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# Monetary and Foreign Exchange Policy in the CAPDR Region

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# Key Questions



How effective was the policy rate in helping tame inflation in the region? Lessons from 2022-23.



What factors are limiting transmission?



Are current practices consistent with countries' growth and development goals in the near- and medium-term? The cost of Foreign Exchange Interventions (FXIs).

# Key Takeaways



*2022-23 lesson: there is room for the policy rate to play a greater role in influencing borrowers' behavior.*



*The effectiveness of monetary and foreign exchange rate policies also depends on the development of financial markets.*



*FXIs and limited interbank transactions are costly and may impede the gradual policy adjustments required to absorb higher financial inflows in a higher-growth new equilibrium.*

# Monetary and Foreign Exchange Policy Frameworks in the CAPDR Region

## Inflation Targeters

### De Jure: Managed Floating

Costa Rica (De Facto: Floating)  
Dominican Republic (De Facto: Crawling-like)

### De Jure: Floating

Guatemala (De Facto: Stabilized arrangement)

## Exchange Rate Anchor

### De jure: No Separate Legal Tender

El Salvador, Panama

### De jure: Crawling Band/Peg

Honduras (De Facto: Stabilized arrangement)  
Nicaragua (De Facto: Crawling Peg)

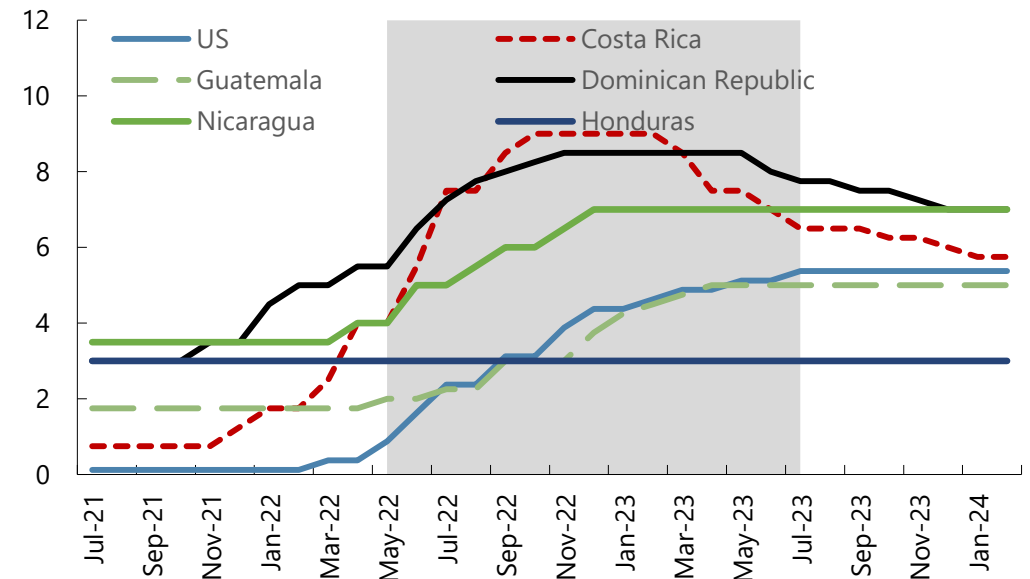
# The *policy rate's* role in the 2022-23 high-inflation episode

1. Control second-round effects. External factors dominated inflation.
2. Anchor expectations and foreign exchange (FX) channel
3. Reduce arbitrage gains against the U.S.
4. Cool-off the economy

When can we say:  
Mission accomplished?

**Policy rate in CAPDR vs US**

(Percent)

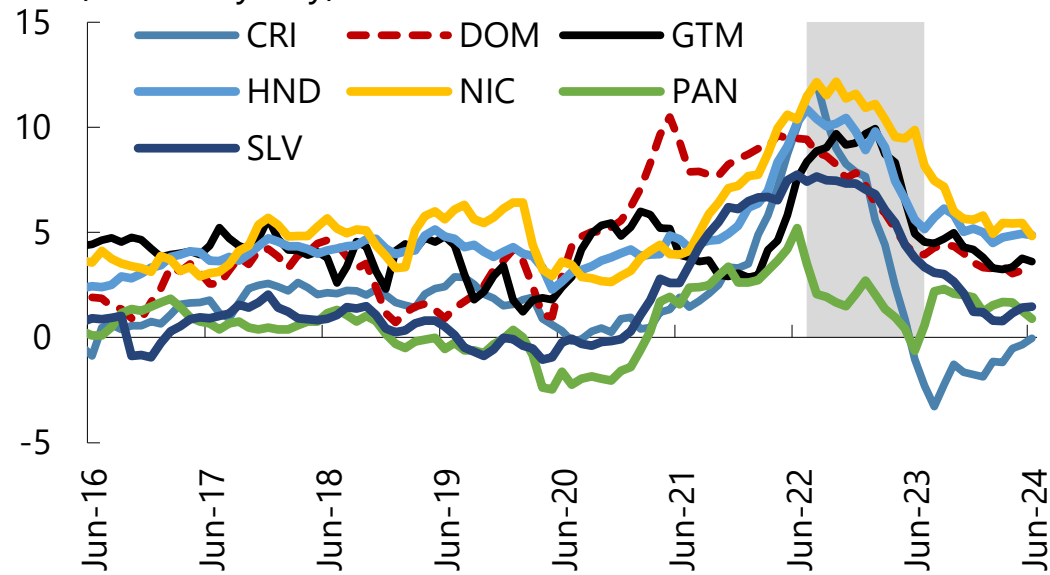


Source: Haver Analytics.

# Externally-driven Inflation

## Headline CPI Inflation

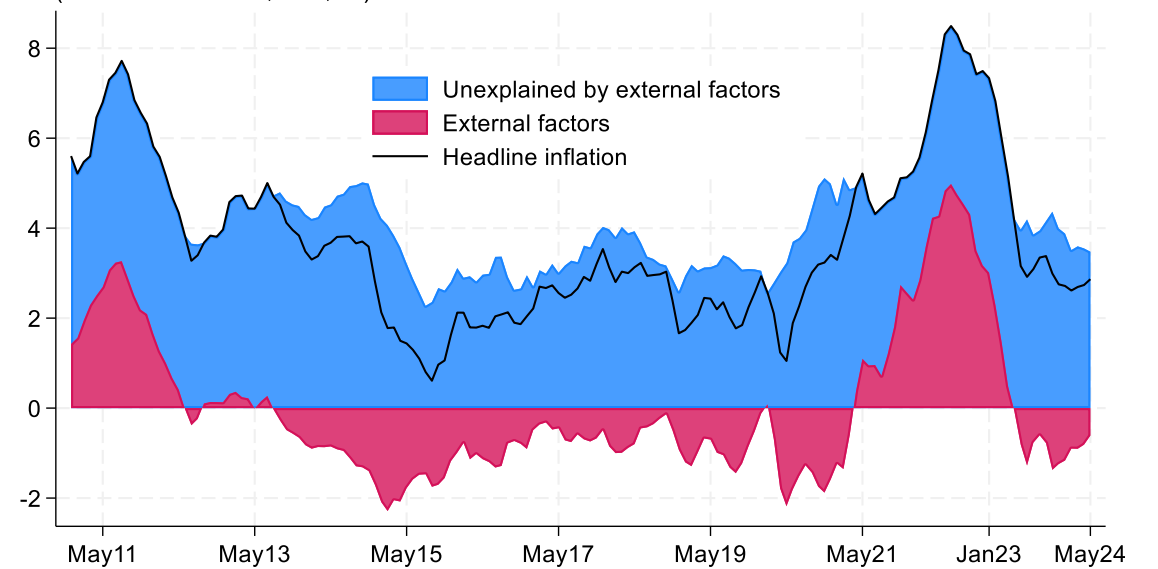
(Percent, y-o-y)



Source: Haver Analytics.

## CAPDR: Contribution of External Factors to Inflation

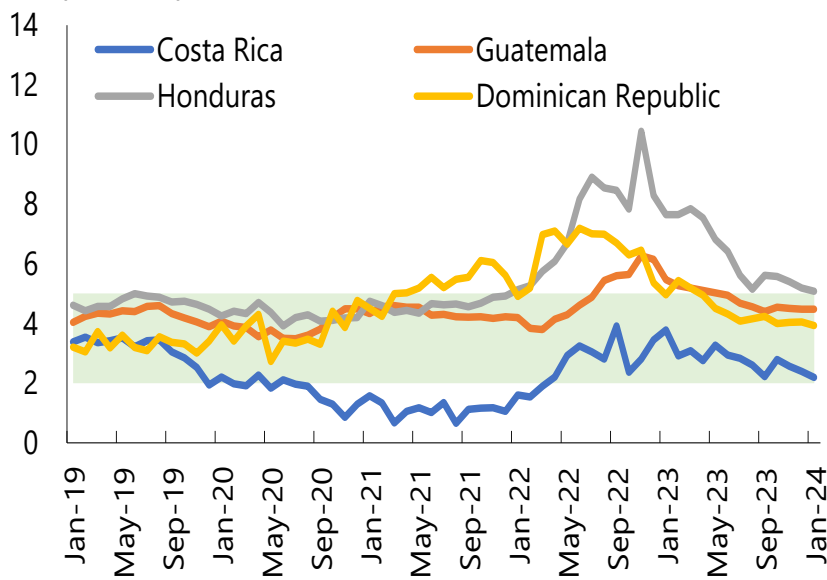
(Headline inflation, YoY, %)



# The Expectations and Foreign Exchange Channels

## 12 Months inflation expectations

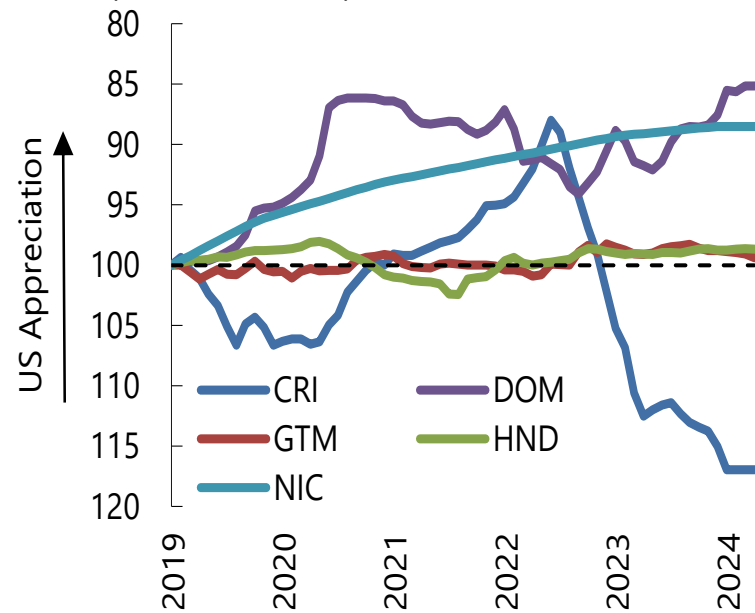
(Percent)



Source: SECMCA.

## US Dollar per National Currency

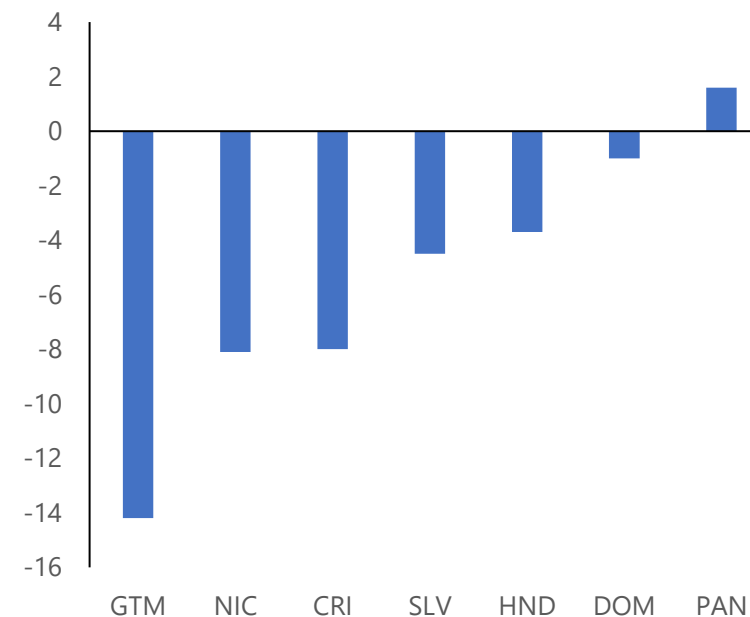
(Index, 2019=100)



Sources: WEO.

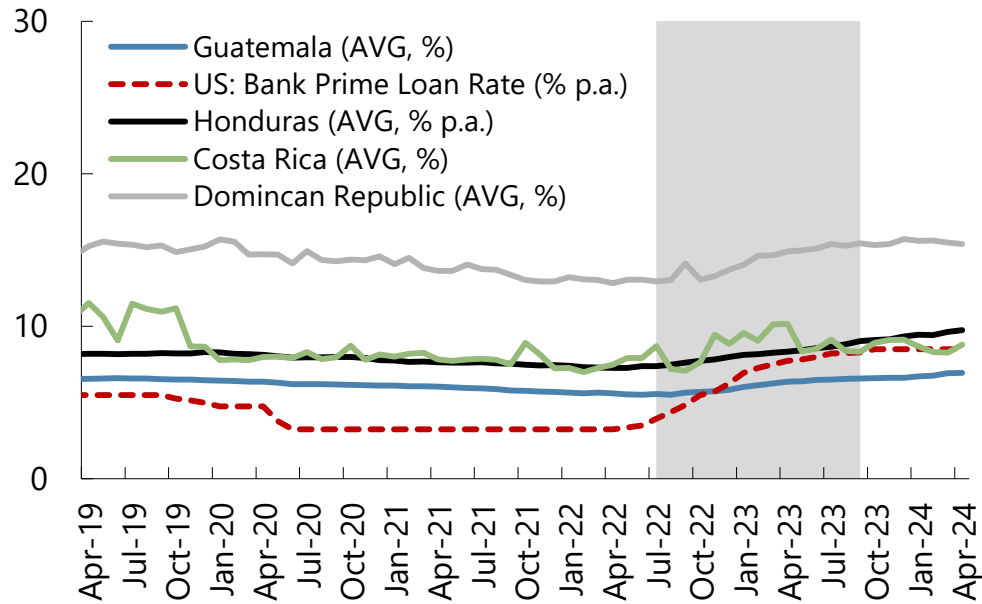
## Real Effective Exchange Rate GAP

(Latest AIV, CA model based, in percent)



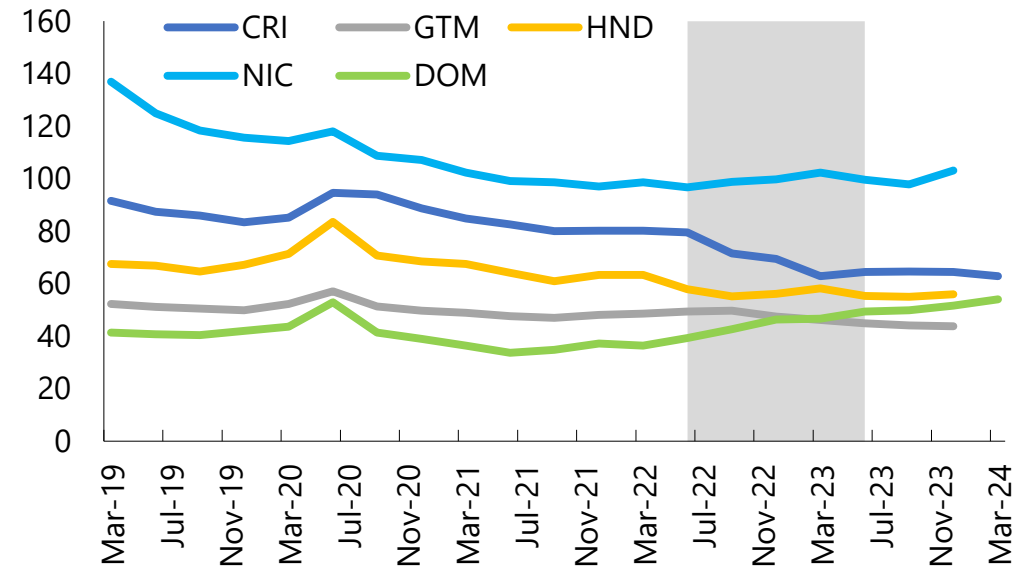
# Reduce Arbitrage Gains Against the U.S.

**Foreign Currency Lending Rates in Central America vs. US Loan Rates**



Source: Haver Analytics; and National Authorities.

**Foreign credit to private sector**  
(% of GDP)



Source: Haver Analytics; SECMCA; and IMF staff calculations.

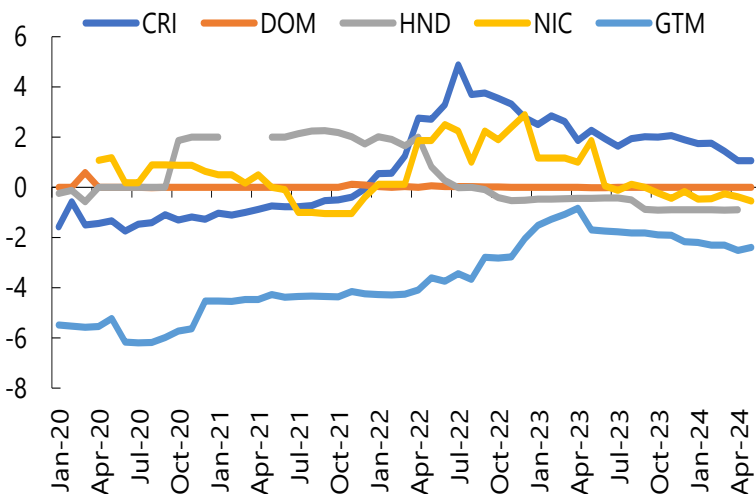
Note: Only considers credits from Other Depository Corporations (ODC) which are depository institutions excluding the central bank.



# Cooling off the Economy\_The Credit Channel

## Gap Between Policy Rate and Overnight Rate in CA, 2020-2024

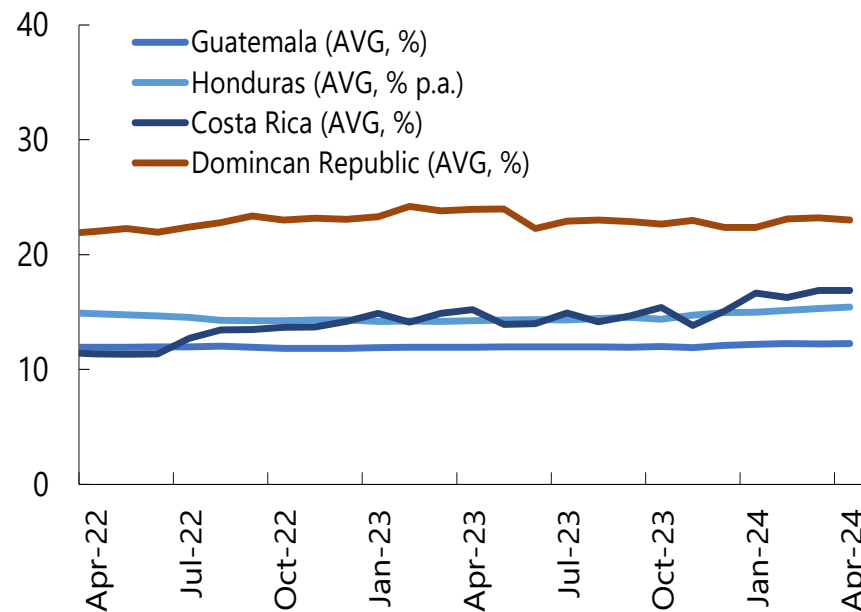
(Percent, end of period)



Source: Haver Analytics; Bloomberg.

Note: Gap = Policy rate - overnight interest rate

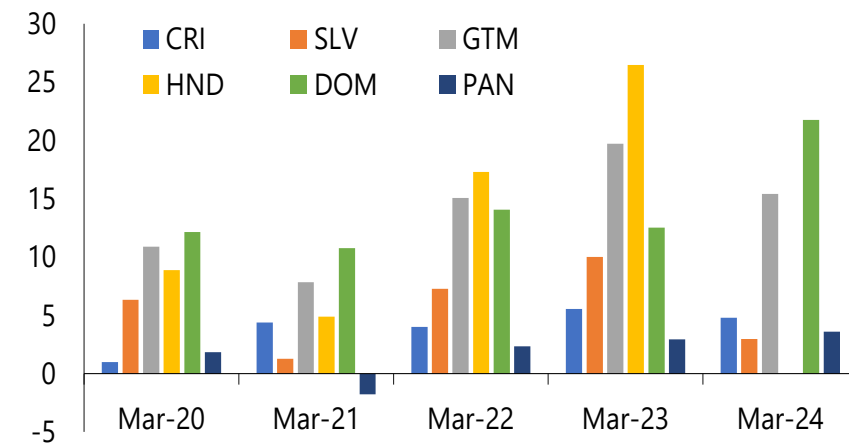
## National Currency Lending Rates in Central America



Source: Haver Analytics; and National Authorities.

## Bank Credit to the Private Sector in Domestic Currency

(Changes Y-o-Y)



Source: SECMCA; and IMF staff calculations.

Note: Only considers credits from Other Depository Corporations (ODC) which are depository institutions excluding the central bank.



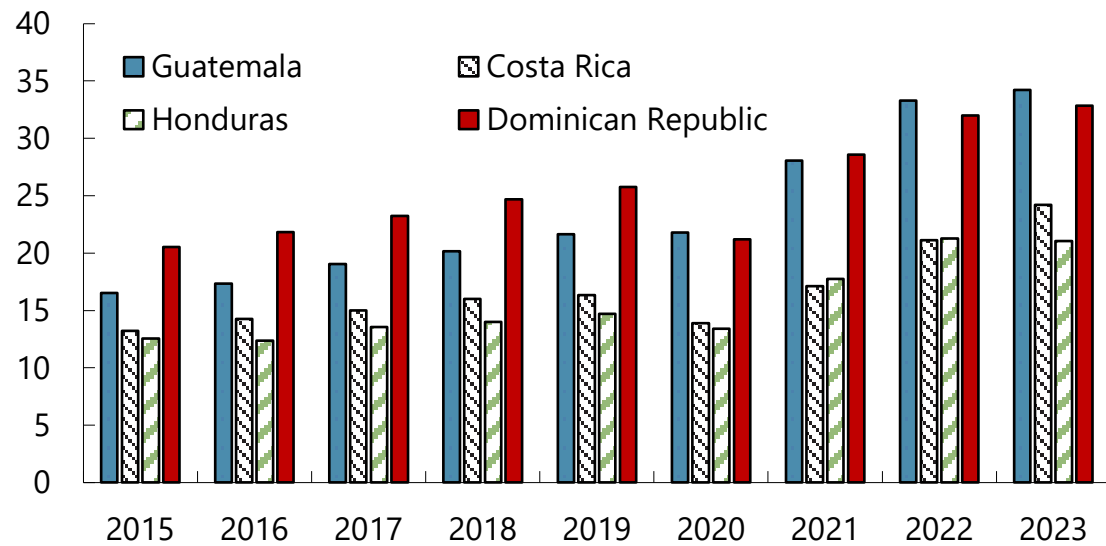
## What Factors Limited Transmission?

### STRUCTURAL FACTORS

- Large Liquidity and CB as the Market Maker
- Large Margins in the Banking Sector
- Foreign Exchange Interventions (FXIs)

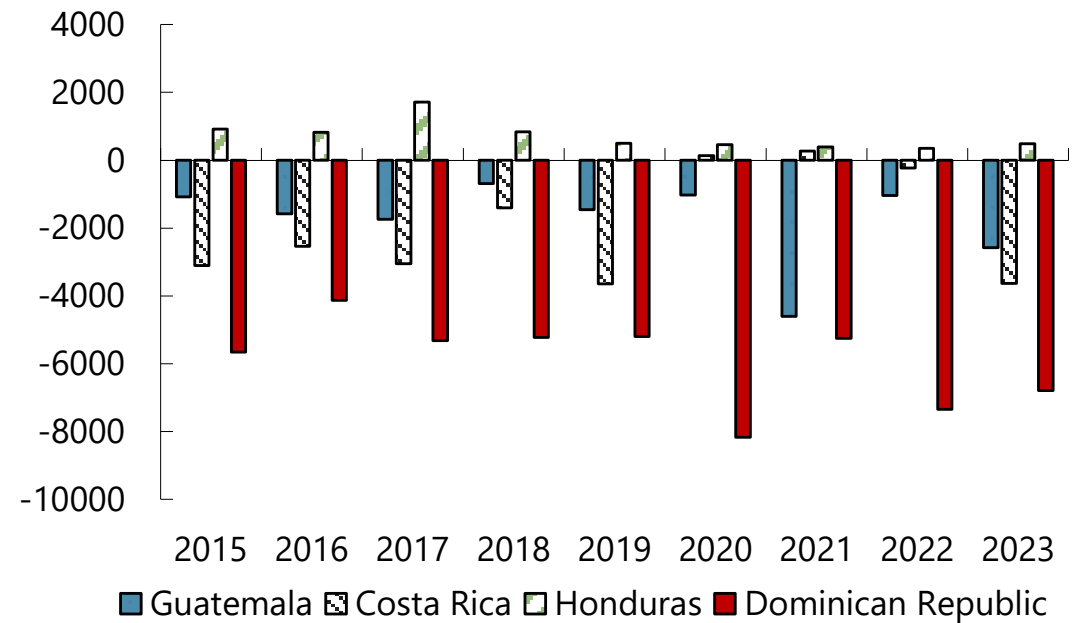
# Large Foreign Exchange Inflows

**Exports, Remittance, and Tourism**  
(Billions of US\$)



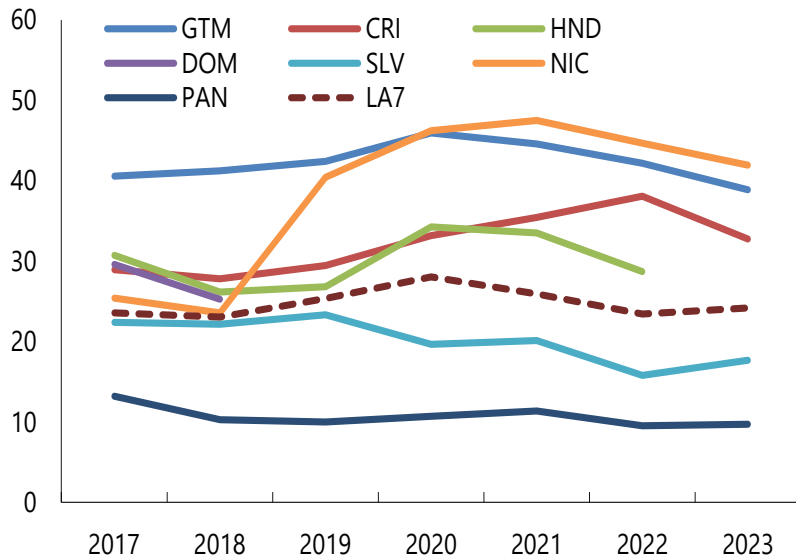
Source: Haver Analytics.

**FDI and portfolio inflows**  
(Millions of US\$)



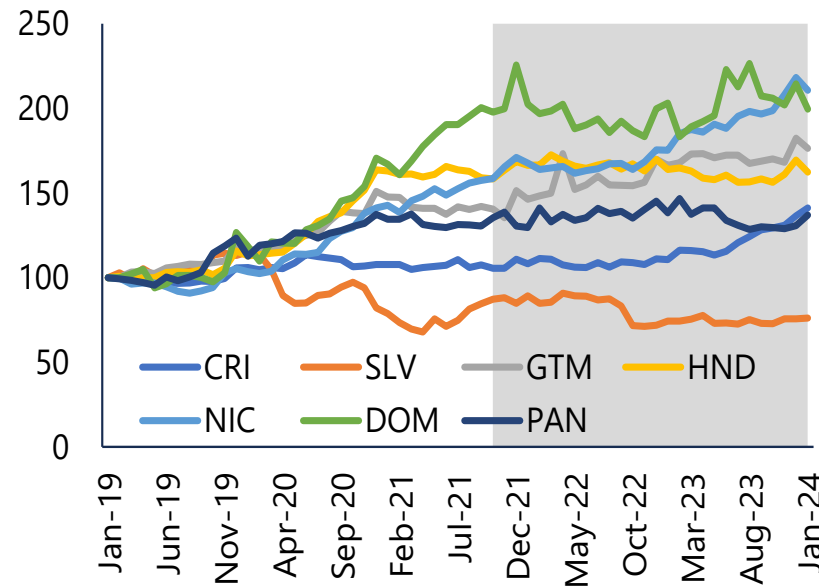
# ... Resulting in Ample Liquidity

**Liquid Asset Ratio**  
(Percent)



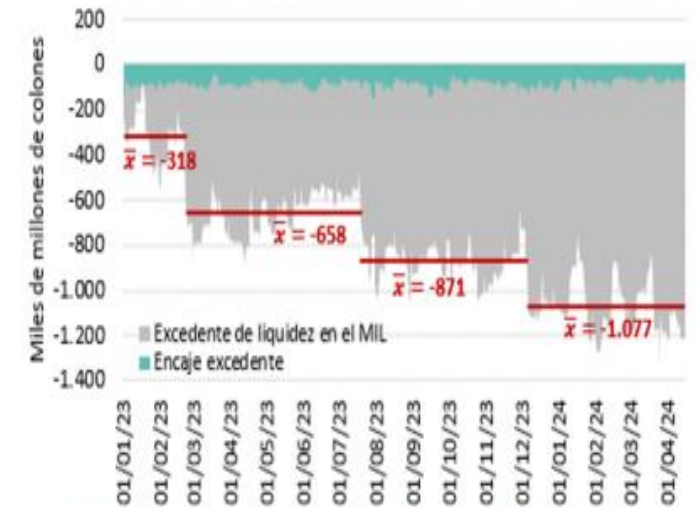
Source: FSI; and IMF staff calculations.

**Monetary Base**  
(100=January 2019)



Source: SECMCA.

**Liquidity in Costa Rica's Financial Sector**  
(In millions of Colones)

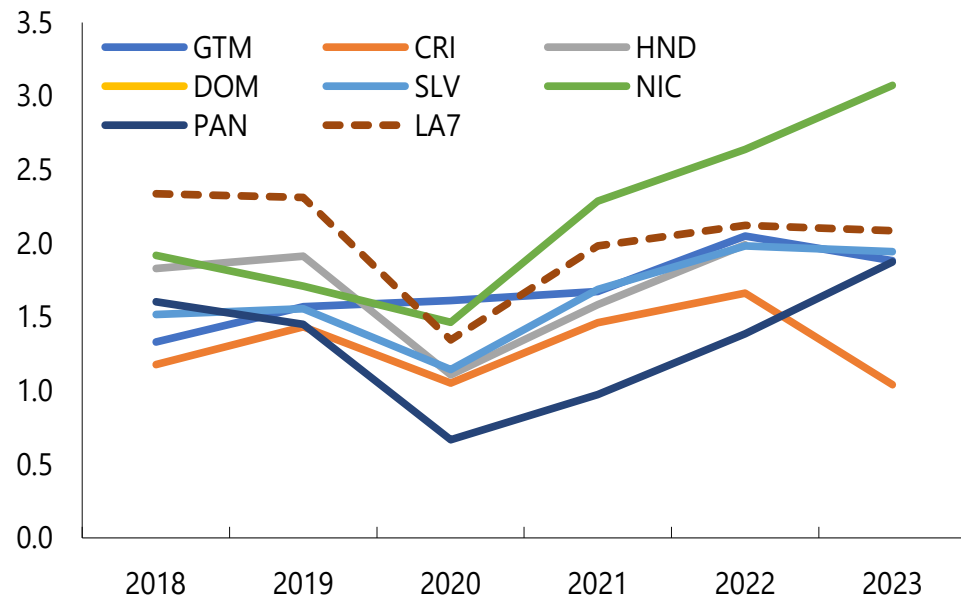


\* Se estima mediante la participación neta del Banco Central en el MIL. Si el BCCR es deudor neto indica que hay un excedente de liquidez y a la inversa.

Fuente: Banco Central de Costa Rica.

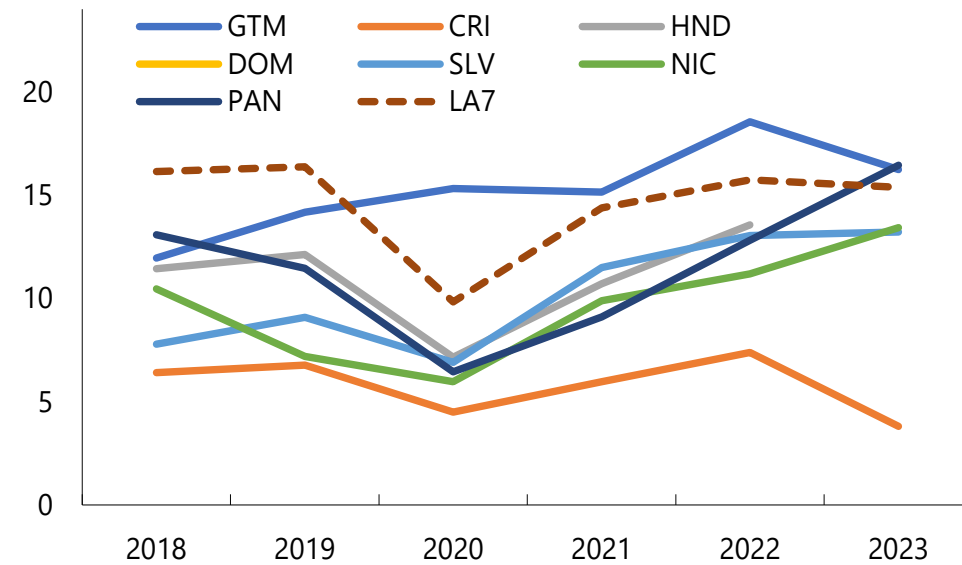
# High Profitable Banks

**Return on Assets**  
(Percent)



Source: FSI; and IMF staff calculations.

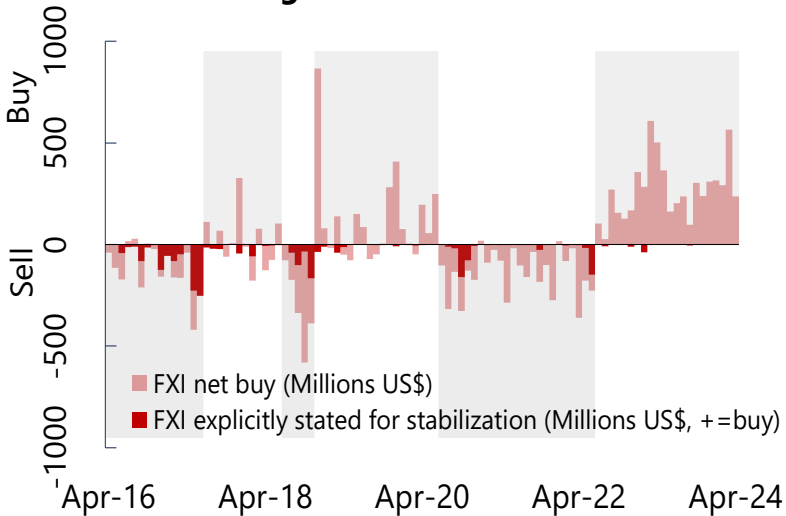
**Return on Equity**  
(Percent)



Source: FSI; and IMF staff calculations.

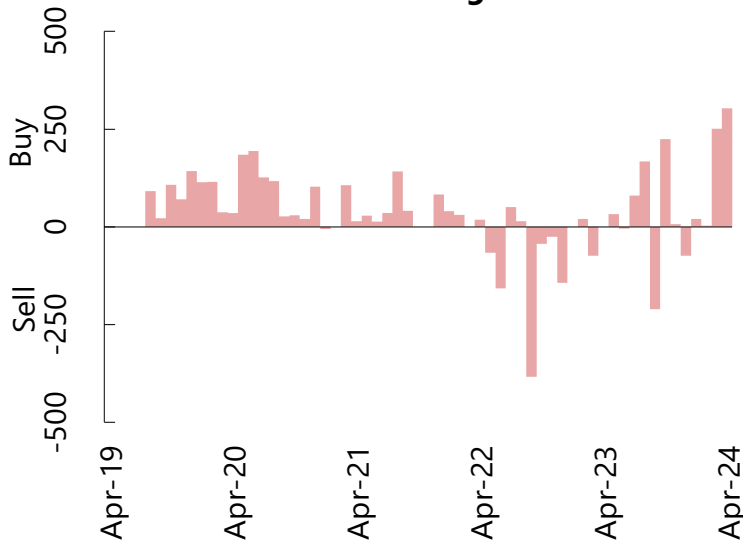
# Foreign Exchange Interventions

### Costa Rica: Foreign Exchange Intervention and Exchange Rate



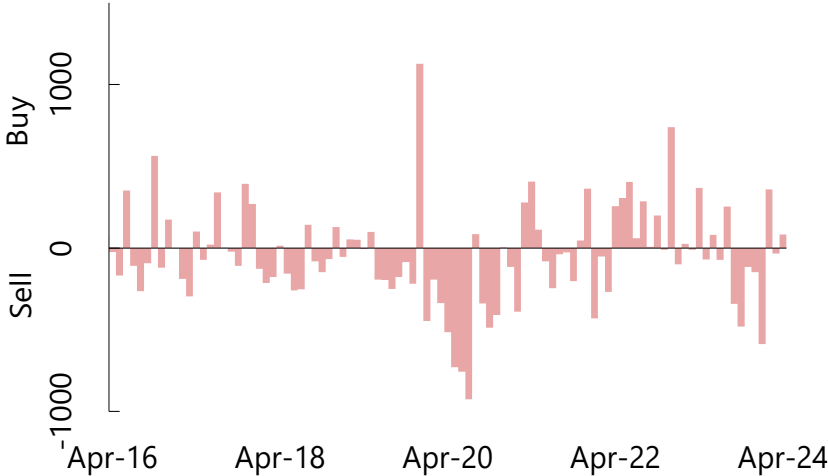
Sources: BCCR; and IMF staff calculations.

### Guatemala: Foreign Exchange Intervention and Exchange Rate



Sources: Banguat; and IMF staff calculations.

### Dominican Republic: Foreign Exchange Intervention and Exchange Rate



Sources: Banco Central RD; and IMF staff calculations.



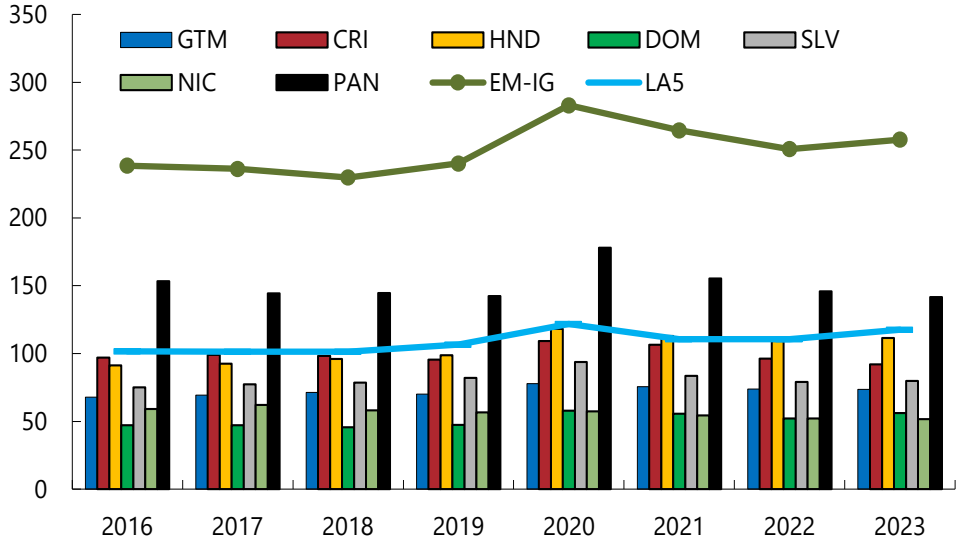
# FX Policy and Financial Sector Depth/Stability

- ❑ Panel data analysis covering 157 emerging and developing economies in five regions, 2000 – 22.
- ❑ The model links financial development and financial stability to financial inflows (remittances, FDI, and portfolio) and FXIs (Oliva and Khinashvilli, 2024).
- ❑ We find empirical evidence that
  - ❖ Higher remittances tend to help build bank deposits and banks' holdings of sovereign debt (*financial depth*),
  - ❖ If at all significant, FXIs work as an insurance tool,
    - encouraging higher consumption (lower deposits) and spending
    - lowering buffers and higher FX exposures in the financial sector (*financial stability*).
- ❑ These costs add to other direct FXI-related costs already identified in the literature.

# Foreign Exchange Policy, At What Cost?

## Bank Assets to GDP

(Percent)

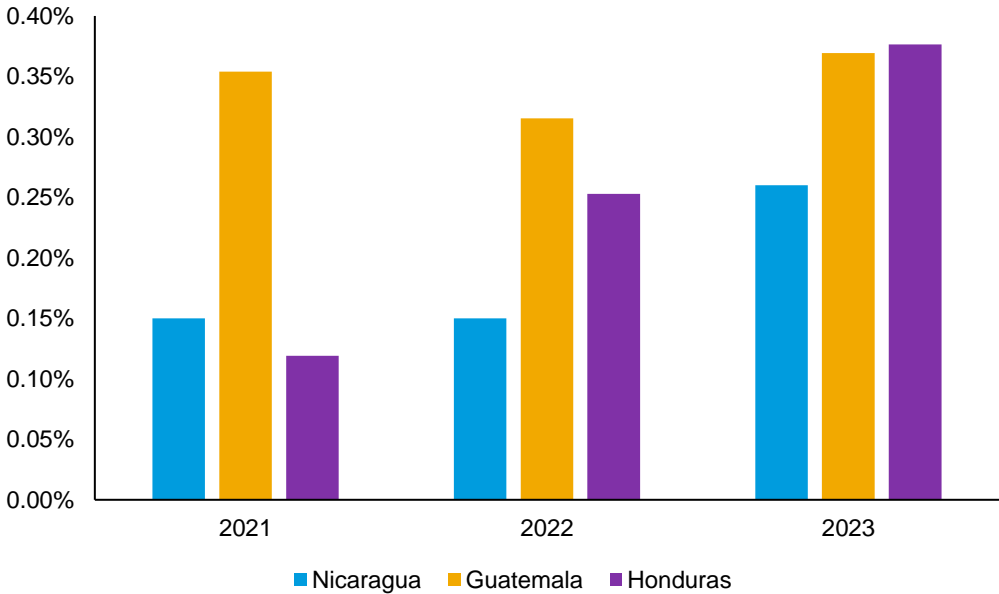


Source: Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.

Note: LA5 = Brazil, Chile, Colombia, Mexico, and Peru. EM-IG = Investment grade emerging economies: Kuwait, Qatar, Saudi Arabia, United Arab Emirates, Indonesia, Malaysia, Philippines, Thailand, Botswana, Mauritius, Kazakhstan, Bulgaria, Hungary,

## Central Bank Cost of Monetary, FX, and Credit

(Estimates, In percent of GDP)



Source; Central banks' audited financial statements and IMF Staff calculations





# Moving Towards a Higher-Growth Equilibrium/IG Status



## Demographic Bonus and New Technologies

New payment instruments and systems: Credit Card Growth, Digitalization  
Financial Inclusion and financial literacy



## Removal of restrictions to enhance policy transmission



## Market development supported by less FX intervention

private sector FX markets and hedging, secondary debt market,  
Insurance, pensions, asset management.



## Panel Discussion



The Costa Rican Experience



Policy coordination with higher policy rate transmission



The role of communication: more and better



The new technologies