3
Monetary Policy in Brazil under a Flexible Exchange Rate

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3.1 Introduction

Although the Brazilian economy experienced hyperinflation from the middle of the 1980s until the beginning of the 1990s, the Real Plan stabilization policy implemented in July 1994 successfully eliminated high rates of inflation by adopting an exchange rate anchor system. It is very evident that the policy reforms introduced during the 1990s helped this disinflation process by liberalizing trade and capital markets, which significantly increased market competition and capital inflows. On the other hand, a stabilization policy based on a dollar peg inevitably led to overvaluations of real exchange rates, which in turn led to external imbalances and higher dependence on foreign capital.

As is well known from open macroeconomics, a country cannot simultaneously adopt fixed exchange rates, free capital movement and an independent monetary policy without experiencing involuntary adjustments like a currency crisis. In this respect, Brazil has been no exception. Faced with the currency crises prevailing in the second half of the 1990s, Brazil was eventually forced to abandon the fixed exchange rate system in January 1999 in the face of large capital outflows and speculative attacks. Under the new exchange rate regime – a flexible exchange rate system – the Brazilian government has adopted inflation targeting as the new anchor for inflation.

Between 1999 and 2000, inflation rates were contained within the target range, which created much kudos for Brazilian monetary policy. However, actual inflation rates exceeded the target range in the period from 2001 through 2003. In particular, the inflation rate reached 12.53 percent in 2002 – much higher than the upper limit of 6 percent – due to sudden shifts perceived in country risk and exchange rates that were provoked by market expectations about the presidential election. This event conforms to the accepted truth that a country in “fiscal dominance” is likely to face to difficulties in managing an inflation targeting policy.

The purpose of this chapter is to discuss the main problems of the current monetary policy in Brazil under a flexible exchange rate system. Section 3.1
briefly examines some characteristics of the inflation targeting policy implemented in July 1999. Section 3.2 summarizes the institutional aspects of the policy and macroeconomic performance under this regime. Section 3.3 presents a theoretical model for inflation targeting that takes public debt and exchange rate risk premium into consideration. These two factors are very important for managing inflation targeting policy, particularly in the context of emerging markets, which suffer from the fiscal dominance problem. In Section 3.4, Brazilian inflation targeting policy is examined by estimating response functions regarding interest rates. The estimation verifies that the Central Bank determines interest rates, taking into account the changes in risk premium and public debt.

### 3.2 Some problems of inflation targeting under a flexible exchange rate system

Research regarding the theory and the experience of inflation targeting are found, among others, in Blejer et al. (2000), Bernanke et al. (1999), Taylor (1999), and Svensson (1999). The methodology of setting an inflation target means that the monetary authority conducts stabilization policies using traditional instruments of monetary policy – basically short-term interest rates – to realize the target rate set in advance. According to Haldane (2000), Bernanke et al. (1999), and Svensson (1997), the main advantages of inflation targeting are: (1) the monetary authority can set an inflation target as a nominal anchor for monetary policy or as a reference index for inflationary expectation, (2) it can increase not only the transparency of monetary policy but also the capacity for evaluation of monetary policy and its performance, (3) it can demonstrate to the public that monetary policy has a long-run effect on stabilization.

However, inflation targeting policy in an open economy is likely to experience problems in Latin America. Under a flexible exchange rate system, inflation targeting policy faces difficulties due to large and volatile changes in exchange rates. Changes in exchange rates affect price levels directly through import prices and indirectly through aggregate demand and supply. In turn, exchange rates are affected by external shocks and expectations. Historically in Latin American countries exchange rate changes have been quickly passed through to price levels (Mishkin and Savastano 2001).

Particularly when a country is in fiscal dominance with unsustainable public debt and budget deficits, it is inevitable that the credibility of the public debt decreases and default risk becomes serious, which immediately leads to a deterioration in the risk premium and a large depreciation. According to Blanchard (2004), while a standard argument predicts that an increase in interest rates will lead to an exchange rate appreciation by attracting foreign capital, fiscal dominance makes an inflation targeting policy difficult due to higher default risk and depreciation caused by the increase in interest rates.