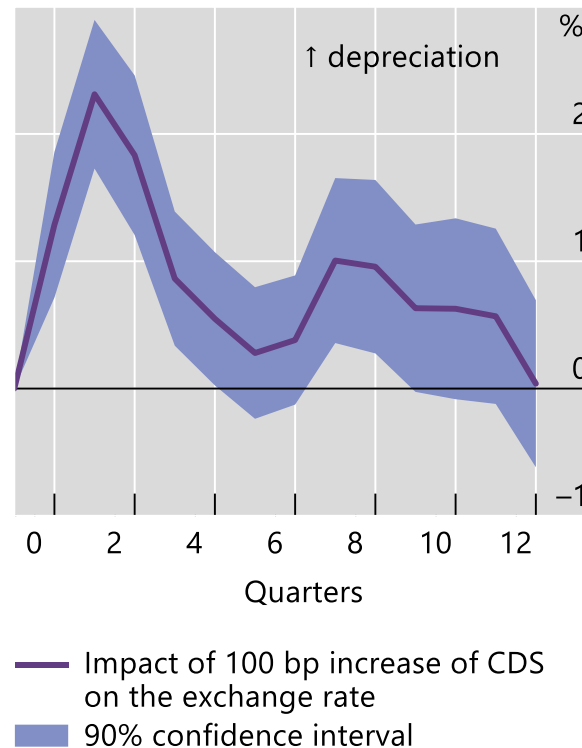
What are the challenges that this configuration brings?

- Risk premia channel in Latin America is higher than in other EMEs

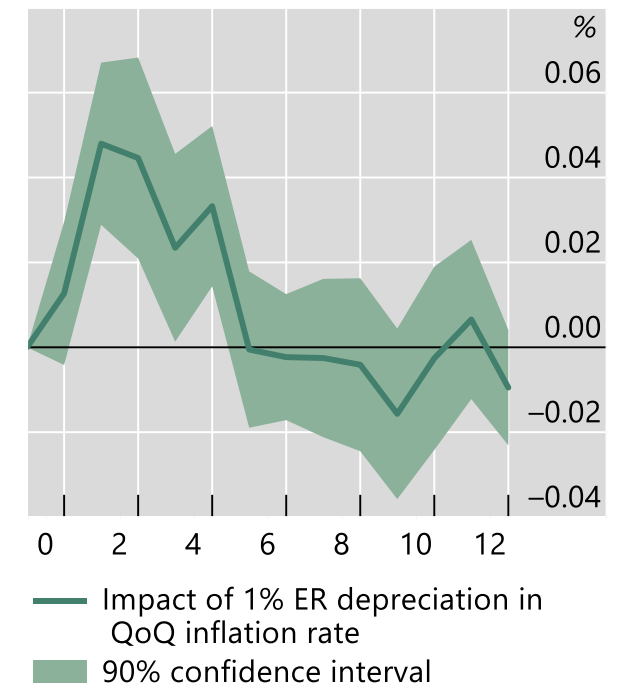
Higher debt raises sovereign risk



Risk weakens exchange rates



ER depreciation pushes inflation

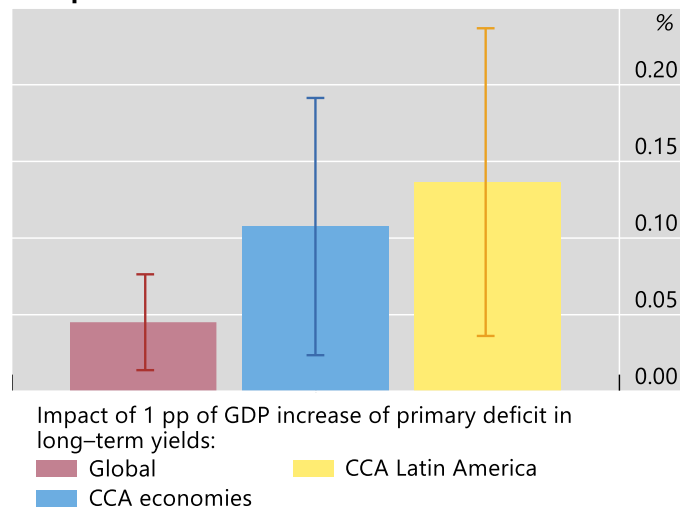


Source: Aguilar, A, C Cantú and R Guerra (2023): "Fiscal and monetary policy in emerging market economies: what are the risks and policy trade-offs?", *BIS Bulletin*, no 71.

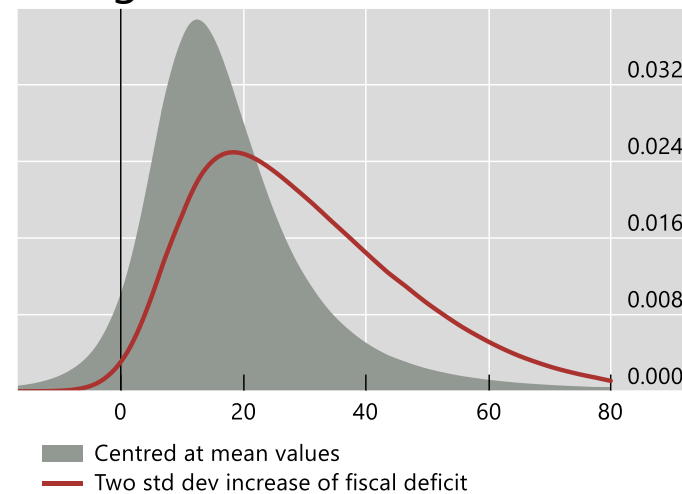
What are the challenges that this configuration brings?

- There is strong evidence that the current lack of fiscal consolidation efforts in Latin America could compromise monetary policy effectiveness and even financial stability

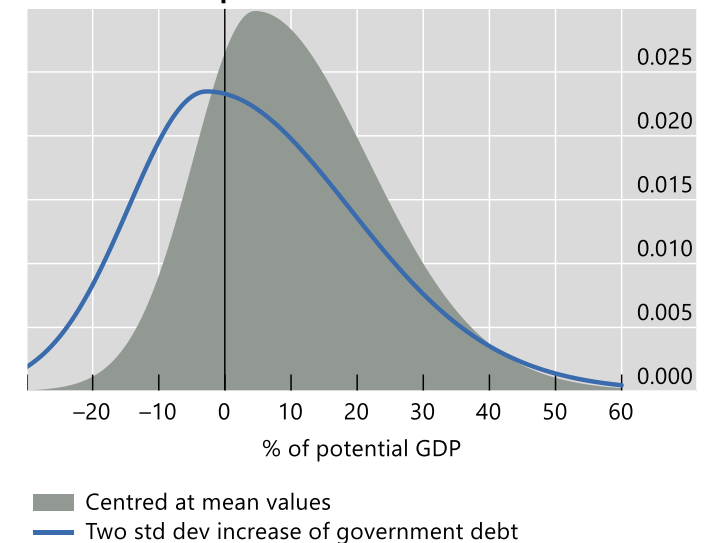
Latin American yields are highly responsive to fiscal news



Higher deficits increase the risk of higher inflation levels



Higher debt levels increase the risk of capital flow reversals



Source: Aguilar, A, C Cantú and R Guerra (2023): "Fiscal and monetary policy in emerging market economies: what are the risks and policy trade-offs?", *BIS Bulletin*, no 71; Aguilar, A, R Guerra and F Zampolli (forthcoming): "Assessing capital flows domestic risks to emerging market economies", *BIS Working Paper*.
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