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Reducing inflation: Asserting the role of the "right hemisphere"

The state of the art in monetary policy

Today, my main objective is to present the ongoing upgrade of our monetary policy framework in Uruguay. However, before diving into the details, it is essential to place this process within a broader global and historical context to better understand how the design and execution of monetary policy has evolved over time.

Modern monetary policy has undergone a profound transformation. Over recent decades, inflation-targeting regimes have become the dominant framework, now adopted by more than 50 middle- and high-income countries.

These regimes have delivered lasting gains in price stability, departing from the previous era when inflation control in emerging markets relied on exchange-rate management. This new policy technology was broadly successful in resolving the crisis-prone nature of emerging markets — Uruguay included — from the 1980s through the early 2000s.

A key pillar of inflation targeting is the short-term interest rate as its core instrument. It relies on a framework of mathematical models and rigorous processing of vast economic data, which feed into projections that guide policy decisions. In other words, it rests on traditional, orthodox economic science. The interest rate is the main gear in the monetary transmission mechanism, displacing the exchange rate's role.

But inflation-targeting regimes also rely on the tools and the art of persuasion — which are anchored in trust and credibility.

These two pillars of monetary policy can be seen as reflecting the two hemispheres of the brain: one analytical and technical, the other communicative and relational.

The left hemisphere of the brain: rationality, logic, and structure

The interest rate is a direct, cold, but effective tool. It does not persuade — it impacts. Its determination is based on macroeconomic models that simulate and structure an extremely complex system with dozens of interconnected variables.

When these models indicate a rate hike is needed to control inflation, what we observe is only the tip of the iceberg: a visible decision emerging from sophisticated technical machinery. It's meant to act as a brake: slowing credit, cooling consumption, and curbing investment. It is a tool that demands technical rigor and, often, difficult yet necessary decisions.

The right hemisphere of the brain: creativity and emotion to enhance credibility and align expectations

How is credibility built and maintained? The literature shows a key ingredient is that the central bank leadership must have technical soundness and independence from political power in order to remain focused on the institution's core objective. This unstinting pursuit has been a defining trait of successful inflation-targeting regimes worldwide since their inception. Central banks must also show determination in action and build a strong track record.

But there's another essential factor — one long neglected globally: for someone or some institution to be believed, they must first be seen. And when seen or heard, people must understand what the monetary authority is doing and why. In short, the institution must be visible, active, and understandable to trigger the desired coordination. Academic evidence shows that when information fails to reach its target audience, market participants tend to ignore relevant events and form expectations without properly incorporating new data.

Central banks leverage this pillar to act like orchestra conductors. Even without playing an instrument, they fulfill their mission by helping many agents — consumers, businesses, investors, and the financial system — fine-tune their decisions to a shared melody: stability.

Initially, this new pillar of monetary policy's impact may seem, at least to the left-brain mind, too ethereal or unserious. But over the past 20 years, a substantial body of academic, empirical, and theoretical literature has emerged — the most dynamic and innovative area of the discipline — that establishes communication as a key monetary policy instrument. The staff of the Central Bank of Uruguay has made important contributions to this field.[1] This shift is part of a broader evolution in economics, which has incorporated advances in psychology to better understand economic behavior — reflected in Nobel Prizes awarded to Kahneman, Shiller, and Thaler, among others.

The key finding: what the central bank says, when and how it says it, directly affects expectations of inflation and future rates. Michael Woodford crystallized this vision. In his work — especially *Interest and Prices* (2003) — he placed the central bank at the heart of modern analysis: not only as a rate-setter but as an expectations coordinator. In his approach, monetary policy transmits signals through several channels: its track record vis a vis its commitments, who is in charge, what is communicated, what is anticipated, and what is believed will be done.

A growing body of evidence underscores the powerful role of this channel. It highlights the value of building credibility through consistent actions, fostering direct engagement with the public, and producing speeches, presentations, and materials that are more accessible. It also emphasizes the importance of informing, educating, and telling a compelling story[2] — through communication that is clear, simple, readable, and well-founded.[3] Transparency, particularly regarding the inputs behind policy decisions, is essential to enhance public understanding of the central bank's strategy, objectives, and actions—helping ultimately to align expectations with policy goals and commitments.

This approach encompasses a range of operational elements now considered fundamental. A simple example illustrates this: research on visual and textual communication shows that how the inflation target is visually presented can have tangible effects on firms' planning and price-setting.[4]

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[1] See, for example, the BCU working papers published on the Economic Studies Portal and Weber et al. (2025), "Tell Me Something I Don't Already Know: Learning in Low- and High-Inflation Settings." Econometrica, 93(1).

[2] See "Narrative Economics" by Nobel Prize-winning economist Robert Shiller. w23075.pdf

[3] See Evdokimova, T. et al. (2023), "Central Banks and Policy Communication: How Emerging Markets Have Outperformed the Fed and ECB," Peterson Institute for International Economics Working Paper.

[4] Mello, M., Ponce, J., and Arnabal, R. (2025), "Visual vs. Textual Communication: Impact on Firms' Inflation Expectations and Central Bank Credibility." BCU Working Paper.

Inflation expectations ultimately have a real and measurable impact on observed inflation.[5] Evidence shows that building a robust expectations-coordination infrastructure and a strong track record enables more countercyclical and less costly monetary policy. For example, in 2022, developed countries faced an inflation surge comparable to that of the late 1970s, yet managed it with less than half the interest rate hikes and unemployment increase — resulting in a lower "sacrifice ratio." This innovation did not go unnoticed by the global policy community.

Contrasting with Alan Greenspan's enigmatic era or the motto "never excuse, never explain,"[6] Janet Yellen noted that the new approach to communication represented a "revolution" in 2012.

In 2019, Jerome Powell told Congress that expectations were the most important factor in lowering inflation. Ben Bernanke went even further: monetary policy, he said, is 98% talk and 2% action.

The expectations channel operates across multiple dimensions. One is influencing future interest rates, thereby affecting the entire yield curve—not just the policy rate. Another, which is essential in Uruguay and in any regime undergoing consolidation, is building credibility. Price-setting is ultimately a tangible expression of a belief about the future: How will my costs evolve? What will my competitors do? What policies should I expect?

The last mile: communicating to build trust

Inflation in Uruguay has fallen in recent months and is now virtually at the 4.5% target. Central Bank projections in the baseline scenario suggest it will remain around the target in the monetary policy horizon of 24 months. As always, projections are subject to uncertainty. However, in a break from the past — with a current account deficit near 1% and historically high reserves — the risk of sharp currency adjustments undermining inflation gains is limited.

The credibility gap — the difference between analysts' inflation expectations and the central bank's target — has narrowed to one-third in just three months. It has reached historic lows at an unprecedented pace. Business expectations have also fallen (though they usually lag).

As a result, yields on Uruguayan sovereign bonds have dropped to record lows.

Moreover, Uruguay's public conversation around inflation is changing — and becoming more visible. Business leaders now refer to price stability as a national policy. References to interest rates are growing, while focus on the exchange rate — no longer a control variable — is taking a back seat.

Uruguay is entering a new reality — one we are building together. An ideal scenario the country hasn't experienced in over 80 years.

The key to this recent rapid progress — the "last mile" in consolidating the monetary regime — has been harnessing the "right hemisphere" of monetary policy. This was especially important given that Uruguay's inflation exceeded international averages, and its roots are also cultural and somewhat unconventional.

[5] That expectations directly influence inflation is a well-established result in the academic literature for decades. This link was first established by the pioneering work of Milton Friedman and Edmund Phelps on the augmented Phillips Curve. Both demonstrated that inflation dynamics cannot be understood without considering what economic agents believe will happen in the future. However, for a long time, economic literature treated expectation formation as an exogenous phenomenon—beyond the direct reach of policymakers. The central bank was seen as a reactive actor, not one that shaped or led.

[6] Motto associated with some central bankers in the past, particularly Montagu Norman, Governor of the Bank of England from 1920 to 1944. This attitude reflected a belief that transparency and public communication were not essential for effective monetary policy and might even be detrimental.

In Uruguay, higher-than-peer inflation has not been driven by a classical monetarist dynamic — there is no fiscal deficit financing — nor by an overheated economy, as the output gap is essentially closed. Inflation has behaved more like a social convention — or, in technical terms, an inefficient coordination equilibrium — where a lack of confidence in meeting the Central Bank target fuels behaviors that perpetuate high price growth.

In this context, it is useful to think in terms of a credibility deficit. Breaking out of this suboptimal[7] equilibrium requires monetary policy to coordinate expectations and effectively reach key audiences, including price setters. As the literature suggests[8], transitioning between equilibria requires a disruptive approach.

A necessary breakthrough in building credibility

Shifting an expectations regime and moving into a new coordination equilibrium entails a profound strategic transformation. This involves several key dimensions.

Starting with this administration, the selection criteria for the Board has now changed toward a technical profile, and there's full commitment across all levels to the inflation-targeting regime — eliminating "tail risks" of political interference in monetary policy parameters. The Board now acts independently, free of private or public pressure. In stark contrast with the past — or with current experiences in some countries — Uruguay's President and Minister of Economy have explicitly embraced the idea of inflation reduction as a state policy and supported a technically-driven central bank, where bringing inflation down is the overriding objective. Moreover, and equally important, technical teams at the Ministry of Economy and the Central Bank are now tightly coordinated so that wage-negotiation guidelines and the five-year fiscal budget are anchored to the inflation target.

There has also been a complete transformation in visibility and communications strategy: MPC (COPOM) decisions are now explained openly to the press; there is a higher frequency of speeches (which are being published); and more direct spaces for dialogue with the public (such as this very one!).

The content creation approach has also changed, with more focus on narrative: clear decisions, transparent reasoning, legibility, and strategy across statements, minutes, and reports. There is a stronger emphasis on visuals and on explaining *why* reducing inflation matters and the benefits it entails over the short and medium term.

Communications products have been diversified: styles and language are being adapted to different audiences, across both Spanish and English platforms. New, less technical formats go beyond financial markets lingo and speak to broader publics. I encourage you to subscribe to our newsletter and share it with those around you.

And more changes are on the way.

The narrative around what a country achieves when inflation is low and stable is not just theoretical, or something from an economics textbook. It is also an intangible, social idea — a construct of trust and credibility as tools of monetary policy.

Uruguay is now managing to harmonize both hemispheres — the logical and emotional ones — and moving swiftly through the final stretch toward a mature inflation-targeting regime. This will allow us to reap the dividends of credibly low and stable inflation — and build trust towards a new phase for our economy: boosting growth and improving income distribution.

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[7] For example, Arnabal, L. R. & García-Cicco, J. (2024). Central Bank of Uruguay Working Paper. The authors argue in favor of an optimal inflation rate of 3.5%.

[8] Heymann and Leijonhufvud (1995)

Trust as a transmission amplifier

For a long time, it has been said that the interest rate has "little traction" in Uruguay — and that, as such, it won't achieve its goal, rendering communication efforts futile. That criticism doesn't hold up.

First, the facts show that both recent rate-hiking cycles were followed by drops in inflation. Second, even if the interest rate channel is weaker, that does not mean the communication channel doesn't work. Modern literature — which places psychology at the heart of traditionally "hard" economic science — confirms this. I experienced it firsthand in Armenia, where transmission channels were even weaker, and yet the results were strong.

In principle, it is possible to shift from an inefficient coordination equilibrium to a better one without the negative side effects that are inevitable when monetary policy is used to cool an overheating economy. Economists describe this situation as one of multiple coordination equilibria — and the task is to steer expectations towards the better equilibrium.

In fact, when the monetary policy transmission channel is weak, the expectations channel becomes even more crucial. In economies with low domestic currency financial intermediation such as Uruguay, decisions are not transmitted only via interest rates, but through signals, perceptions, and narratives. Shaping expectations and correcting biases multiplies monetary policy's impact — especially where the classic tool is only gradually gaining ground.

The experience of other emerging markets shows that credibility can compensate for operational weaknesses. It doesn't replace the rate, but it amplifies its effects. In Uruguay — where credit in local currency is scarce— monetary policy transmits more through confidence than through contracts.

Of course, strengthening the technical pillar is also part of building credibility. Making sound decisions on interest rates, showing resolve, avoiding ambiguity. Because when you hesitate, you eventually have to hit harder — and the economic and social costs of delay multiply. That's why, when emerging from a legacy of low credibility, central banks tend to adopt a deliberately hawkish bias — not because every move implies a hike, but because it's essential to project determination.

At the same time, agility and context-sensitivity are essential. When inflation expectations fall — as they've been doing sharply over the last months — monetary conditions through real rates contract automatically and may no longer match the macro context. But if the COPOM lowers nominal rates too fast to maintain real rates unchanged, it could send a message of complacency under a superficial reading. Avoiding that perception is part of the art of good communication — but caution is also needed.

Towards a balanced disinflation process: closing the credibility gap

The job isn't finished. Uruguay's previous inefficient coordination equilibrium — with high and persistent inflation — is most visible in non-tradable goods inflation. Unlike tradables (whose prices are shaped by global context and exchange rates in a highly open and still dollarized economy), non-tradables reflect domestic dynamics where expectations play a key role. High non-tradable inflation has historically hurt the export sector — a vital part of the economy — and created major external imbalances.

In recent months, lower inflation expectations have begun to feed into lower non-tradable inflation — as expected from international evidence. But this gain must be consolidated (interannual data covering last year's second half still show high levels). This does not mean non-tradable inflation must also reach 4.5%. At times, it may respond to real shocks (e.g., raw material prices). But currently, there is no reason to observe the large gap seen in recent years.

Preventing new distortions requires a strong emphasis on building trust — fine-tuning and oiling the gears to consolidate low, stable inflation *without* any exchange-rate intervention.

To achieve this, we must deploy the available tools — both the traditional monetary policy pillar and the newer one focused on building credibility. A one-legged strategy — one that neglects the right hemisphere — leads to one-legged disinflation: a process that fails to contain inflation in non-tradable sectors. In contrast, a modern and comprehensive disinflation strategy holds the promise — as we are beginning to observe — of reducing inflation without generating macroeconomic imbalances.

Fine-tuning the gears

To strengthen the transmission of monetary policy and build deeper trust, it is also necessary to adjust the institutional framework that supports the monetary regime.

Some key complementary measures include:

- **Promoting de-indexation and the expansion of local currency invoicing** across the Uruguayan economy are key to reducing inflation persistence and limiting automatic inflation pass-through.
- **Development of domestic currency financial markets** to enhance monetary policy transmission through interest rates.
- **Agile open market monetary operations and management of monetary liabilities** to absorb currency pressures without generating further imbalances.

These actions are part of the fine-tuning work — adjusting the gears to make the regime function more nimbly and resiliently. Though less visible, they are crucial to building a balanced, sustainable, and credible disinflation.

Concluding remarks

Uruguay has reached an advanced stage in its upgrade of the monetary policy regime, marked by low, stable, and sustainable inflation — notably, without generating external imbalances. Achieving such inflation outcomes is not solely a matter of interest rates; it is fundamentally about beliefs and confidence. Mental models shape the behavior and decisions of those who set prices, those who advise price setters, those who provide financing — ultimately, of all who project their economies into the future.

When agents believe in the target, their decisions reflect that trust: they negotiate moderately, set prices prudently, and invest with confidence.

This new equilibrium isn't imposed — it is built. It isn't forced — it is persuaded. It isn't merely announced — it is acted upon.

And through that process, monetary policy reveals its true nature: an art, a science... and a symphony of well-tuned expectations.