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Uncertainties, economic policy, shocks and inflation

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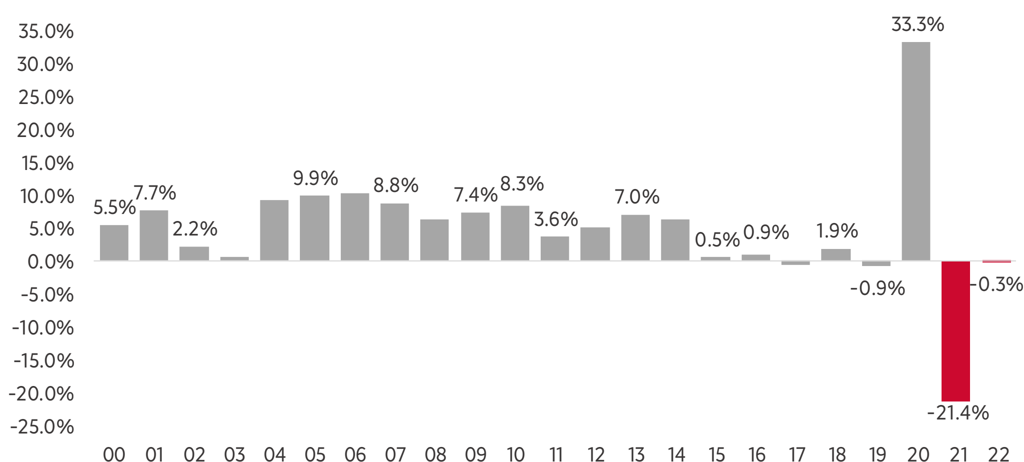
Brazilian inflation is a product of the interaction between economic policy and shocks of different natures. At the beginning of the pandemic, the retraction of the GDP produced a strong deceleration in prices, with accumulated inflation in the first six months at just 0.24%. The drop in the GDP in those months showed the clear role of the output gap and restrictions on price mobility.

In the effort to fight the pandemic, however, the economic policy became expansionist, with expenses that exceeded 10% of the GDP and unprecedented negative real interest rates at around -1.0%. Judging these actions today is easy, after all, no one knew the impact of the pandemic on the economy. But the uncertainty on the extent of Covid's damages, which surrounded policy decisions at the time, did not prevent the economic policy transmission channels from working perfectly.

Chart 1: Total federal government spending
Real annual change



* Expenses with transfer of rights were excluded.
Source: Treasury, Bradesco

Fiscal and monetary responses produced a rapid recovery of the economy to the pre-pandemic level and there were significant sectoral imbalances between supply and demand, given the size of the economic stimulus. Additionally, there was a strong exchange rate depreciation due to uncertainties regarding the dynamics of the public debt and the carry trade lost by the Brazilian currency. At least in the second case, the currency response is an expected result, conventional in terms of the transmission channel, of the chosen policy response.

In parallel to these policy choices, a series of shocks followed: commodity prices rose 40% in U.S. dollars; water risks led to an increase in electricity prices and global production chains suffered relevant stoppages due to excess demand for goods. For the same reasons, wholesale inflation is also breaking historical records. In the case of the consumer, these shocks found fertile ground for propagation due to the response adopted in the country and, to some extent, in the world. As a result, inflation rose in subsequent months and has been under pressure ever since.

But a reversal of this scenario is underway. Real interest is already at a level higher than the pre-pandemic period, when the GDP did not expand by more than 2% a year and which led to the first interest rate cut cycle of the current administration; the BRL recovered from its lows; the fiscal stimulus for the next 18 months will be significantly less than last year and there is a chance of stabilization, or even a drop, in commodity prices in U.S. dollars. Despite the economic resumption, unemployment remains higher than conventional NAIRU estimates, even assuming some productivity gain in the period, and the current account surplus, even discounting the effect of the rise in commodities, is another thermometer on the existence of some idleness in the economy.

Chart 2: Ex-ante real interest rate

Pre-DI Swap Deflated by Inflation Expectations 12 Months Ahead

Source: Bloomberg, BCB and Bradesco

Add to this the fact that the power of monetary policy has increased in recent years. There was a great densification of credit, both bank and capital markets; the para-fiscal policy is almost non-existent in Brazil today and the interest rates of government-controlled banks tend to follow the Selic more closely. There are also signs of a drop in the economy's neutral interest rate due to the spending cap, the pension reform, the Central Bank's autonomy in law and the credibility of the monetary authority itself.

In other words, there is no reason to doubt the effectiveness of monetary policy. The interest rate tightening currently underway will play its role in slowing the economy and bringing inflation down. If we abstract recent domestic uncertainties for a moment, disinflation would be a safe path over the next year. It's hard to see it at the height of price pressures, but no macro determinants suggest that inflation is out of control at this point.

Uncertainties, however, may divert inflation from this safe convergence path. What will inflation be in 2022 if the exchange rate is 15% more depreciated than its current level? Is there a chance for price setters to practice preventive readjustments, detached from the gap, to protect themselves from unknown scenarios? What if the U.S. 10-year rate rises, finding the domestic fiscal debate off course? What if the shock of global chains persists? What if power rationing is enforced? What will happen to the spending cap? The inflation dynamic itself is uncertain in an unprecedented context of reopening, in which permanent effects of changes in habits are mixed with changes in relative prices.

These uncertainties translate into higher inflation projections than would be suggested by the fundamentals, the Central Bank's models and the expected position of economic policy in the coming months. If this reasoning is correct, the deterioration of inflation expectations cannot be credited to the credibility of monetary policy, but to greater than usual uncertainty regarding prospective scenarios.

In this situation – given the intensity and multiplicity of shocks and uncertainties – the flexibility of the targeting regime should be used, focusing on the secondary effects of the shocks. Eventually, there will be no reasonable interest rate – in the sense of avoiding an overkill of economic activity – capable of bringing expectations to the center of the target, under these circumstances. In other words, given the myriad of doubts surrounding the 2022 economic scenario, the cost of converging inflation expectations to the center of the target may be prohibitive. This does not mean that the Central Bank will stand pat, but it does impact how much it will want to interfere and how far above neutral the interest rate it should be positioned, at least until the uncertainties translate into its base case scenario.

One caveat must be made: the longer the fiscal uncertainty lasts, the lower the chances of inflation converging to the target next year given the deterioration of the economic scenario, even before a decision is made on whether there will be changes to the tax regime. The fiscal responses needed to support this inflation convergence are urgent and feasible within a framework that is close to the current regime. The whole point of the spending cap has always been to force the country to make public policy choices. And this is one of these crucial moments, but the spending cap remains in force – at least for now.

Since monetary policy tends to lag behind significantly, the same effect of negative real interest that produced currency depreciation, economic growth and price acceleration will produce the opposite effects as the currency appreciates. Especially if the fiscal impulse proves to be limited, despite the noises that generate exchange rate depreciation and make ex-ante inflation convergence more uncertain.

As always, steering monetary policy is an art, particularly given the unprecedented nature of the pandemic. We'll only find out the answers ex-post. Coordination between fiscal and monetary policy will be the most powerful tool to prevent the dominant economic discussions of 2022 from contracting activity and the risks of fiscal dominance, which would certainly add to next year's menu of uncertainties.

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