Getting it all together

To resume growth, Brazil needs to fine-tune and better coordinate its monetary, fiscal, and exchange rate policies.

Solange Monteiro

The main challenge for central banks in developed countries is to support the gradual recovery of their economies. Today, much of the hope of building up U.S. and European Union economies depends on normalization of U.S. monetary policy by the Federal Reserve Bank (the Fed) and on monetary quantitative easing by the European Central Bank (ECB).

For Brazil, however, the Central Bank challenge is managing monetary and exchange rate policies so as to correct relative prices and curb rising inflation expectations while fiscal policy is tightened, which may further reduce growth. “In cases like Brazil’s, Central Bank attention and responsibility must be intensified,” says José Julio Senna, head of the Monetary Policy Center of the Brazilian Institute of Economics (IBRE).

To explore risks to Brazilian monetary policy arising from the global outlook and recommend policies to curb inflation, on March 12 in Rio de Janeiro IBRE brought together former directors of the Central Bank of Brazil in its first Seminar of Monetary Policy.

Adjusting relative prices
Experts in attendance warned that, unlike what happened during the adjustments in 1998 and 2003, this time Brazil cannot count on a favorable export outlook to help reduce the external current account deficit, because deflationary pressures persist in many countries. Senna points out that core inflation in the euro area is just over half a percent a year and in China wholesale prices have been declining for three years.

In addition to a lack of demand from China, Brazilian exports have also been affected by falling commodity prices as the U.S. dollar has strengthened. Commodities typically have an inverse relationship with the value of the dollar, so that when the dollar strengthens against other major currencies, commodity prices usually drop. When the value of the dollar weakens against other major currencies, commodity prices tend to move higher. The main reason this happens is that commodities are priced in dollars, and when the value of the dollar increases, it takes fewer dollars to buy commodities. According to the Foreign Trade Studies Center Foundation, in the first two months of this year, the Brazilian commodities price index fell by 28% compared to the same period in 2014. “[Falling oil prices] have not benefited Brazil’s economy because of depreciation of the exchange rate and adjustment of controlled energy prices,” says Eduardo Loyo, former central bank Director of Special Studies. “The decline in oil prices is related to the expansion of shale oil and gas production in the United States,” adds Affonso Celso Pastore,
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The relatively stronger recovery in the U.S. compared to other developed countries has contributed to the dollar appreciation. It is still difficult, Senna says, to predict how long it will take for European and Japanese economies to recover. He points out that recovery from a recession preceded by a surge in debt depends on both businesses and households cutting their debt, which so far has not happened. The asymmetry of the adjustment of the balance of payments between countries in the euro area is an additional problem that slows growth there because the burden of adjustment falls on the most vulnerable countries.

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Source: U.S. Federal Reserve Bank and Bloomberg.
As a result, the ECB may have limited scope for monetary easing to boost the euro area economies. So far, quantitative easing—purchases of securities worth €60 billion every month through September 2016—has certainly caused the euro to devalue against the U.S. dollar and kept interest rates in the region low.

With a more balanced economy, where the private sector has already relieved itself of much of its debt, the U.S. will be in the best position to attract the capital made available by the ECB monetary easing, which will provide more business opportunities and gains for investors. “When I see that U.S. growth is sustainable and that of Europe and Japan still needs a lot of stimulus to keep growing,” Pastore says, “I have no doubt that the U.S. will attract capital flows, and that this will bring about another round of appreciation of the dollar, which as in previous times should be long and persistent.”

The Brazilian currency has been depreciating more than that of Brazil’s trading partners because domestic inflation is much higher. In the 12-month period into early 2015, the dollar had appreciated 27% against the euro and 32% against the Brazilian real. This, explains Pastore, is partly caused by Brazil’s large external imbalance: “Our external current account deficit reached US$90 billion—4.2% of GDP. We are not competitive enough to increase exports. The external adjustment is much more dependent on adjusting the exchange rate.”

In other words, Brazil will now have to face a sizeable correction of relative prices, allowing prices of its internationally traded goods to rise over the price of goods and services not traded internationally, such as services. “Since 2011, the pass-through of exchange rate movements to internationally traded goods denominated in domestic currency was blocked. This kept inflation down, but also prevented a major adjustment in the external trade balance,” Pastore explained.

Pastore, Senna, and Loyo agreed that to realign relative prices, the central bank will have to stop intervening in the foreign exchange market.
market, which since 2013 has helped to curb inflation. The central bank “has to let the exchange rate move more freely and intervene only to smooth out volatility. It should not prevent the Brazilian currency from finding its new equilibrium,” Pastore said in defending the cut-back in the central bank foreign exchange swap auction program. Such a correction of relative prices, the three economists agreed, will encourage a reduction in household and government consumption and a drop in wages and employment similar to those experienced in 1998 and 2003.

**Back to the inflation target**

Another challenge for monetary policy that seminar participants identified is how to bring inflation back to the 4.5% target promised in principle for 2016. IBRE staff expect inflation to hit 8% this year, partly because of adjustments in controlled prices. However, the jump in inflation to far past the inflation target ceiling of 6.5% has reduced the ability of the central bank to curb inflation expectations, according to seminar participants. “With 12-month inflation running at 8% to 8.5%, it is not clear what new factor can limit inflation expectations over the next few years,” says Afonso Bevilaqua, central bank director of economic policy (2003–07).

Bevilaqua believes that in the last four years the central bank abandoned the 4.5% target, and this apparent leniency has now expanded

**Off-track?**

Strong inflation earlier this year raises skepticism about central bank ability to bring inflation back to the 4.5% target promised for 2016.

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*Affonso Celso Pastore*
the range of expected inflation. “The perception is that the 4.5% target is no longer a relevant anchor for inflation; but if we lose confidence in the 6.5% target ceiling, what nominal anchor do we have? Once confidence in the inflation targets is lost, the cost of bringing inflation down can be very high,” says Rodrigo Azevedo, central bank director of monetary policy (2004–07).

Azevedo believes that, well-managed, the inflation targeting system is a good summary of the government policy stance and should not be abandoned. He thinks it was a mistake for the government not to have reduced the inflation target in 2007. At the time, the government decided to hold to the 4.5% target because there was a belief that changing it would increase unemployment. Mario Mesquita, central bank director (2007–10), thinks that the central bank must now restore the inflation target system but with a more ambitious target. “I would hope that by 2019 we would have a more civilized inflation target of 3%, which 20 years after the inflation target system was introduced is not too much to ask,” he says. He also suggests more intensive inflation monitoring, along the lines adopted by India: “There the central bank has to write an open letter if inflation breaches the target for three consecutive quarters. If we had a similar system, penalties for the central bank could have been more frequent and the correction in monetary policy, which started in 2013, could have come earlier,” he says.

Correcting the fiscal imbalance
Sergio Werlang, central bank director of economic policy (1999–2001), believes that, even though there is a need to curb inflation expectations, there is not much room for tighter monetary policy. The consensus among economists attending the seminar was that without fiscal adjustment, monetary policy alone will not be able to curb inflation. His opinion is that “The efficient way to reduce domestic demand is not by raising taxes, but always by cutting current spending.”

Bevilaqua underlines the necessity of restoring the fiscal regime that operated until the 2008 crisis, when there was a substantial fiscal loosening that “increased the debt-to-GDP ratio by 10 percentage points of GDP and turned the fiscal primary balance into a deficit of 0.6% of GDP in 2014,” he says. “More serious than the deterioration in the quality and transparency of the fiscal stance was the dismantling of fiscal institutions that seemed consolidated, as for example the recently approved changes to the law of fiscal responsibility,” he says, referring to the relaxation of the conditions for states and municipalities to pay down their debt. He points out that these factors increase the risk of loss of the country’s investment grade rating, which would make management of monetary, fiscal, exchange rate policies even more complex. “Unless this situation changes, growth will not resume,” he says.

Azevedo says that large fiscal adjustments imply friction and bring about deterioration in the political situation. “Political support is

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essential because building confidence depends on the realization that the policy adjustment will not be abandoned mid-way,” he says, citing episodes in 1999, 2003, and 2008, when Brazilian governments demonstrated determination and mustered the necessary political support: “We have to come up with credible gains that reduce the risk premium because this reduces the cost of capital, encourages investors, and contributes to more balanced growth.”

United States leading

With a more balanced economy, the U.S. will be in the best position to attract private investment.