Brazil: Economic Zombies Are Back

Márcio G. P. Garcia[1]
March 1, 2011

It is extremely dangerous to entertain the idea that inflation can be controlled without affecting GDP growth.

The recent Rio carnival samba school parade's most impressive scenic innovation was presented by the Unidos da Tijuca school's lead group with its zombies whose heads suddenly fell off.[2] Also in the economy, some economists are once again enthusing about ideas that seemed to be long buried. For the good of the Brazilian economy, these economic zombies should be dispatched back to their tombs. Let's examine them.

It is frequently argued that as, during the Dilma Rouseff government, the Central Bank (CB) has begun to make use of a more diversified set of so-called macroprudential policy instruments to combat inflation, real interest rates will be significantly lower. In fact, these instruments have been widely used in the Brazilian economy for decades to curb credit expansion. Brazilian levels of reserve requirements with the CB, which is the main instrument used, have probably been the highest in the world for decades. The proof of this is that, in 2008, the R$ 100 billion reduction in banks' reserve requirements aimed at combating the crisis made a great contribution to restoring liquidity. The increase in reserve requirements in 2010, together with other measures that restricted credit growth, are not exactly a novelty in Brazil. After the Real Plan, when aggregate demand was growing at a dangerously fast pace, the CB imposed a big reserve requirement increase, even instituting an unprecedented reserve requirement on bank loans.

Brazil does indeed have considerable experience in the use of such administrative measures to control inflation. The problem is that - notwithstanding the help in combating the crisis in 2008 that may have been provided by the release of reserve requirements - it is not clear that the use of reserve requirements to control inflation and credit has been successful in Brazil (or in other countries). The truth is that reserve requirements have been raised here when aggregate demand was exploding and it was decided that interest rates should not shoulder the whole burden. After the explosion in demand had passed, the reduction in reserve requirements was always very gradual and they remained at abnormally high levels by world standards.

Although less in evidence than high interest rates, high reserve requirements have, in tandem with the latter, constituted the basis of the extremely tight monetary policy needed to keep inflation under control since the Real Plan, simply because fiscal policy has traditionally been very loose. Good Brazilian macro-economists have become positively hoarse in calling for changes in the macro-economic policy mix in order to institute a less expansionist fiscal policy and a looser monetary policy. However, our

[1] http://www.econ.puc-rio.br/mgarcia.
[2] http://www.youtube.com/watch?v=TUzHi29OZsY.

political system seems incapable of generating coalitions that put a permanent brake on the expansion of public spending.

The idea has also been aired that the change in the CB's leadership has led to a better coordination between fiscal and monetary policy. This is not a very reasonable assessment, given that the change occurred at the CB which is not responsible for fiscal policy where the root of the problem in fact lies. As is well-known, the Minister of Finance who presided over the misguided and electorally motivated fiscal expansion in 2010, was invited to stay on. Why then should the supposed current coordination lead to a better fiscal policy?

The recent fiscal measures adopted show that the essence of this expansionism remains unchanged. Despite this year's positive initiative regarding spending cuts - that still needs to be complemented by a multiannual plan to control the growth in public expenditures - the government continues to expand aggregate demand with successive and highly onerous loans to public banks, especially the BNDES. Thus, it will be difficult for monetary policy's supposedly new instruments, or the illusory improvement in CB-Ministry of Finance coordination, to allow a permanent reduction of real interest rates in the Brazilian economy without putting the fulfillment of the inflation target at risk.

Another zombie that threatens the economy is the presumption that inflation's convergence to the target can be engineered without affecting GDP growth. Without unpredictable favorable shocks, such as an improbable fall in commodity prices, reducing inflation will certainly be costly in GDP and employment terms. If the design of macroeconomic policy (in the monetary, fiscal and exchange rate spheres) tries to ignore such costs, inflation will probably take much longer to converge to the target, if it does succeed at all.

One should never tire of repeating the following. It is essential for those who conduct our economic policy to realize that, given 2010's misguided fiscal expansion and the cost shocks that are currently being imported from abroad, bringing inflation back on target will require GDP to grow below its potential level. This means that growth this year will have to be less than 4% and that tough decisions will need to be made, such as cutting government expenditures to the bone and putting loans to public banks definitely on hold.

In sum, it is illusory to believe that we now have a set of new economic policy instruments that will enable us to obtain the benefits of low inflation and growth, at no cost. This discourse's implicit risk is well known – high inflation. Brazil has not yet come of age in terms of controlling inflation, which was conquered, at great pains, only in 1994. The reaction of Brazilian economic agents to high inflation tends to be much greater than in countries that have not experienced hyperinflation. The minutes of the Copom (Monetary Policy Committee) meeting released yesterday once again appropriately mention inflation inertia and warn indirectly about the dangers of indexing wages to inflation, such as in the case of the rule adopted for minimum wage increases ("*an important risk resides in the possibility of granting nominal wage increases that do not reflect productivity growth").* One should not fool around. It's better to keep the inflation zombie well and truly buried.