MONETARY POLICY
The interest rate roller coaster

Claudio Accioli, *Rio de Janeiro*

DEFENSE OF THE EXCHANGE RATE, the need to attract foreign capital, foreign crises, inflation control – these are all reasons that have been invoked to justify a policy of high interest rates. For decades, Brazil had the highest interest rates in the world. This changed only recently, in August 2011, when the Central Bank, contrary to market expectations and without ever signaling its intention, reversed the monetary tightening that had begun in January, when President Rousseff took office. Since then, the central bank's policy interest rate, which had risen to 12.5% in July 2011, has come all the way down to 7.25% today—the lowest level since the 4.5% recorded in March 1999.

"When the central bank began that move in August last year, I spoke publicly against it, but I was wrong. The policy rate fell 525 basis points and the world has not ended. Inflation did not explode," says Samuel Pessôa, consultant to IBRE/FGV.

Briefly reviewing the history of interest rates in Brazil, Pessôa notes that immediately after the Real Plan that stabilized the economy during the Itamar Franco and Fernando Henrique Cardoso administrations (1994–98), the government focused on building institutions and on constitutional changes, achieving price stability, privatizing state-owned corporations, establishing regulatory agencies, renegotiating the debts of state banks and restructuring the financial system. But this was also a period of fiscal imprudence that led to increased government borrowing, though that was necessary to prevent capital flight and to mitigate the terms of trade losses Brazil suffered in the aftermath of the Mexican and Russian crises.

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SAMUEL PESSÔA

PRICE OF STABILIZATION

"Facing this situation required a policy of very high interest rates. That was the price that had to be paid to stabilize the economy in an adverse environment with a history of hyperinflation, defaults on public debt, and a series of unsuccessful stabilization programs.

It was the anchor that allowed government to put the house in order. It left a negative inheritance, high public debt; but it also left a positive one, a better institutional framework," Pessôa emphasizes.

During the Cardoso administration, interest rates remained high to compensate foreign investors for relatively high country risk: "We suffered the effects of past errors and not-so-promising prospects," Pessôa explains. "The situation only began to improve when we adopted the current macroeconomic framework: floating exchange rates, high primary budget surpluses, and inflation targeting." Floating the exchange rate brought about a significant devaluation that helped to eliminate the external current account deficit: the current account deficit of about 4% of GDP in 1998 turned into a surplus of 2% in 2000 and 2001 without unemployment and deep recession.

The new monetary policy was tested during the transition from the Cardoso administration to that of leftist Luiz Inácio Lula da Silva. The central bank policy rate rose from 18% a year in July 2002 to 25% in December because of uncertainty about the new administration. "When it became clear that we had an elected leftist administration that was fiscally responsible and committed to respecting contracts, country risk plummeted," Pessôa explains. "However, interest rates remained high due to the strong increase in consumption demand generated by the policies of the Lula administration to improve income distribution, reduce inequality, and increase the purchasing power of the lower classes, supported by credit expansion."

OVERSIGHTS

These policies, according to Pessôa, had the merit of accelerating social change and opening up access to consumer goods for Brazilians in poorer classes. However, the Lula administration neglected public goods, leaving as a legacy rundown infrastructure and low-quality public services that retard growth. In the specific case of interest, this problem eventually led to the solution adopted by the Rousseff administration. "What led to the dramatic fall in policy interest rate in recent months has been the combination of two factors: the worsening of the international outlook, which should result in very low interest rates for longer than previously thought [possible] in major economies, and six quarters of negative growth in investments in Brazil. If the Brazilian economy resumes growth and investment recovers, interest rates will increase again," said Pessôa.

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Silvia Matos, coordinator of the IBRE Economic Outlook, believes that "the challenge today is to maintain growth with controlled inflation and low interest rates. During the Lula administration, although the interest rate was higher, monetary policy achieved a better balance between these variables." Matos attributes current difficulties to an economic stabilization that was not completed. "Our real interest rates are effectively converging to international levels, but in a distorted way. Chile, for example has a real interest rate of 2%, the difference between a nominal interest rate of 5% and inflation of 3%. Brazil's real interest rate is close to 2%, but it is the difference between a nominal interest of 7.25% and inflation above 5%. Our situation is worse," Matos says. "When inflation does not approach the official target of 4.5% a year or even fall below it, we cannot say that our stabilization process is 100% complete."

Pessôa believes that if the choice is between growth and inflation the central bank will not hesitate: "President Rousseff has committed herself politically to a reduced policy rate and will resort to all available instruments to fulfill it in the coming years. The central bank will accept higher inflation to keep interest rates lower. Any inflation below the target ceiling of 6.5% would be acceptable. I hope the government seizes this moment to permanently reduce the cost of rolling over public debt."

Matos agrees. She adds that resolution of the puzzle of balancing growth, inflation, the interest rate, and the exchange rate exceeds the central bank's responsibilities and power: "The central bank has cut interest rates and tried to maintain a more favorable exchange rate to help industry, even sacrificing a bit of its own credibility with regard to curbing inflation, yet economic growth has not resumed, because the current consumption model is exhausted. You need to change the development strategy, prioritizing investments in infrastructure, increasing productivity, adopting microeconomic policies that improve the efficiency of markets, and clearly defining the roles of government and private enterprise."

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