Latin America's Central Banks Still Prove More Hawkish Than Fed

- Brazil set for at least 100 basis points interest rate hike
- Fed seen raising by quarter-point as war raises growth concern

By Maria Eloisa Capurro and Simone Preissler Iglesias
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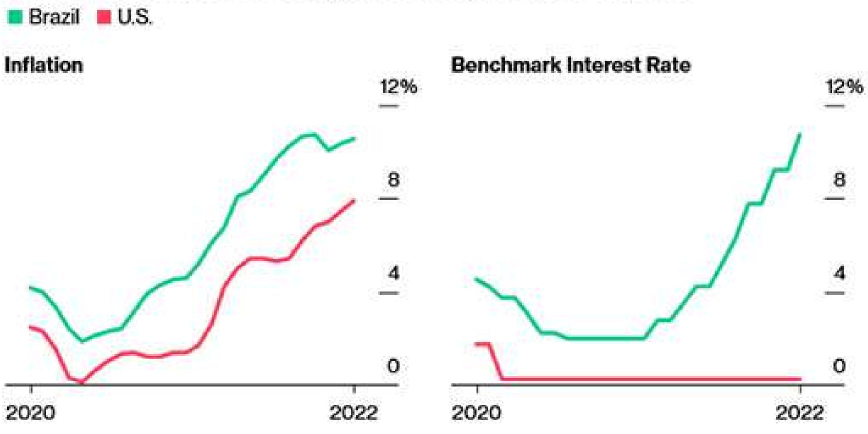
Look at inflation rates, and the biggest economies of North and South America appear to be in the same ballpark. Look at interest rates, and they might as well be on different planets.

Brazil's central bank is forecast to raise its benchmark rate by 100 basis points to 11.75% on Wednesday, taking the total amount of hikes over the last year to 975 basis points. That same day, the U.S. Federal Reserve -- which has kept rates close to 0% since Covid-19 arrived -- is expected to deliver a quarter-point increase.

Same Difference?
Similar inflation paths have triggered a very different response



Source: BLS, IBGE, Bloomberg

The numbers capture how vastly different the approaches to pandemic inflation have been in Latin America and the U.S. What's also striking is that investors reacted in opposite ways when news broke of the latest global price shock: Russia's invasion of Ukraine, which sent oil surging.

In Sao Paulo, the reasoning of traders was straightforward: they figured that higher oil means higher inflation, so they stepped up bets on more aggressive rate hikes. Economists now expect the central bank to go further with its tightening cycle than they did a month ago, before the Russian attack.

> **What Bloomberg Economics Says**
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> "The BCB has important hurdles to overcome. The rise in oil prices led Petrobras to announce double-digit hikes to prices of gasoline, diesel and cooking gas. That prompted the government to announce measures to mitigate those pressures, but at a significant fiscal cost. This adds to high and widespread inflation, and unanchored and rising inflation expectations."
>
> -- Adriana Dupita, Latin America economist
>
> -- Click here to see full report

Inflation expectations have been rising in the U.S. too since the war began -- but there, the initial market response was quite different. Traders took the argument a step further -- reasoning that higher inflation will sap consumer demand and curb economic growth. So they initially scaled back bets on Fed hikes.

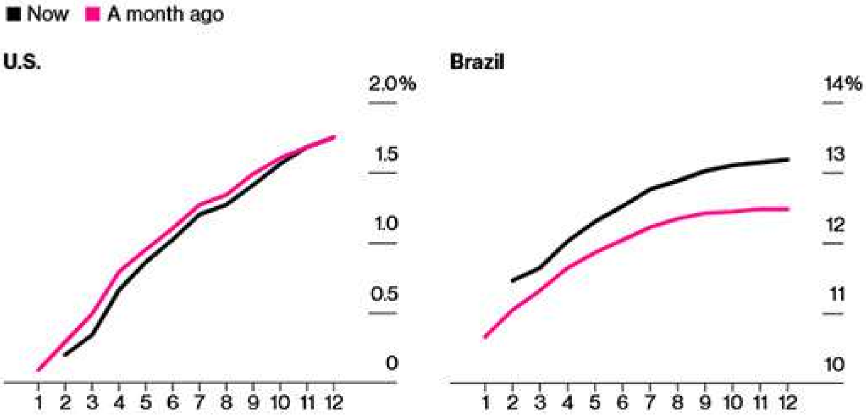
Oil Swings

Since then the picture has muddied. Fed-hike expectations have come back up to roughly where they were a month ago. And oil has plunged from post-invasion highs -- partly driven by China's new Covid lockdown, which poses risks of its own to global supply chains, as well as demand.

In the U.S., bonds plunged on Monday on the combination of building inflationary pressures and looming monetary tightening. In Brazil, expectations for year-end inflation jumped 80 basis points -- and for interest rates by 50 basis points -- in the central bank's latest weekly survey.

Opposite Responses

War led traders to lift rate bets in Brazil, unlike the U.S.



Source: Bloomberg
Note: Data from futures on interest rates, x axis refers to months from now

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There are plenty of reasons why central bankers in Brazil -- and elsewhere in Latin America, too, where tightening has been under way since mid-2021 -- respond differently to a price shock than their U.S. peers.

In Brazil, a volatile emerging market, policy makers are haunted by recent memories of hyperinflation. They also have to worry about risks like capital flight and currency collapse. They tend to strike at the first sign of a price spike, even if that means an economic slowdown. Last year the country fell into its second recession of the pandemic period.

In the U.S., a stable developed economy, the concern over the past decade was the opposite one: that inflation may be grinding too low.

Reason to Be Fearful?

Still, the widening rates gap between the countries come at a time when their inflation problems are pretty comparable -- Brazil's annual rate has soared from 4% at the start of the pandemic to 10.5%; in the U.S. it jumped from 2.3% to 7.9% -- and being driven by broadly similar causes.

It's possible that each country has chosen the right course in its own context -- and also that each has something to learn from the other.

Henrique Meirelles, Brazil's longest-serving central bank chief, reckons that the Fed will end up moving at least some way in the direction of its Brazilian counterpart.

"The U.S. certainly needs a more aggressive approach," said Meirelles, who hiked rates to a whopping 26.5% soon after taking charge in 2003. That allowed him to tame inflation expectations, and just a few years later he was cutting rates to at the time record lows.

"There's no reason for the Fed to be fearful of hiking rates," he said. "They are facing a classic inflation spike: excess demand, fiscal stimulus and low unemployment. They can't get stuck into running the economy hot."

But in a global economy now getting buffeted by shock after shock, Jose De Gregorio -- who presided over the central bank of Chile during the 2008 financial crisis -- can see some merit in the play-it-by-ear approach.

"Latin America can't stop the tightening," he said. "But the proper response to these levels of global uncertainty would be to wait."

– *With assistance by Valentina Fuentes*