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Latin America A new Volcker shock?

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The annual inflation rate in the US reached 8.4 % in March 2022, the highest in four decades. Latin America shudders at the memory of how Governments controlled inflation then. Are there conditions for a new Volcker shock? What is different four decades later?

With the end of the Bretton Woods agreements in 1973, fixed exchange rates, and the devaluation of the dollar that followed, intending to alleviate the US trade deficit, imports became more expensive. The US experienced rising and sustained inflation from higher oil costs while dealing with economic stagnation. Thus, stagflation was born, and Keynesianism went down the drain.

In March 1980, when inflation reached 14.8%, then-Federal Reserve Chairman Paul Volcker tightened the money supply, resulting in a sudden increase of the federal funds rate to a monthly average of 17% p.a. and an average real interest rate of 2.2%. The nominal rate remained above 16% until May 1981, when it rose to 19%, equivalent to a real interest average of 7%.

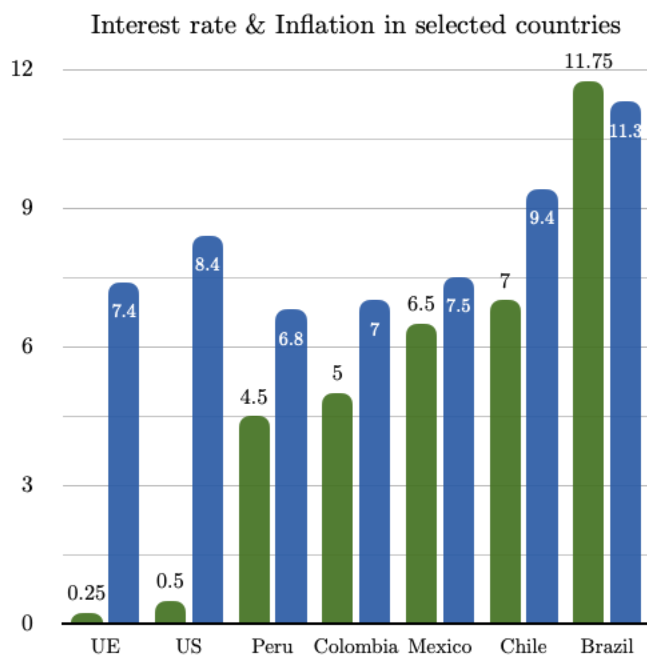
This sudden and prolonged interest rate increase, known as the Volcker shock, served its purpose of controlling inflation but nosedived the US economy into a recession with an unemployment rate of 6.4 % that reached 11 % in the following years. The rate hike and its effects were transmitted globally through the external public debt in dollars. The world economy soon plunged into recession, with commodity markets collapsing and primary exporting countries facing an unprecedented crisis.

Latin America faced devaluation of exchange rates, a lost decade without economic growth and unpayable foreign debt, sooner or later accepting IMF conditions for economic

stabilisation. The IMF's diagnosis of the crisis was that it was a problem of industrialisation. Therefore, the Washington Consensus recommendation was to open up economies and move from closed to open economies. Governments abandoned import substitution industrialisation processes, and international financial institutions pushed the export growth model with low wages and reduced public spending.

Can history repeat itself?

Fed Chairman Jerome Powell revealed on 21 Match of 2022 that the Fed is ready to take a more aggressive stance on inflation. At least a 0.5% interest rate rise is expected in May, with two or three more increases to bring the rate closer to 2% by July, leaving the real interest rate at -6.5%. The nominal interest rate has been 0.25% since March 2020. These expectations are reflected in financial market performances, which have accumulated significant losses this year. Following Powell's statements, commodity prices fell. As exchange rates have not fully recovered from the impact suffered in 2020, if the same trend continues, the terms of trade for non-oil and non-mineral exporters, could deteriorate.

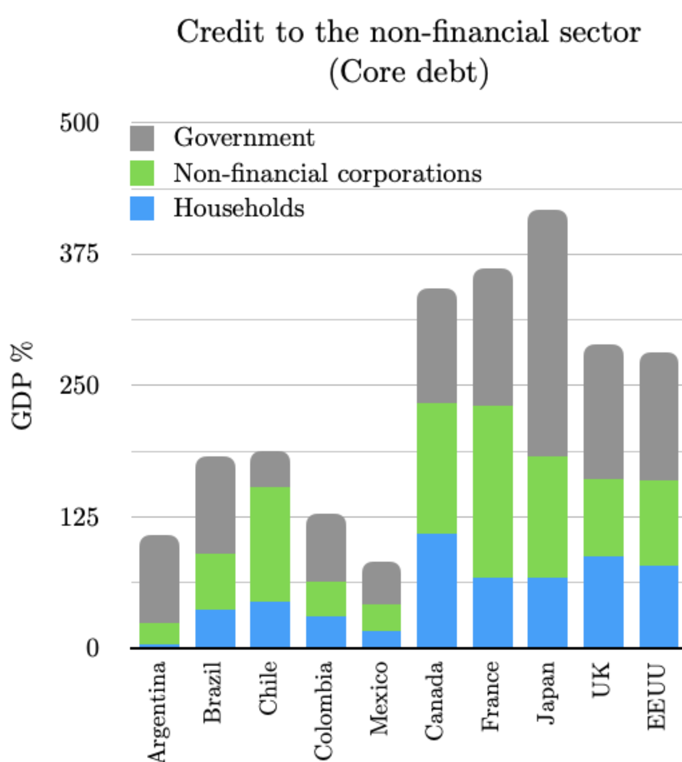


Source: Own elaboration with data from central banks

In Latin America, central banks have already raised interest rates to control domestic inflation. The Russian-Ukrainian conflict's inflation rate hikes and the international political uncertainty bring conditions for an economic recession already showing in some countries. Oil exporting and mining countries will have a boost, much like in the seventies.

Unlike the Volcker shock, inflation is now in the single digits, and the real interest rate is negative in most

cases, broadly negative in the US and the EU, at -7.15% and -7.9%, respectively, which are unprecedented. The door to commodity trade in non-dollar currencies is open. The context is of a world economy chained to China with a reduced weight of exports to the US, except for China, Mexico and Central America. As interest rates rise, the cost of debt increases, yet debt levels in Latin America are relatively low and primarily issued in local currency. The HIRCs (highly indebted rich countries) should be most concerned by the Fed's aggressive monetary policy.



In the 1980s, the expansionary fiscal policy of the US government, in combination with the restrictive monetary policy of the Federal Reserve, led to large deficits and an increase in the cost of federal debt, which prompted Congress to take fiscal restraint measures. The US national debt accumulated and increased from 32% in 1980 to 124% of GDP in 2021. At the time, with a 19% interest rate, the US debt service was 6% of GDP. In 2022, an interest rate of 4.8% will result in the same fiscal burden. The same is true for all G7 countries, with a debt-to-GDP ratio above 100%. The private sector in HIRCs accumulates a similar proportion of debt, so interest rate increases will directly affect its profit margin. Households, especially in developed countries, accumulate debt that will cause them to resent monetary policy, especially on mortgages.

Although the coming years will be difficult for Latin American economies, the scenario is less catastrophic than in 1980. On the contrary, the US continues with a sustained trade deficit, slow growth, and a buoyant financial sector that does not correspond to the real

economy. In contrast, Latin America, with some exceptions -Mexico- continues to grow despite higher inflation. Can the US export its crisis again?