More uncertainty about inflation

With little clear about the direction of monetary policy and fiscal adjustment, curbing inflation expectations and meeting the inflation target has become more questionable.

Solange Monteiro

THE DECISION OF THE MONETARY Policy Committee (Copom) in January to keep the central bank policy interest rate at 14.25% surprised the market. The Copom announcement contradicted previous signs that the central bank would raise the rate and generated speculation that the government, concerned to revive the economy, had influenced the decision. “On the technical side, there are many who argue that it was a wise move. But the way it happened

More than expected

In January, the increase of bus fares in four capitals was 9.8% on average, and may set the pace of adjustment in other cities.
Involves a difficult element to incorporate into numerical estimates, and that is the credibility of the central bank. Since the central bank is responsible for guiding the market, a context of very divergent expectations about inflation is damaging,” says Salomão Quadros, IBRE deputy superintendent of general price indexes.

The January decision added more uncertainty to an already difficult inflation outlook. Like other analysts, in early February IBRE revised its 2016 inflation projection from 7.5% to 7.9%. Quadros points out that the revision incorporates recent adjustments to bus fares in São Paulo, Rio de Janeiro, Salvador, and Belo Horizonte cities. On average, the adjustment was 9.8%—lower than the 13.3% in 2015 but higher than what had been expected for 2016. “The bus fare increases have contradicted the principle that in an election year the adjustment is low, or even zero,” he says, though noting that the cash problems of municipalities limit their room for maneuver and have forced local governments to take unpopular measures, which may set a precedent for increases in other cities.

Another element that weighed negatively was fresh food, the prices of which began rising in December. “The drought last year reduced the production of tomatoes, potatoes and onions, raising their prices,” says André Braz, IBRE coordinator of prices. On the other hand, the rigor of El Niño this year may bring more rain, which would bring some relief not only for food producers but also for hydropower plants, which would take some pressure off electricity costs.

The Copom announcement contradicted previous signs that the central bank would raise the rate and generated speculation that the government, concerned to revive the economy, had influenced the decision.

However, the depreciation of the exchange rate early this year is considered to be a clear indication of a new round of pressure on prices. “If this trend intensifies, we must extend the impact of the exchange rate even to items that had been spared in the 2015 devaluation, such as food,” Quadros warns. He points out that the speed of transmission of the exchange rate is different for each sector, depending on its ability to survive with narrower profit margins than desired. Quadros notes, “We have identified residual devaluation pass-through especially on durable goods—refrigerators, TV sets, cars—that have imported inputs.

The monetary policy problem
IBRE researcher Vinicius Botelho believes the exchange rate effects in January have consolidated the market view that the rate will fluctuate around R$4.50 to the US dollar in 2016. “When there are negative surprises in fiscal adjustment, the heightened perception of risk tends to weaken the Brazilian currency,” he says. This, in turn, has a negative impact on prices.
“Since the central bank is responsible for guiding the market, a context of very divergent expectations about inflation is damaging.”

Salomão Quadros

Quadros says that the fiscal deterioration has complicated the large necessary correction in controlled prices (fuel and electricity tariffs) in 2015: price adjustments have spilled over future prices, bringing about inflation inertia.

José Julio Senna, head of the IBRE Monetary Studies Center, is convinced that the monetary policy that accompanied the correction in controlled prices in early 2015 was correct: “At that time, the central bank took advantage of the new climate prevailing in the country that an economic adjustment policy would be carried out and tightened monetary policy. It achieved a very reasonable result, particularly with regard to the reversal of inflationary expectations for 2016, which declined to 5.4% for the year.” He emphasizes, however, that the reversal of expectations was short-lived — when the second half of 2015 began, it became clear that the fiscal imbalance was very serious but the desire to make the macro adjustment was not that strong. “Then the central bank lost the rationale to continue taking action. It would not be all bad if inflation expectations had remained stable, since real interest rates reached about 8% per year, a pretty strong dose. [But] inflation expectations went out of control because of the worsening of the fiscal stance, the political crisis, and ever clearer signs that the macro adjustment would not materialize,” Senna says.

In contrast, Botelho believes that the fiscal deterioration was not the major factor in the loss of the power of interest rates to keep prices from rising. He attributes rising inflation to monetary policy inertia: “The issue is not that the interest rate policy lost effectiveness because of the fiscal deterioration, but rather that interest rates are simply not being used aggressively.” Botelho argues that today the country is still paying for the

The drought has pushed up food prices.
accumulated inflationary pressure resulting from the low policy interest rate after the 2008 international crisis—7.25% between 2012 and 2013—and real interest rates below 2%. “We lived with this repressed inflation for too long, and when we finally decided to fight inflation, we decided to do so gradually,” Botelho says. “If, instead, we had been more aggressive, we would have generated a much stronger contraction in demand, and the economy would have responded [by reducing prices].” Botelho points out that opting to raise interest rates by half a percentage point to the current level opened up space to maintain the inflationary pressure of demand for longer than was prudent.

Botelho estimates that the tightening of interest rates after 2008 took 60% longer than between 2001 and 2008: “Instead of fighting inflation, the gradual rise in the interest rate increases the inertia of the monetary authority and has inflationary effects because shocks take longer to dissipate.” He emphasizes that the central bank seems uncomfortable with hiking already high interest rates, especially given the questions in the market about whether the government was interfering in the monetary authority’s decisions. This creates an expectation bubble that is more inflated than it should be.

Botelho recognizes that to combat inflation more aggressively, interest rates need to be much higher in the short term, which increases payments on public debt. But, he emphasizes, “On the other hand inflation gives way sooner and opens room for interest rates to fall sooner too—a fact that, in Brazil, could have a positive impact on the debt.” He believes that maintaining the current situation—with the central bank slow to act to curb inflation, expectations of currency depreciation, and the deterioration of the fiscal balance—jeopardizes plans to bring inflation down to the central bank target (between 3% and 6%) in 2017, pushing the deadline into an indefinite future. “This combination of factors may leave us with long-term high inflation,” he concludes.

“Inflation expectations went out of control because of the worsening of the fiscal stance, the political crisis, and ever clearer signs that the macro adjustment would not materialize.”

José Julio Senna