How do you see the current situation of the Brazilian Central Bank?

It’s a delicate situation. In fact, the situation is difficult not just for the central bank but also for anyone concerned about the current predominant scenario. There is confusion even over conceptual issues. Since Brazil has an inflation targeting regime, some argue that the only task of the central bank should be to calibrate its policy so that the target can be met in a reasonable time: in other words, the central bank should set the real benchmark interest rate sufficiently high to keep inflation at 4.5% per year.

José Julio Senna
Head of the Monetary Studies Center of the Brazilian Institute of Economics (IBRE, FGV)

Solang Monteiro
THE BRAZILIAN CENTRAL BANK is struggling today with the persistence of inflation above the ceiling of the inflation target range, and its hands are tied by a severe recession, a high fiscal deficit, and a difficult political scenario. José Júlio Senna, head of monetary policy studies at the Brazilian Institute of Economics and former director of monetary policy for the Central Bank, says that recent monetary policy is likely to result in a change of the inflation level of the economy from 6% to 8%–8.5% and the consequence will be more unstable inflation. “The only chance we have to make inflation targeting work properly is a true fiscal adjustment built on a consensus of the political parties about reform,” he says.
The central bank chose to postpone meeting the inflation target when recession was already deep; it would be even worse if the central bank had forced convergence of inflation to the target in the short term.

This way of looking the problem seems to me incorrect. Inflation targeting has not just one exclusive goal but a hierarchy of objectives. The priority is to fight inflation, but not at any cost. You must take into account the pace of economic activity, spare production capacity in the economy, and unemployment. Brazilian history shows that the central bank chose to postpone meeting the inflation target when recession was already deep; it would be even worse if the central bank had forced convergence of inflation to the target in the short term. The most appropriate policy is to define an adjusted inflation target to be met immediately, without abandoning the original target in the medium term. This allows convergence to the original target to occur gradually, which should minimize the cost in terms of economic activity and employment. This view is supported by the economic literature on inflation targeting. In my view, the great difficulty at the moment is that the central bank is not in a position to follow the recommended path or adjust the targets.

Did the loosening of interest policy in 2011 contribute to the worsening inflation outlook?

Since 2011 there has been a certain aggressiveness in interest policy. The central bank has adopted a strategy to bring the interest rate down to a very low threshold, less than 2% in real terms—and without doubt that helped to raise inflation. In fact, this decision was part of a broader policy strategy, a strategy based on an incorrect view of economic growth. In general, economic growth is a supply, not a demand, issue. The government sought to promote expansion of the economy by higher public spending, subsidized interest rates for investment, credit for consumption of durable goods, and discretionary tax cuts. Regardless of where the economy was in the economic cycle, the government tried to boost it by stimulating demand. That is not what an economy needs to grow. What is needed is to stimulate supply by encouraging people and companies to mobilize resources for productive purposes. The government needs to provide businesses with better infrastructure and reduce bureaucratic costs. The tax system needs extensive reform and simplification. With such measures supply tends to expand and significant gains in productivity appear, especially when governments also improve the quality of education.

The combined result of the policies the government adopted, not just the forced fall of interest, was the frightening imbalance of public accounts, which affects the perception of the Brazil risk. The consecutive downgrades in the country’s credit ratings are a good example. Of course, there are entitlements in the Constitution that make the situation worse … . Public spending in Brazil has been growing about 0.4% of GDP a year for over 25 years. Many argue that the legal provisions make it impossible to control government spending. If you really want more balanced public accounts, and a tax system that causes less distortion and productive inefficiency, there must be reforms that change such legislation. Is it difficult? There’s no doubt it will
be. Will there be resistance? Without a doubt. But if Brazil wants to generate more wealth and more jobs, and lower inflation, there is no alternative. … The old way of raising taxes is closed. Thus remains only one alternative to correct the fiscal imbalance: cut expenses. If this does not occur, uncertainty will continue to be excessively high.

One of the most serious economic policy mistakes of recent times, I believe, was to stimulate household borrowing: regulations to facilitate consumer credit, discretionary reduction of taxes on durable goods (particularly cars), and political discourse all encouraged household indebtedness. Many families borrowed more than would be recommended to purchase durable goods. Now the bill has arrived. The economic downturn and high unemployment have forced families to adjust. Consumption fell more than 4.0% in 2015, and will fall by about the same in 2016. This is unprecedented.

In short, we are experiencing a hangover from several years of excessive demand stimulus. The recession is the result of the low quality of recent economic policy. And that escaped the control of the Central Bank. From the start of the recession early in 2014 through the end of this year GDP is likely to shrink by 8%. Faced with this situation, it is understandable that the central bank feels the need to raise interest rates.

**Does this mean the central bank’s hands are tied?**

In general, yes. Today there are three restrictions on what the central bank can do. The first is the recession. The second is the magnitude of the fiscal deficit; the nominal deficit is close to 10% of GDP and interest payments are high. … When an interest rate adjustment is concerned, anywhere in the world, generally the fiscal stance is not a concern of the central bank governor. In Brazil, however, the perception of risk is reflected in the rate on 5-year certificates of deposits as almost 500 points. This is something that should not be ignored. …

The third restriction relates to the environment we live in. When inflation is low, 2 to 3% a year, the monetary authority adjusts the interest rate smoothly. But in Brazil adverse reactions to an increase in interest rates tend to be more pronounced than in other countries, because the interest rates here are already very high. In the credit market, there are so many distortions that interest rates are absurd. You need to have a minimum of acceptance by society to raise the interest rate. And in the long run it discredits monetary policy.

**So there is no room to increase interest rates in Brazil today?**

The moment for it is not favorable. Inflation is a problem, but so is the recession. And we are in the midst of a political crisis. For monetary tightening to have good results, society must believe that monetary policy will not suddenly be reversed. Moreover, the central bank alone cannot do much. There is a direct relationship between the potential
The old way of raising taxes is closed. Thus remains only one alternative to correct the fiscal imbalance: cut expenses. If this does not occur, uncertainty will continue to be excessively high.

growth of an economy and the equilibrium real interest rate. Since potential growth has declined significantly, it is likely that Brazil’s equilibrium real interest rate has also fallen. Therefore, a real interest rate of almost 7% is a significant monetary tightening. The problem is that, while monetary policy is far from being loose, it will not solve the problem because the fiscal imbalance is dramatic, and there are no initiatives to correct it.

Is it possible to remove the threat of high inflation?
An inflation targeting regime operates to anchor the price system. If the target is credible, the central bank is reliable, and economic policy supports the bank’s actions, society has a base on which to adjust prices and wages. But the inflation target must be met. ... However, the government began to consider the acceptable range of 2.5 to 6.5% to be the target, instead of 4.5%. When inflation is close to 6.5% and the government says it is meeting the target that confuses people. For the last six years, inflation has been well above 4.5%, so people believe that is not the target and adjust accordingly.

Another great lesson from the recent period is never control prices—because down the road all repressed inflation becomes corrective inflation. The Brazilian government controlled urban transport prices, gasoline, and electricity tariffs, and yet average inflation was high. But now reality imposes itself. In 2015 all controlled prices increased up to 18% and inflation closed the year at 10.7%. The problem now is that society sees the upward trend of prices as the new reality and the way forward.

A demonstration of this is the IBRE/FGV consumer survey, which asks people what inflation they expect for the next 12 months. For the three years ending early in 2015, the expectation averaged 7.1%. This February, expected inflation is 11.4%—in line with the minimum wage increase and 2015 inflation of 10.7%. Entrenched inflation expectations are a problem for the central bank. What to do to anchor expectations? There is nothing the central bank can do. The recession is very serious, the fiscal imbalance very serious, and the political situation very bad.

The only chance we have to make inflation targeting work properly is a consensus of the political parties around reforms and a true fiscal adjustment.

Is it possible to position the economy on the path of convergence to the inflation target?
With the current recession and high unemployment, inflation should fall. To understand why it does not fall, consider that inflation is determined by three main factors: shocks, such as exchange rate changes, which affect the price of tradable goods and the very expectation of inflation; unemployment, which when it is high brings down inflation; and inflation expectations. What we had in 2015 was a corrective price shock. In countries where inflation expectations are anchored, these shocks are just a transient disturbance
in the economy, dissipate in a few months, and inflation is back to its previous trend. But when expectations are not well anchored, the shock causes the level of inflation to change. I fear that Brazil’s inflation level is rising from about 6% to 8 or 8.5%. It is difficult to be more precise than that. If the level has really changed, it will be even more difficult to reduce inflation, despite the brutal recession. Can it be 8% for three years in a row? Yes. But the international evidence is clear: the higher the inflation rate, the more unstable it is.

How would you evaluate the economic deceleration in developed economies?
The world is going through a very strange phase. I do not believe there are economists who can explain what is happening. The world economy is growing less than its historical average, particularly the developed world. … Generally, economies grow slowly because they have modest gains in productivity, have less physical capital for companies to work with, and there is a shortage of labor. Now, however, some speculated that low growth might be related to a chronic deficiency of demand. Several hypotheses justify this thesis. One is the increased inequality in the developed world. To the extent that income and wealth are concentrated in the hands of people who are less willing to spend, consumption is hurt. Another hypothesis involves demographic changes. When the population is growing fast, many are mobilizing to invest because a larger population will demand more power generation, more housing, and more infrastructure in general. None of this is needed when the population shrinks. Moreover, in the modern world, technological advances have meant that entrepreneurs do not need to mobilize large sums of money to invest. … In the developed world, investment rates are declining, and this may explain the current modest growth, or stagnation.

We are experiencing a hangover from several years of excessive demand stimulus. The recession is the result of the low quality of recent economic policy.

And without demand, there is no inflation...
True. Inflation is running below the historical average throughout the developed world. And central bankers are flabbergasted. In the acute phase of the financial crisis in 2008-2009, central bankers were able to correct it immediately …. They managed in the short term to unlock financial markets and put credit to work. But they failed to stimulate the economy. Quantitative easing is not producing the desired effect. … Now, with new shocks to prices, particularly the fall in oil prices, it is natural that inflation expectations would decline further. Central banks have come to understand that there is no room to raise interest rates.

Does the international scenario help or harm the Brazilian recovery?
This weakness of the developed world, and incredibly low inflation, could be seen as something that could help us, give some hope. But I see no channel through which lower inflation abroad and slower growth would actually help us. Our problems are domestic. They were manufactured here and require domestic solutions.