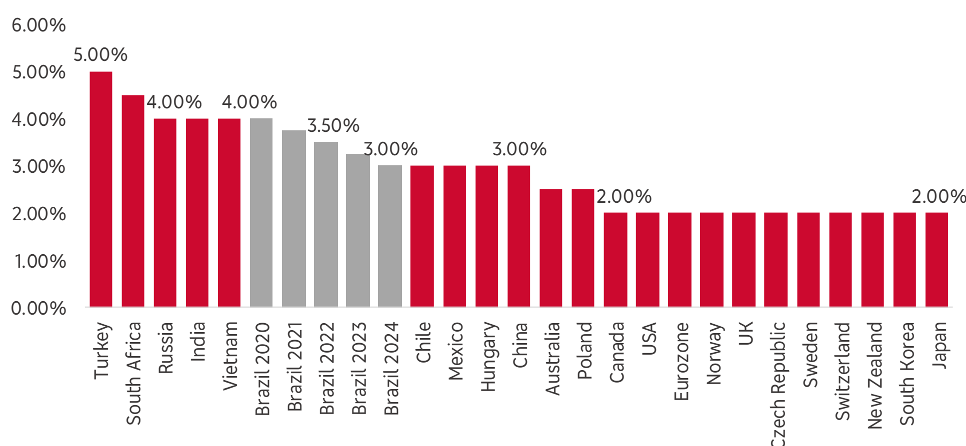
Inflation target and fiscal consolidation

Robson Rodrigues Pereira
Myriã Bast

In late July, the Brazilian National Monetary Council (CMN) announced a reduction in the 2024 inflation target, down from 3.25% to 3.0%. This decision comes as no surprise and continues the process of gradually converging the target to international standards. The 2024 target announcement brings our monetary policy goal closer to those of countries like Chile and Mexico, among others (Chart 1). Although one may argue about the sluggish speed of such convergence process, given that we adopted the inflation targets regime in 1999, this is undeniably a positive approach.

Chart 1: Inflation target in selected countries
Central target or midpoint of target range, in % per annum



Source: Bloomberg, BCB and Bradesco.

This convergence process prompts some questions regarding the country's fundamentals, vis-a-vis those seen in Brazil's peers. The inflation target is an important beacon to guide the expectations of economic agents, enhancing the monetary policy steering process. Moreover, there is a valid argument that inflation (and interest) converges as other macroeconomic variables converge towards international levels, in countries with lower macroeconomic volatility. In other words, there is some extra work to be done to ensure the price change target – nearing international levels – is accompanied by interest rates also close to the global standard. Inflation adjustment can be faster or slower depending on the economy's openness to global financial markets and trade. As shown in Table 1, some of the main fundamentals of Brazilian economy diverge from those seen in other countries with a current inflation target of 3.0%.

Despite the higher indebtedness of Brazil's public sector compared to its peers, the 2017 spending cap changed the perception of equilibrium inflation and interest, ultimately making changes to the inflation target more credible. Before this period, Brazil's inflation and interest (nominal and real) were above its peers' average. After adopting the spending cap, the country reached inflation and interest rates more compatible with those of its peers. In other words, the public indebtedness trend affects the scale of shocks and their effects on the economy in times of uncertainty. This point is relevant to consider the challenge of convergence at a time of combined shocks. However, the fiscal push limited by the spending cap seems to have been decisive to lower domestic interest and inflation rates.

Table 1: Selected economic indicators of countries with an inflation target of 3.0%.

	Average 2017-2019	Average 2020-2021	Average 2022-2024
Brazil			
GDP (%)	1.5	0.6	2.7
Debt-to-GDP (%)	74.4	85.3	83.9
Consumer inflation (%)	3.7	5.8	3.2
Short-term interest rate (%)	6.0	4.5	7.3
Current Account/GDP (%)	-2.4	-0.5	-0.2
Total Trade/GDP (%)	20.7	28.1	24.9
Chile			
GDP (%)	2.1	0.8	2.6
Debt-to-GDP (%)	25.8	33.1	39.2
Consumer inflation (%)	2.6	3.4	2.9
Short-term interest rate (%)	2.3	0.9	2.2
Current Account/GDP (%)	-3.3	0.6	-1.7
Total Trade/GDP (%)	48.0	53.8	61.6
Mexico			
GDP (%)	1.4	-1.1	2.2
Debt-to-GDP (%)	53.6	60.6	60.6
Consumer inflation (%)	4.8	4.1	3.6
Short-term interest rate (%)	7.6	5.0	4.6
Current Account/GDP (%)	-1.4	1.9	0.2
Corrente de Comércio/PIB (%)	72.9	74.5	75.4
China			
GDP (%)	6.5	5.7	5.0
Debt-to-GDP (%)	54.2	68.2	77.1
Consumer inflation (%)	2.6	1.5	2.3
Short-term interest rate (%)	3.0	2.3	2.6
Current Account/GDP (%)	0.8	2.3	2.4
Total Trade/GDP (%)	31.7	30.4	31.4
Hungary			
GDP (%)	4.8	0.4	3.5
Debt-to-GDP (%)	68.9	80.6	76.6
Consumer inflation (%)	3.0	3.3	3.1
Short-term interest rate (%)	0.2	0.8	1.7
Current Account/GDP (%)	0.7	0.2	-0.3
Total Trade/GDP (%)	131.8	130.4	121.8

In Brazil's case, fiscal data related to gross debt according to the Central Bank methodology and IMF's in other cases.

Source: EIU, Bradesco

Therefore, there is an ambiguous effect that distinguishes Brazilian economy from its peers. On the one hand, while advancing towards convergence and reducing the flow of public spending helps in this task, on the other hand, the level of indebtedness makes us more vulnerable to shocks, which could skewer inflation farther away from the center of the target. With an autonomous Central Bank, this matter becomes even more relevant. Inflation convergence towards the target is credible, but the question is whether it can be delivered with the same real interest rate of peers or if additional effort will be required to do so. Control over public spending, reforms on the productivity side, opening and flexibility of the economy all seem to be relevant to reach this goal.

The inflation target reduction comes at a particularly challenging moment for Brazil's monetary policy. Current inflation is rising, vastly influenced by mainly temporary factors, which tend to fade away over the next few quarters. While the Focus forecasts for 2024 are not far from the established target, implicit inflation for the same period has been rising. As shown in Table 2, the difference between implicit inflation for the next three hears and the announced target is of 1.14 percentage point – the highest deviation in the last three years (0.31 p.p. in 2019 and 0.57 p.p. in 2020). Such deviation could merely be a result of the current inflation dynamics, rather than questions regarding the target's future feasibility, given the strong historical correlation between current inflation and expectations.

Table 2: Current and expected inflation in moments of target setting in Brazil
Current expectations in mid June each year, around the time of the CMN's meeting to establish the target

Decision	jun/17	jun/17	jun/18	jun/19	jun/20	jun/21
Target Horizon	2019	2020	2021	2022	2023	2024
Target	4.25	4.00	3.75	3.50	3.25	3.00
12-month accumulated IPCA until June	3.00	3.00	4.39	3.37	2.13	8.35
Focus expectations for current year (year	3.64	4.33	3.88	3.84	1.60	5.83
Focus for year T+1	4.33	4.25	4.10	3.99	3.00	3.78
Focus for year T+2	4.25	4.25	4.00	3.75	3.50	3.25
Focus for year T+3	4.25	4.25	4.00	3.75	3.50	3.25
Implicit inflation for 1 year	5.65	5.65	5.89	3.73	3.57	4.07
Implicit inflation for 2 years	5.64	5.64	5.91	3.77	3.71	4.10
Implicit inflation for 3 years	5.63	5.63	5.92	3.81	3.82	4.14

Source: IBGE, Bloomberg, BCB, CMN, Bradesco.

In addition, the debate surrounding global inflation is intensifying, but still far from being over, including uncertainties regarding how long price pressures will remain present. Our current scenario is one of strong inflationary acceleration around the world, amidst a context of growing demand, limited supply in some segments, adverse climate shocks and unprecedented economic policy stimuli. In the short and medium term, there are two risk factors in this debate, an exogenous factor and an endogenous factor: (1) the evolution of the pandemic with new virus variants, and impacts on economic reopening processes; and (2) the magnitude and timeliness of reactions coming from the main central banks, particularly the Fed, amidst such pressures. Among emerging nations, there is already a cycle of stimuli reductions or at least adjustments in communications, earlier than expected a few months ago. This response to rising prices tends to mitigate risks related to the inertia of current inflation for subsequent years, as well as expectations. In each country, such mitigation tends to be greater directly proportionally to the greater complementarity (in the same direction) of the fiscal policy.

In general, it is our opinion that lowering the inflation target is a positive move, as part of the disinflation process started in the country in 1994 and institutionalized in 1999, with the inflation targets regime. According to the very definition of the inflation target regime, expectations of agents and effective inflation will converge towards the announced target in the absence of shocks, if the commitment of the monetary authority is credible and its communication is effective, which is the current case. The advance brought by the spending cap significantly broadened the likelihood of convergence towards these international standards, based on interest rates also similar to those seen among our peers. However, it is important to carry on the agenda of fiscal consolidation and reforms that boost the country's growth potential. These challenges tend to be even greater if: (i) the post-pandemic period is accompanied by more structural price pressures on a global scale; and/or (ii) in case of any abrupt and anticipated adjustments of interest rates in the world, leading to questions regarding the fiscal sustainability of more vulnerable countries or the effective level of balance of interest rates among developed and emerging nations.

Technical Staff

Director of Economic Research and Studies	Fernando Honorato Barbosa
Economists	Ana Beatriz Moreira dos Santos / Constantin Jancsó / Ederson Luiz Schumanski / Fabiana D'Atri/ Felipe Wajskop França / Myriã Tatiany Neves Bast / Priscila Pacheco Trigo / Renan Bassoli Diniz / Robson Rodrigues Pereira / Thiago Coraucci de Angelis
Interns	Bruna Andreata Valentino / Henrique Monteiro de Souza Rangel / Lorena Pires Sene / Lucas Daniel Duarte / Rafaela de Sousa Silva

economiaemdia.com.br

DEPEC – BRADESCO may not be held liable for any acts/decisions taken on the basis of the information available through its publications and projections. The information and opinions provided herein are carefully checked and prepared by fully qualified professionals, but should not be taken as a basis, support, guidance or standard for any document, assessment, judgment or decision of formal or informal nature, under any circumstances. Therefore, the user hereby undertakes sole responsibility for all consequences arising from the use of the data or analyses hereof, hereby exempting BRADESCO from all claims thereof. Upon accessing the information hereof, users hereby accept these terms of use and responsibility. Total or partial reproduction of this publication is strictly prohibited, except upon due authorization from Banco BRADESCO or full citation of the source (including the authors, the publication, and Banco BRADESCO).