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MONETARY CONDITIONS AND FAIR CURRENCIES: GAUGING THE STANCE OF MONETARY CONDITIONS AND FAIR MONETARY CURRENCY VALUES

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MONETARY CONDITIONS AND FAIR CURRENCIES

Gauging the Stance of Monetary Conditions and Fair Monetary Currency Values

Introduction

One of the leading drivers of financial opportunities is the Central Bank's ability to reign-in and keep inflation low. As a result, gauging the stance of monetary conditions has been a critical component of interest rate policy decisions. Economists have increasingly turned as well to measures of how tight or how loose monetary conditions might be at any given time. Tight monetary conditions are usually associated with relatively high interest rates that could be near a cyclical high, thus paving the way for rising bond prices, and stable or appreciating currencies. If monetary conditions are loose, however, interest rates would be too low both in nominal and real terms, thereby limiting the ability of the monetary authorities to contain inflation pressures. The Central Banks of Canada and New Zealand have pioneered most of the complex work that goes into gauging the stance of monetary conditions. Invariably, though, the key concept that captures the basic tenant of the how tight or loose monetary conditions might be is the notion that interest rates and exchange rates and their equilibrium interaction provide the most critical measure of the stance of monetary conditions. As a result, tight monetary conditions are usually tied to high-enough interest rates and stable or appreciating currencies, while loose monetary conditions are usually tied to unsustainably low interest rates and weakening currencies. Because of the sharp improvement in monetary management that followed the adoption of floating exchange rate regimes, leading Latin American economies today provide a unique opportunity to gauge the monetary stance base on the framework developed by industrialized nations. We argue that monetary management is the single most important achievement of Latin American economies in

1 The author is grateful to Ms. Gabriela Gutierrez for her extensive comments and contributions in developing Barclays’ Monetary Conditions Model.

2 This report is an edited excerpt from an internal report prepared by the Barclays Capital Research Group, entitled, “Latin America 2005: Stepping Up”. Barclays Capital (or one of its affiliates) has managed or co-managed an offering of any or all of the governments discussed in this publication and/or has received other investment banking compensation from any or all of the governments within the preceding 12 months. Readers should assume that Barclays Capital intends to seek investment banking or other business relationships for which it will receive compensation from the governments that are the subject of this report.
ensuring that financial conditions remain stable. Indeed, for the first time in modern Latin American history, all the leading Central Banks in the region, Brazil, Mexico, Chile and Colombia have entered the recent period of US monetary tightening with fairly valued currencies, as opposed to grossly overvalued currencies as it happened typically in the past, as well as with tight monetary policies, rather than the past loose monetary policies that invariably led to currency crises.

Still, despite all the progress made, determining the monetary stance is especially difficult because any assessment hinges on the choice of a reference period when monetary conditions are deemed to be neutral, which in turn depends on an uncertain, equilibrium real exchange rate. To deal with this, we focused on a monetary measure that weighs actual, not necessarily equilibrium, real interest and exchange rate levels as well as changes in the interest rate and in the exchanges rate compared to a measure of its fair value. Accordingly, the stance of monetary conditions is gauged based on whether monetary conditions have become tighter or looser vis-à-vis a reference period, without making a specific reference to whether they were too tight or not to start with. We emphasized actual, objective levels of real interest rates by assigning a 2/3 weight to the real foreign exchange-adjusted interest rate and 1/3 to the equal weighted average of the change in the real interest rate and a measure of real exchange rate over- or under-valuation given a fair value of the real exchange rate. The fair value of the real exchange rate, in turn, is derived from the relative inflation differential adjusted by productivity differentials between the reference country and the United States for an equilibrium base year. The base year needs to satisfy two conditions. First, both the current and capital accounts need to be in equilibrium. And second, the actual real interest rate for such period needs to be associated with a relatively stable real exchange rate.

In this regard, while the equilibrium exchange rate is not known, we can still infer whether it has become more appreciated or depreciated based on fundamental events that capture an economy’s price and productive competitiveness. For example, should medium-term capital inflows strengthen, such as foreign direct investment, or technical progress rise, or the fiscal stance strengthen markedly, or significant structural reforms be implemented, the equilibrium real exchange rate would tend to appreciate, suggesting that its fair value would lie below the present level. However, if structural conditions change only slowly, there is a greater chance that the equilibrium real exchange rate is close to a measure of fair value based on price competitiveness. In our view, this is what has happened in Latin America over the past four years – except perhaps for Brazil, where progress on fiscal performance and reforms has been much better than expected a few years ago. Accordingly, a measure of FX fair value would err in understating the level of overvaluation or overstating the extent of undervaluation if reforms advanced or economic policies strengthened. However, FX overvaluation might be understated if such progress was made, suggesting that the equilibrium FX may be stronger in Brazil than actually estimated to be.

Measuring the Stance of Monetary Conditions

The monetary measure constructed provides broad guidance as to the behavior of monetary conditions and, in that sense, how they evolve over time appears more relevant than a measure of how loose or tight monetary conditions are to start with. The Monetary Conditions (MC) measure introduced helps to draw more definite implications.
First, a measure of monetary conditions is estimated through a weighted average between the actual levels and changes in the actual real interest and exchange rates. The measure provides definite guidance as to whether the monetary stance is becoming tighter or looser. It captures the concept of broad monetary neutrality discussed above and, more importantly, is more sensitive to short-term changes, or “blips,” in the monetary stance. We used a weighted average of the change in the real interest rate and the change in the real measure of exchange rate over- or under-valuation to gauge the direction of change in the monetary stance, regardless of how many times and how much the Central Bank has tightened monetary conditions. This gives a sense of how effective the monetary authority has been in tightening or loosening monetary conditions. This measure does not have an explicit view on when monetary conditions were “fair,” or broadly neutral, to start with and, in that sense, may provide better guidance.

We thus relied on the change or direction of monetary conditions, as measured by the expected real interest rate and a productivity-adjusted measure of real exchange rate over- or undervaluation. This measure hinges on the base, fair value period. The reference period for the fair foreign exchange rate is that period during which the current account was roughly balanced and monetary conditions helped achieve an inflation rate that might be thought to be compatible with the country’s structural growth capacity and, therefore, with a balanced measure of price competitiveness. The required currency depreciation corresponds to fair value changes implied by the relative price changes between the US and the specific Latin country based on the initial fair value of the currency. If the country’s inflation rate remains well above US inflation, a weaker currency will be required, while if it is below the level in the US, the fair value of the currency will be stronger than its reference value. This measure of over- or undervaluation is then adjusted by the average annual productivity differential between the US and the reference countries. In this setting, our MC directional component measures a productivity-adjusted monetary stance based on an equal-weighted average of the change in the real interest rate and the real over- or undervaluation of the exchange rate.

Brazil’s Tight Monetary Stance

In a world with still ample liquidity and fairly accommodative monetary policies, Brazil’s monetary policy has been especially prudent and willing to err on the side of caution. In fact, the bias of the monetary stance has been decisively toward tight monetary conditions. In this setting, a measure of monetary conditions based on the direction of monetary policy, as suggested by a weighted average of the change in the real interest rate and the real exchange rate, shows that the monetary stance was, on balanced, fairly loose in Brazil from 2001 through the first half of 2003, thus accounting for the marked rebound in inflation from the fourth quarter of 2002 through the first half of 2003 (Figure 1). In fact, our measure of the direction of monetary conditions shows that until the second half of 2003, the bias in monetary policy was to actually loosen conditions rather sharply from 2001 through the first half of 2003. This does not mean that monetary policy was not being tightened, but that its impact did not become restrictive enough until the second half of 2003. In our view, this partly reflects the fact that monetary policy was tightened somewhat late in 2002 amid sharp BRL pressures starting in the second half of 2002.

Monetary conditions became very tight from the second half of 2003 through the
end of the first half of 2004. Indeed, the recent spike on inflation can be explained by the loosening of monetary conditions at the end of second quarter of 2004, while the sharp drop in inflation during 2003 reflects the marked tightening of the monetary stance beginning in the second quarter of 2003. After being close to broadly neutral into the summer, monetary conditions are now fairly restrictive (Figure 2). In fact, the monetary stance today, in our view, may be tighter than our measure of the stance of monetary conditions might suggest because of the recent gains in productivity in Brazil as investment has strengthened during the second half of 2004.

Figure 1: Brazil – The Stance of Monetary Conditions (MC) vs. Inflation

Source: Banco Central do Brasil, Brazilian Foundation Institute of Geographic and Statistic, Barclays Capital.

Computing a measure of the stance of monetary conditions based on a weighted average of productivity-adjusted percentage deviations in the actual value of the BRL versus its fair value and changes in the real interest rate would bring together two key concepts of the underlying strength of monetary conditions. The key finding here is that monetary conditions in Brazil have been tight and are now much tighter than a simple measure of monetary conditions might suggest (Figure 2).
Figure 2: Brazil – The Stance of Monetary Conditions (MC)


The Fair BRL Real

Our measure of BRL exchange rate over- or undervaluation adjusted by average Brazilian productivity gains or losses vis-à-vis the US during the year underscores the impact of relative prices moves and productivity trends on the country's export competitiveness. A close inspection of Brazil's balance of payments suggests that the level of the BRL was near equilibrium at BRL 2.09 in March 2001, as a sharp devaluation brought an otherwise important current account deficit into balance. The bias of this measure, if any, would be in understating the current level of BRL undervaluation, as an earlier, lower fair BRL value would be tied to an even stronger fair value for the BRL currently, suggesting an even stronger undervaluation than otherwise measured.

Also, a productivity gain differential in favor of Brazil over the US would suggest that the "standard" measure of real exchange rate over- or undervaluation would be overstating the actual extent of overvaluation or understating the extent of undervaluation.

Our measure of BRL over- or undervaluation adjusted for productivity differentials between Brazil and the US suggests that the BRL was overvalued by as much as 6% in early 2001. The BRL then depreciated markedly in 2002, and as it fell

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1 US and Brazilian productivity gains indices are based on standard production per worked-hours in manufacturing data from the Bureau of Labor Statistics and the National Industrial Confederation, respectively.
2 After a 40% depreciation through September 2001, it would be especially difficult to argue that the BRL was still overvalued.
dramatically through October, the competitive position of the BRL switched to a large, 26% undervalued position by November 2002 on a productivity-adjusted basis (Figure 3). During 2002 and 2003, however, US productivity gains sharply surpassed Brazilian gains – by an average of 6.4% in 2002 and 4.9% in 2003. In 2001 and thus far in 2004, the average productivity differential between the US and Brazil is essentially zero, with Brazil experiencing sharp gains that surpassed those of the US in recent months, as Brazilian domestic investment has strengthened. As a result of this development and a sharp monetary tightening that led to high real interest rates, BRL undervaluation rose dramatically to a high of about 30% during the third quarter of 2003. After that, BRL undervaluation has fallen, and now it is close to its fair value with a 1.4% overvaluation over the March level of 2.55.

**Figure 3: Brazil – BRL Over- Undervaluation: Productivity Unadjusted vs. Productivity Adjusted**

The highest levels of BRL undervaluation occurred during the fourth quarter of 2002, a year in which the BRL devalued markedly; late 2001; and early 2004, when real interest rates rose to a high of 10.5% and the BRL was over 12% undervalued (Figure 4). This suggests that the period of tightest monetary conditions was the second half of 2003. Monetary conditions, however, are now tightening markedly after a brief period of modest loosening during the second quarter of 2004. What is critical is that Brazilian monetary conditions have been consistently tight and that rebounds in inflation have been associated with either political shocks (as in 2002) or global credit shocks (as in April of 2004 when the US Federal Reserve was believed to be on the verge of tightening monetary conditions markedly).
Figure 4: Brazil – Real Interest Rate vs. Productivity-Adjusted Real BRL Over-/Under-Valuation


The average fair value for the last six months is about 2.62 BRL per dollar and 2.58 BRL per dollar in March 2005, suggesting that the BRL is about 1.4% overvalued (Figure 5). This does not mean, of course, that the BRL will necessarily weaken to BRL 2.58 or so, but that it could slightly depreciate below BRL 2.58 without necessarily affecting Brazil’s export performance.

The fair value of the BRL has shifted from BRL 2.18 in late 2001, when the BRL was trading at BRL 2.54, to BRL 2.42 in July of 2002, and to a low of BRL 2.57 early this year when the BRL was actually at 2.85 per dollar. Not surprisingly, the competitive bias on the BRL (in addition to Brazil’s investment recovery and stronger global growth) helps explain why Brazilian exports have remained so competitive in the last two years (Figure 5).
Figure 5: Brazil’s BRL Actual vs. Fair Value (Productivity Adjusted)


The BRL and Interest Rates in 2005

In a setting where growth remains well supported, investment is recovering, the BRL is close to its fair value, and the balance of payments performance is exemplary, the BRL is likely to strengthen somewhat if inflation continues to decline. Indeed, recent moves to tighten monetary conditions are proving effective in bringing inflation down more rapidly than envisaged by financial markets, despite recent hikes in utility prices. Although the BRL is likely to be under further strong upward pressure and likely to strengthen, our concern is that the monetary authorities appear to have signaled concern over export growth when, of course, their exclusive goal is to bring inflation down, and soon, given that the high real interest rates are limiting further improvements in Brazil’s debt dynamics. The fairly hawkish bias of the Central Bank of Brazil has tried to ensure that the BRL remains stable to continue to rein in inflation. However, the immediate pass-through of the BRL to inflation, as seen both in 2002-03 and during the second half of 2004, in our view, should only increase the resolution of the Central Bank to ensure a somewhat stronger BRL, as long as the currency remains competitive – as it is today. In this sense, intervention to draw a line to avoid a massive appreciation (well below BRL 2.62 or so) might make sense to ensure that Brazilian exports remain competitive in the face of a possible slowdown of global economic activity. Unlike Mexico today, the pass-through of the BRL to inflation is significant, suggesting that some BRL strength ahead of a possible global slowdown and likely future downward pressures on the BRL, the Central Bank appears keen to lower inflation and eventually the high interest rates.
Because a hawkish stance implies high real interest rates, Brazilian fiscal policy will become increasingly instrumental in allowing for gradual declines in real interest rates, as Brazil’s primary fiscal surplus (possibly above the targeted 4.5% of GDP in 2004) delivers strong savings that should continue to ease pressures on real interest rates. Recent BRL intervention may also underscore a renewed focus on further rebuilding international reserves, especially ahead of the expiration of the present IMF program in March 2005. Finally, both a strong fiscal anchor and declining inflation will continue to help bring real interest rates lower, while a continued shift from dollar- to BRL-denominated debt will continue to ease financial vulnerabilities stemming from a high, yet declining stock of domestic debt, which stands at about 45% of GDP. While the composition of Brazilian domestic debt has shifted from dollar-linked to Selic-debt primarily, the effective improvement in its composition appears more limited since interest rates and the exchange rate tend to move markedly during periods of credit pressures. In fact, short of eliminating indexation, which would be a desirable policy action, indexation to inflation would prove much more effective in easing the vulnerability of Brazilian debt to credit shocks that weaken the BRL and lead to higher interest rates. Inflation indexation would result in more limited net increases in financing requirements because both nominal payments and tax revenues would be rising, limiting their real cost.

**Mexico’s Monetary Stance and 2005 Inflation**

Besides US Fed policy, Mexico’s disinflation story from 2000 through mid-2003 reflects the steady decline in services inflation and, therefore, in wage growth (as real wages represent the implicit relative price of services). Indeed, the remarkable correlation between wage growth, and services inflation shows that after disinvestment began in 2000, Mexico’s disinflation has had as much influence on the steady decline in wages as has the accommodative monetary stance pursued by the US Federal Reserve (Figure 6). Mexico’s marked disinvestment followed the end of the US high tech bubble of 2000, and, hence, the onset of the US slowdown, which helped to keep growth in Mexican domestic investment at sub-par levels through end-2003. This reduced the demand for labor at a time when labor supply continued to grow steadily, thus exacerbating downward pressure on real wages. Real wages declined by about 1% recently, after growing by over 4% in 2001. The “excess” investment of the 1990s, however, led businesses to focus on strengthening productivity growth, an objective that finally is being met and has contributed to the marked decline in unit labor costs. Mexico’s remarkable decline in inflation through the end of 2003 also helped to reduce inflation expectations, and wages. However, with inflation expectations rising, wages are unlikely to fall much further and could even begin moving higher for the first time since disinflation began, albeit this is still unlikely.
Merchandise inflation, on the other hand, has been rising steadily since early 2003, recently surpassing services inflation (albeit only slightly) for the first time. Still, most of the rise has been offset by the continued decline in services inflation and wage growth. Although food has been a more important driver of core inflation, merchandise also has been relevant, especially after the summer, suggesting that vigorous consumer spending in the face of capacity constraints may indeed be impacting inflation performance more than realized.¹

Our MC analysis shows that Mexico’s monetary stance tightened modestly in the first quarter of 2004 to then loosen somewhat in the second quarter. The prior period of monetary loosening began in the second quarter of 2002, after a period of easing in 2001. The bias toward a tightening monetary stance, but erring on the side of somewhat loose monetary conditions, after mid-2002 is, of course, consistent with the sharp global monetary easing that took place during this period. The stance of monetary conditions tightened after the summer of 2004 to reach a broadly neutral position during the fourth quarter of the year and a tight stance more recently (Figure 7).

A gradual monetary tightening through most of this period, except in the second quarter of 2004, kept inflation rising, forcing a move toward an even tighter monetary stance in December and, early this year. Shifting to a tight monetary stance, as seen in early 2002, however, required assuming that the productivity-adjusted real exchange rate remains stable. The key point is that the modest monetary tightening until recently likely began from a loose monetary stance, which is why Mexico’s monetary tightening probably

¹ The leading contributor to inflationary pressures, in our view, is rising inflation expectations, followed by stronger-than-envisaged consumer spending. MXN depreciation has a markedly more limited pass-through than it had in the past. However, rising inflation does exert meaningful pressures on the peso, albeit its value likely will continue to be dominated by rising interest rates.
will continue during 2005. In our view, shifting to an effective, tight monetary stance will require one more 25 bp rise in the overnight interest rate. In light of major operational drawbacks of Banxico’s monetary tool: the corto, or targeted borrowed reserves framework, the most powerful way of changing the financial markets’ inflation expectations involves the intra-meeting announcements, which can lead to sharp, front-loaded moves in interest rates, as seen in April. Because even these actions are subject to the interpretation and reaction of the leading commercial banks in Mexico, Banco de Mexico will have to switch to a reference rate system earlier than envisaged. The reason is that sometimes when the Central Bank sends a strong monetary signal, local banks shrug off the hike in the overnight rate, rather than swiftly raising rates as the signal suggests. This problem likely will become more acute when inflation starts to turn around and the long end of the MXN yield curve rallies, putting downward pressure on the short-end of the yield curve, even if Banco de Mexico wants to keep those rates still high because is not yet easing.

Figure 7: Mexico – Stance of Monetary Conditions (MC) vs. Inflation


Finally, our measure of the monetary stance based on a benchmark fair value level of the MXN (as well as variations in the MXN’s fair value based on relative movements in US and Mexican prices and productivity compared with the actual level of the MXN) suggests that monetary conditions were fairly loose from 2000 through mid-2004 and then began tightening modestly in the second half of 2004 (Figure 8). The fairly easy stance of monetary conditions is consistent with the steady decline in the fed funds rate and, hence, the US monetary policy. A key driver of the result, of course, is the large difference in productivity gains in favor of the US relative to Mexico from 2000 through the first half of 2004. With the return of domestic investment, productivity began...
growing more rapidly in Mexico than in the US in the past few months. This measure shows that the monetary stance has tightened after correcting for productivity differentials. However, the amount of monetary tightening appears more robust now at nearly 4%.

**Figure 8: Mexico – A Tight Stance of Monetary Conditions (MC)**


**The Fair Value MXN**

In the setting of recently tighter monetary conditions, Figure 9 shows that the productivity-adjusted fair value of the peso implied by the productivity-adjusted monetary stance is about MXN 11.03 today, suggesting that the MXN is slightly undervalued. Not surprisingly, the MXN is now undervalued and its sharp 16% overvaluation peak reached in the first quarter of 2002 is now gone (Figure 9).
Whether monetary conditions were initially too tight or too loose can also be inferred from the actual levels of potential over- or undervaluation of the MXN, and especially the level of expected real interest rates (Figure 10). If real interest rates begin from an unusually low level, they may have to rise more strongly than if they began from a higher level, and, therefore, from a much tighter monetary stance.

Unlike during the 2001-02 periods, real interest rates were low when Banxico's monetary tightening began in early 2004 (Figure 10). After rising markedly in the second quarter of 2004 from an unusually low 1%-handle, real interest rates stayed at around 2% until recently when they have moved to about 3%. Indeed, Mexico's monetary challenge may be as straightforward as the simple fact that real interest rates fell to about 1% starting in the second half of 2003 and, except for brief periods, have not moved to higher, more sustainable levels.

Although nominal interest rates have been moving higher, they have been doing so only gradually, thus limiting the extent of the actual monetary tightening that helps to abate inflationary pressures. In the past, during periods of sharp hikes in nominal interest rates, real interest rates moved higher and inflation came down quickly. For example, during the last quarter of 2000, nominal Cetes rates reached a 17.9% peak and inflation quickly declined from about 9.5% to 7.5% by the end of the first quarter of 2002. Of course, this does not mean that real interest rates again have to rise to 10% to rein in inflation, but it does mean that discrete, front-loaded hikes in interest rates go a long way toward easing inflationary pressures. Gradual moves, however, risk lagging behind inflation and, therefore, eventually ending at a much higher nominal level than a front-loaded move would have required. Indeed, times of gradual moves usually led to climbing inflation and declining real interest rates that eventually exacerbated both inflation pressures and interest rate hikes.
To curb inflationary pressures, Banco de Mexico has taken a hawkish stance that is now leading financial markets to make discrete interest rates hikes to ensure that real interest rates are high enough to bring down inflation more rapidly. While Banco de Mexico is firmly committed to pro-actively leading financial markets to tighter monetary conditions, its monetary policy instrument, the *corto*, has hindered Banxico's ability to pursue the kind of sharp, front-loaded tightening campaign that could have contained inflation sooner. Instead, to enhance the *corto*’s efficacy, Banco de Mexico has relied on unanticipated *corto* moves that result in a higher overnight interest rate.

The Mexican experience shows that the critical issue over interest rates is not how high they get, but how long they stay there. Banco de Mexico, in our view, is now effectively leading financial markets to interest rate hikes that are likely to break inflation expectations and, indeed, swiftly contain inflationary pressures. With core inflation at 4.2%, sharper, hawkish, unanticipated monetary tightening is now acting to strengthen inflation performance.

In October 2004, Banco de Mexico raised the *corto* for the ninth time in 2004 to 69 MDP from 63 MDP in an unanticipated move to break inflation expectations. The hike underscores a more hawkish monetary stance that should succeed in breaking inflation expectations. Early this year, Banxico raised the *corto* by 6 MDP to reach 75 MDP, and then on February, the *corto* was raised to 77 MDP. On March 11, 2005, Banxico left the *corto* at its previous level of 77 MDP.

As inflation expectations improve, Mexico’s local yield curve should flatten. The MXN, which now looks somewhat undervalued, should gain strong support.
especially as further monetary tightening takes place in a bearish (albeit still expansive) US dollar global environment. Inflation should be peaking in the near term, despite some utility price hikes during January and February. As a result, rising short-term interest rates, declining inflation and a declining USD (on a trend basis) should provide sharp support to the MXN.

**Chile’s Sharp Monetary Conditions**

Chile’s monetary stance began 2004 from one of the tightest positions in Latin America, resulting in further support for the CLP by the end of 2003 and early 2004 (Figure 11). High copper prices and euro appreciation have also contributed to keep the CLP relatively strong in 2004. In general, the CLP performed strongly on the back of a sharply improved global backdrop, especially for copper prices.

Monetary conditions eased rapidly after the first quarter of 2004, as monetary easing led to a drop in real interest rates from just over 2.5% to slightly negative recently. In this setting, Chilean inflation fell quickly from a high of about 4.5% in early 2003 to almost 1% price deflation a year later, prompting the Central Bank to ease monetary conditions sharply. Accordingly, the Chilean stance of monetary conditions eased quite dramatically starting late in the first quarter of 2004 and thereafter. The dramatic monetary easing that followed helped reduced our MC measure from over 14% to a low of 1% and, thus, not far from a balanced stance in December 2004. In the meantime, monetary easing has resulted in a steady rise in inflation to about 2.3% recently.

**Figure 11: Chile – Stance of Monetary Conditions (MC) vs. Inflation**

![Figure 11: Chile – Stance of Monetary Conditions (MC) vs. Inflation](image)

Source: Banco Central de Chile, Barclays Capital.

A fair value measure of the exchange rate-adjusted MC suggests that Chilean
monetary conditions have been consistently tight since the second half of 2003. There are two periods in which monetary conditions could be thought of as loose: in 2001 and early in 2003. Still, the level of easing is fairly small at a MC of about 2% in early 2005, compared with over 10% in early 2000 (Figure 12). As a result, inflation may continue to rise somewhat, but should start leveling off as the Central Bank tightens monetary conditions by another 150 bp. This would place Chilean real interest rates near 1.25% or so in 2005, thus helping to keep inflation stable near 2.75% in 2005.

**Figure 12: Chile – The Stance of Monetary Conditions (MC)**

\[\text{MC} = \text{Weighted Avg of Level and Direction of Monetary Conditions}\]

Source: Banco Central de Chile, Barclays Capital.

**The Fair Value Peso**

The fair CLP-adjusted MC suggests that the peso’s fair value is CLP 612.64, suggesting that the currency is modestly overvalued. However, the present extent of overvaluation likely will help the Central Bank contain inflationary pressures more effectively in the near term. Further, should copper prices move to a structurally higher equilibrium level than in the past owing to supply constraints, the Chilean peso may indeed be close to its fair value.
The CLP and Interest Rates in 2005

In 2005, the Chilean Central Bank will likely raise interest rates gradually to contain inflationary pressures. In our view, interest rates could rise by another 150 bp as the Central Bank gradually tightens monetary policy, following US monetary tightening to some extent. Should the Fed raise its reference rate to 4.0%, the Chilean Central Bank may raise interest rates to a level near the fed funds rate or just lower for a flat, or perhaps small interest rate differential in favor of the United States. This would lead to a slight CLP depreciation in 2005 as the interest rate differential moves somewhat in favor of the US or, at best, a level that slightly favor Chilean financial assets. More importantly, copper prices may weaken somewhat after their stellar 2004 performance as global demands slow somewhat in 2005. In this setting, after initially strengthening on euro strength and still-high copper prices, the CLP should weaken gradually in 2005 to close the year at 610. Because real interest are slightly negative and the CLP is slightly overvalued, accommodative monetary conditions should be turning more restrictive in 2005, limiting the decline in the CLP as copper prices began falling and interest rate differentials start moving closer to US interest rates. In this sense, Chile’s monetary policy is the only one in Latin America that truly resembles the Fed’s stance and for which monetary pressures have been building more closely in line with those in the US, after starting from deflation in early 2004.
Colombia’s Restrictive Monetary Conditions

Colombia’s present monetary stance is the tightest today (on a currency unadjusted basis) among all major Latin countries. This explains why the Colombian peso continues to be under such strong upward pressure (Figure 15). In fact, Colombia’s MC has adopted the most consistently tight monetary stance in Latin America this year, with only a brief decline in the MC 10.1% handle during the second quarter. As a result of the remarkably tight monetary policy, inflation resumed a clear downward trend beginning in the second half of 2004.
A fair value COP-adjusted MC suggests that monetary conditions have been almost as tight as implied by a simple MC, but since the second half of 2002 the Central Bank has eased markedly only in the second half of 2004, albeit still within a tight monetary stance (Figure 16). This suggests that the COP may still be under some near-term upward pressures, but it may start declining in early 2005 from recent highs and, perhaps, an even more appreciated level at the start of 2005. Banco de la Republica has received little credit for Colombia’s financial success in 2005. In fact, however, its astute monetary management has been the leading driver of Colombia’s improved sovereign stance in 2004. In 2005, monetary conditions may start easing somewhat more rapidly if there is continued upward pressure on the COP during 2005.
The remarkable, persistent strength of the Colombian Peso can be inferred from our FX fair value exercise. Our COP fair value calculation suggests that the peso got to be as much as 21% undervalued during the first quarter of 2003. Since then, COP undervaluation has declined steadily to start showing overvaluation since December of 2004. As a result, inflation is going down somewhat more rapidly, and the Central Bank is reaching a more stable COP to handle. It is clear, though, that part of the continued strength of the COP, well beyond that of other LatAm currencies can be explained by the fact that it began from a much more undervalued level that other undervalued regional currencies, notably the BRL. Indeed, Colombia’s unique combination of the tightest monetary stance in Latin America today together with the most undervalued currency to start with helps account for the persistent remarkable strength of the COP. In 2005, COP pressures are likely to build gradually as monetary conditions loosen and the COP strengthens to a modestly overvalued level in early 2005. In fact, because Banco de la Republica has been building reserves to limit the peso’s strength and yet the currency continues to appreciate, it may have to start easing monetary conditions more rapidly in early 2005 to avoid a sharp deterioration in the trade balance and, especially, export growth, as the global economy slows somewhat and commodity prices begin declining.
The COP and Interest Rates in 2005

In order to bring inflation down, the monetary authorities will be prepared to endure some further appreciation of the Colombian peso vis-à-vis the US dollar in early 2005, but the ensuing sharp deterioration in trade trends will lead to a depreciating COP, perhaps during the second half of 2005. The COP appreciation will help bring inflation down more rapidly into the first half of 2005, when inflation should fall to about 5.3%. As the current account deficit grows, late in the first half of the year and especially during the second half, the COP will start depreciating more rapidly, especially as the US economy slows down. The COP is therefore likely to appreciate early in the year to about COP 2,350, start depreciating gradually during the second quarter and then more rapidly during the second half to close the year at around COP 2,575, for an annual average of COP 2,495 in 2005, compared with COP 2,631.3 in 2004.

As the COP continues to strengthen, inflation will start falling somewhat more rapidly, thus potentially allowing the Banco de la Republica to cut interest rates in early 2005. It is clear that the Central Bank’s preferred policy for dealing with COP peso strength has been to build reserves. However, reserve accumulation, though dramatically improved in 2004, has failed to ease the strong upward pressures on the COP. As a result, Banco de la Republica may find itself cutting interest rates next year – despite the US tightening cycle. While real interest rates are low, they are close to the 2% handle they’ve been at for the past year, suggesting that the Central Bank may still have some room to cut interest rates as the euro strengthens, workers’ remittances remain strong, and the COP continues to strengthen.
Conclusions

We introduced a simple measure of the stance of monetary conditions that incorporates a directional component that measures the impact of the change of monetary conditions to help gauge them more accurately, regardless of the initial stance. The directional component of MC relies on a fair value concept of the real exchange rate that helps track the impact of a country’s competitiveness on the stance of monetary conditions. The concept is then introduced in our MC measure of the stance of monetary conditions that relies on both the actual level and the change in monetary conditions to gauge how tight or loose monetary policy might be at any given time.

We gauged the stance of monetary conditions in Brazil, Mexico, Chile and Colombia to conclude that monetary conditions are especially tight in Latin America and that, for the first time in modern history, foreign exchange rates entered a US monetary tightening cycle being undervalued. During 2000-03, Brazil, Chile and Colombia had markedly undervalued currencies that helped strengthen the country’s competitiveness. During that period, however, the Mexican peso was markedly overvalued. Today, the Brazilian Real and the Mexican peso are close to their fair values, while the Chilean and Colombian pesos are slightly overvalued, in our view. Still, the sharp stance of monetary conditions will likely allow Latin America to ensure stable financial conditions, unlike most of its crisis-prone past.