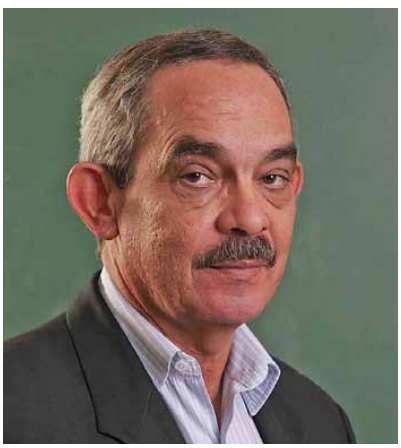
The Central Bank under Lula



Fernando de Holanda Barbosa

The Central Bank of Brazil[1] during the Lula administration did a good job in controlling inflation, complying strictly with inflation targets set by the National Monetary Council (CMN). Its reserves policy, on the other hand, has produced an accumulation of reserves that is not justifiable for a country with a flexible exchange rate system. The social cost of maintaining large international reserves is incompatible with the needs of a still large poor population. Nor has the Central Bank performed satisfactorily as a regulator of the financial system; it should create a committee to take over this function. Finally, the Central Bank has done well as the lender of last resort. It acted promptly and created the necessary domestic liquidity in 2008 to prevent a spillover of the international financial crisis onto Brazil.

Inflation under control

Since 1999 the CMN has set the inflation target. Its members are the President of the Central Bank, the Minister of Planning, and the Minister of Finance, who presides. The Central Bank since the Real Plan[2] has had in effect operational independence to implement monetary policy, even though it does not have

Annual inflation targets (%)

	Target range	Actual inflation
2003	2 - 6	9.30
2004	3.5 - 7.5	7.60
2005	2.5 - 6.5	5.70
2006	2.5 - 6.5	3.14
2007	2.5 - 6.5	3.14
2008	2.5 - 6.5	5.90
2009	2.5 - 6.5	4.31
2010	2.5 - 6.5	5.80*

*Projection.

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such independence statutorily. In the Lula government, when he accepted the job Central Bank governor Henrique Meirelles obtained the "closed gate," which gave him freedom to choose, without political interference, all Central Bank board members.

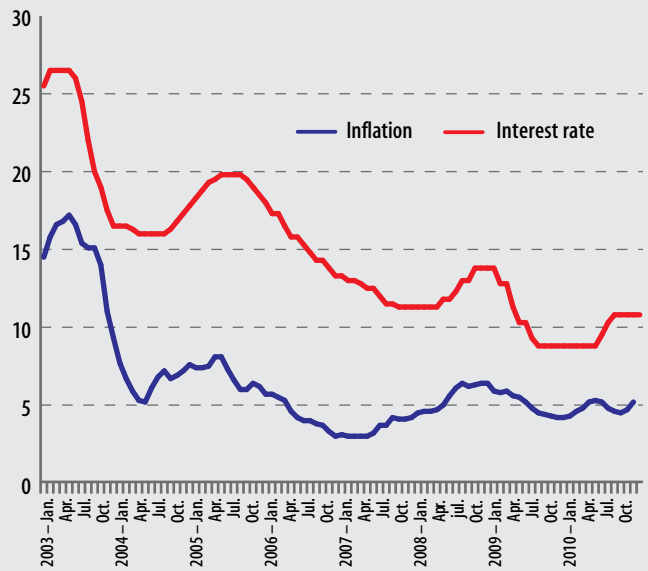
In 2003 the Central Bank was not able to meet the CMN inflation target because of "the Lula effect." Much of Brazilian society thought that the victory of the Worker's Party candidate in the 2002 election meant that default on the public debt was quite possible. The resulting capital flight depreciated the exchange rate substantially, increasing the prices of goods and services. Much of the population also believed that the Central Bank under Lula would not use interest rates to contain inflation. As inflation expectations increased, inflation threatened to jump. The Lula administration had to deal with these public perceptions in its first year, so it increased both the interest rate and the fiscal primary surplus (fiscal deficit less interest payments).

Since 2004 the Central Bank has fully complied with the CMN inflation targets. In 2006, 2007, and 2009 inflation was below or near the center of the band, and in the other years, it was slightly above the center.

The criticism that the Central Bank blundered by increasing the interest rate excessively is unfounded. If this were the case, the rate of inflation would have been systematically below the center of the target. That did not happen. Indeed, the data suggest otherwise: in the eight years of the Lula government, inflation was above the center of the target range in five.

Monetary policy during the Lula government can be divided into four cycles. The first began in January 2003 and ran through April 2004. At that cycle, to rein in inflation the benchmark interest rate peaked at 26.5% early on and had begun to fall by June 2003. An interest rate of 16% is the lowest in this cycle. The second cycle, the longest, began in November 2004 and ended in April 2008. During it the interest rate peaked at 19.75% and the trough was 11.25%. The third cycle began in April 2008, when the COPOM

Inflation versus Central Bank benchmark interest rate



increased the benchmark rate to 11.75%, and ended in March 2010, when the annualized interest rate was down to 8.75%. During this cycle, the benchmark rate peaked at 13.75%. In January 2009 COPOM reduced the rate by 100 basis points, setting it at 12.75% to counter the threat of the international financial crisis, and continued to reduce the rate down to 8.75%. The fourth, a tightening cycle, started in March 2010 when the benchmark rate increased to 9.50% and ended the year at 10.75%. This last cycle is unfinished. The benchmark rate will certainly increase in coming months to curb inflation

It appears from these cycles that the Central Bank was not able to fine-tune a soft landing. After each monetary policy tightening cycle, the Central Bank would try cutting interest rates gradually, only to have to raise them again abruptly.

It is also noticeable that the difference between interest rates at the peak of a cycle and at the trough has become smaller. This corresponds to a reduction in the economy's natural rate of interest, which was extremely high at the beginning of the Lula government but has been falling since. The reduction is associated with the falling rate of interest on public debt in Brazil. Rates fell for two reasons: The first was President Lula's decision to honor contracts and pay the public debt. As a result, Brazil's sovereign risk fell substantially. The second was that interest rates on its public debt also dropped because of excess global liquidity.

The Central Bank benchmark interest rate is contaminated by the rate on Brazilian public debt because Treasury bills are indexed to the benchmark rate. Arbitrage in financial markets implies that the interest rate in the interbank market for reserves, the benchmark rate, would be equal to the interest rate on government securities. This creates a bizarre situation: short-term liquidity in Brazil is remunerated at the same rate of interest as long-term bonds. The Central Bank during the Lula administration ignored this fact; as a result Brazil still has the highest short-term interest rates in the world.

The real reason for the accumulation of large international reserves since 2006 was to prevent the exchange rate from appreciating.

Inflated International reserves?

The Central Bank in 2006 changed its policy and began to accumulate international reserves. In a pure flexible exchange rate regime, central banks do not intervene, leaving the market to set the price of currency. In practice, the flexible exchange rate regime is "dirty" floating — central banks do intervene. Why? For several reasons: A central bank may act to reduce foreign exchange market volatility. Or, because the foreign exchange market is an asset market, the central bank intervenes every time it believes there is a destabilizing asset price bubble. Or the central bank may accumulate reserves in case an international financial crisis stops the flow of credit to the country, causing an abrupt change and a deep devaluation of the exchange rate.

The Central Bank created liquidity tools that nipped the crisis in the bud and kept the problems of the international crisis out of Brazil.

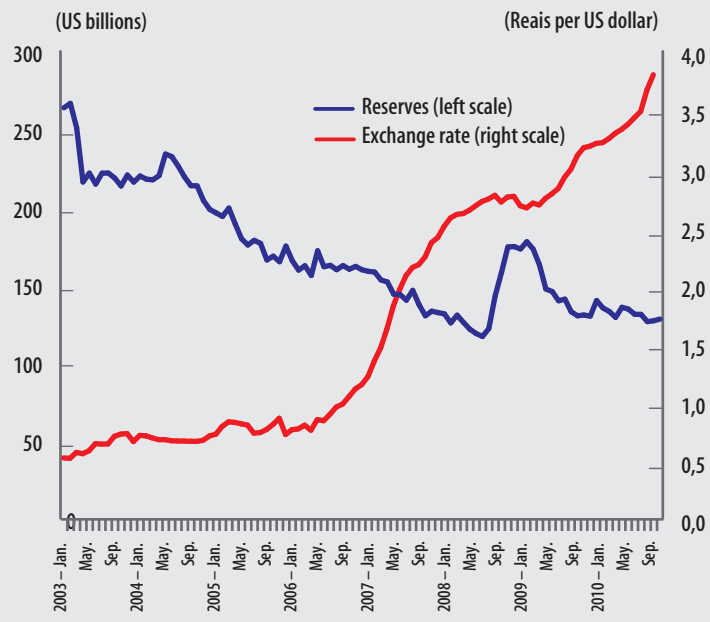
Accumulating reserves has a cost. Sterilization of reserves requires that funding in the national currency (*reais*) at the benchmark interest rate, while remuneration of international reserves is close to zero because reserves are invested in foreign short-term securities with very low yields. Those who advocate a policy of large international reserves argue that reserves are insurance against crisis and the cost is simply an insurance premium (even though estimates suggest that the price of this insurance is excessive). Advocates also argue that the 2008 financial crisis showed that international reserves were essential to reducing the international financial crisis tsunami to a ripple in Brazil. The numbers do not support this argument either, because at that time Brazil used only a fraction of its reserves.

The real reason for the accumulation of large international reserves since 2006 was to prevent the exchange rate from appreciating. Officially, the Central Bank does not interfere in the market. In practice, the policy of accumulating reserves was intended to prevent appreciation of the *real*. To what extent did the Central Bank prevent a much greater appreciation than the one that took place? That is a difficult question to answer. However, if the intent is to prevent appreciation of the exchange rate, why not use fiscal policy?

Financial system regulation

The Central Bank is the regulator of the financial system. In other countries, the institutional arrangement is different. For example, the European Central Bank is not responsible for regulating the financial system. Why should we regulate the financial system? Economic theory of information has advanced greatly in recent decades, and has been studying the problems posed by asymmetric information: the accountholder is the last to know. The bank knows

Exchange rate and international reserves



what it is doing with your money, but you usually do not. A central bank has to issue rules and procedures that discourage practices detrimental to the social interest. Moreover, the entry of new firms into the banking sector is not free; it must be authorized by the central bank. Barriers to entry give existing financial institutions market power to increase lending interest rates and keep deposit interest rates low and charge exorbitant fees.

In the Lula administration, several banking mergers and acquisitions took place that increased concentration in the sector. Here, the Central Bank as regulator of the financial system has let us down: banking services are expensive, and banking spreads are large. Brazil may even be the world champion in banking spreads.

Lender of last resort

Central banks are vital in any financial crisis. They are the lenders of last resort, preventing an institution that has funding difficulties from becoming insolvent and contaminating other institutions in the system. The financial crisis triggered in 2008 in the U.S. by the market for subprime mortgages showed that this function has much wider scope than it had in the past; even quasi-financial institutions received central bank bailouts. Otherwise, a major recession might have become a depression.

Here in Brazil, during the international crisis some small and medium banks had difficulties accessing external credit lines to finance their operations. If the Central Bank had not helped, they would have had to sell assets for very low prices, making the situation worse. This did not happen because the Central Bank created liquidity tools that nipped the crisis in the bud and kept the problems of the international crisis out of Brazil.

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[1] The Central Bank of Brazil, according to Law 4595 of December 31,1964, and subsequent legislation: (i) implements monetary policy; (ii) formulates and executes international reserves policy and manages reserves; (iii) is lender of last resort for the financial system during liquidity crises; (iv) regulates and supervises the financial system; (v) manage and oversees the system of government payments; and (vi) acts as a bank for the government.

[2] The Real Plan was a set of measures that successfully stabilized the Brazilian economy and brought inflation under control in 1994, under then Finance Minister (later President) Fernando Henrique Cardoso. On July 1, 1994, it introduced a new currency, the *real*, and enacted a number of fiscal and monetary measures, increasing tax revenues, restricting public expenditures, and raising interest rates.