The interest base rate: How low can it fall?

Alberto Furuguem

During the March 10th meeting of its Monetary Policy Committee (COPOM), the central bank reduced its annual policy interest rate from 12.75% to 11.25%. According to the press, on the eve of the COPOM meeting President Lula is said to have summoned Governor of the Central Bank Henrique Meirelles and Finance Minister Guido Mantega to the Presidential Palace to tell them that a reduction of 1.5 percent points of the policy rate would be the minimum acceptable.

Whether or not this political pressure was actually applied, the fact is that the COPOM could have had good reason to perform a more modest cut of the policy rate because inflation as measured by the National Statistics Bureau (IBGE) was about 6% (that is, at the upper target limit) for the 12-month period closing in February. The COPOM could have thus justifiably acted more conservatively at its March meeting. On the other hand, there is nothing wrong with the decision to reduce the base rate by 1.5 points in a completely abnormal period for the world economy, and for Brazil. Central bank real policy interest rates are negative in most developed economies and close to zero in most emerging countries. Yet inflation is falling in the face of the recession, triggering fears less of inflation than of deflation, which could lead to a depression.

Even though the COPOM cut the policy interest rate significantly in March, the usual criticism was heard from the business community, which advocated an even more dramatic cut; criticism was also voiced by politicians, among others the Governor of São Paulo, José Serra, for whom the measure came "better extremely late than never." Some economists claimed that there was room for an even bigger reduction. What the critics almost always underscored was that, in spite of the significant March rate cut, the real policy interest rate (policy rate less inflation) in Brazil is still the highest on the planet: 6.5% yearly.

Flawed idea

The idea that Brazil has the highest interest rates in the world tends to lead some to believe that interest rates here are "wrong." They truly believe that interest rates could be much lower were it not for the central bank's stubbornness (this is the recognized opinion of Vice President José Alencar). What most fail to take into account is that Brazil has found it much tougher to bring down inflation than most other countries. Despite high interest rates, inflation in Brazil is moving only very sluggishly toward the targets set for it.

It happens that because Brazil has adopted inflation targeting, the central bank has institutional responsibility for meeting the target (IBGE's IPCA price index) the government sets. With a central inflation target for 2009 of 4.5% and 12-month inflation at 6% in February, the COPOM under normal circumstances could have reason not to speed up the reduction in interest rates, though in the end it happened, apparently (but not necessarily) in response to pressure from the president and a large segment of public opinion.

In this critical phase for the world economy, characterized by widespread recession, Governor Meirelles himself could have considered it fit and prudent to adopt a less conservative stance. It was quite plausible to expect that a reduction of 1.5 percentage points would jeopardize neither inflation control nor attainment of the inflation target for 2009, especially because the world recession may in fact lead inflation to fall in most developed and emerging countries, including Brazil.

It seems only fair to point out that it is generally comfortable for those outside the central bank to claim that the rates may fall without jeopardizing inflation control. Just about everyone wants both low interest rates and controlled inflation, but the central bank alone must meet the inflation target. For a central bank director, a more daring reduction in interest rates would only be comfortable if inflation were below the target. It is not; rather, it is well above it. For that reason the accelerated interest rate cut in March may not have been a comfortable decision for the central bank directors, even though they approved it by consensus.

While it is true that real interest rates in Brazil are the highest in the world, it is also true that Brazilian inflation has been relatively harder to curb. Considering interest rates for the last 15 years, inflation under normal conditions should be closer to zero than to 6%, and GDP growth should have been negative long before the outset of the international financial crisis.

Persistent inflation

Thus, the obligatory question is: Why does inflation persist in Brazil in spite of high interest rates? In other words, why has inflation in Brazil not dropped as rapidly, in response to falling international commodity prices, as it has in other countries?

There are a few easily identified factors that help explain why inflation resists falling in Brazil: The most obvious is the price indexation (even after the de-indexation introduced by the Real Plan) caused by contractual (telephone, energy, road tolls); cultural (rent, private contracts in general, wages); and political (real increase in minimum wages, tax increases, etc.) factors. In most other countries, prices are usually more flexible downward. Because they are not flexible in Brazil, the central bank tends to be relatively more demanding about meeting the inflation target because it is more difficult to curb inflation once it rises.

Fiscal policy is of little help most of the time. Both current public expenditure and the tax burden have risen significantly

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over the past 15 years. The political decisions surrounding the minimum wage helped increase the pressure on business costs and public spending. We are not discussing the merit of the policy of increasing the real minimum wage, which, with inflation controlled, has been a major factor in increasing the real earnings of the poor and has helped promote the highly desirable reduction of social inequality. However, the resulting increase in public spending is a given for monetary policy makers. For society, then, the bill comes in the form of a more restrictive monetary policy to keep inflation within desirable limits.

It is also a fact that in Brazil — as in most other countries — almost the only tool available to fight inflation has been setting central bank policy interest rates. In Brazil, the need to raise interest rates to meet inflation targets has been a harsh reality, based on the evidence of inflation patterns rather than on the whims of central bank management.

Would it really happen that even under very strong pressure to push interest rates down, the central bank would

keep the rates high simply because it so wished? That makes no sense whatsoever. The central bank has a mission (to meet inflation targets) and must deal with the variables — indexation, inflationary culture, increase in public spending, tax hikes, minimum wage increase, etc. — as they are given.

Unique to Brazil

Though the high interest rates have been necessary to keep inflation to the levels defined by the government, they did not prevent GDP growth of 5% in 2008. That is, by the way, a peculiarity of the Brazilian economy in recent years: the economy grows despite such high interest rates. There might be a justifiable argument that lower interest rates might have promoted higher growth. Of course, inflation might have also been much higher. The government, correctly in our opinion, has not consented to higher inflation.

It thus seems neither fair nor correct to assign Brazilian monetary policy any responsibility for the current recession. The major cause of recession since the last quarter of 2008 is the world recession. That is obvious.

As long as the world recession deepens and drags on, inflation should continue falling in Brazil, as elsewhere. The fall in interest rates, which elsewhere are close to nominal zero, and even negative in most cases, has not managed to foster a speedy recovery. In Brazil both nominal and real interest rates may continue declining as long as inflation also falls.

Abroad, interest rates are far below the equilibrium rate, but that problem for Brazil cannot be addressed until the current recession is over. Fiscal deficits may also reach astronomical levels in 2009 in most developed countries, according to projections by *The Economist*: 11.1% of GDP in the US, 5.4% in Japan, 11.3% in the United Kingdom, and 4.6% in the euro zone. Again, this is a problem to be solved later. The urgent task now is to deal with the economic crisis.

The real interest rate in Brazil, although still very high compared with rates internationally, may already be below the equilibrium rate, according to some economists. If inflation continues to fall to the central inflation target of 4.5%, there is no reason for the Brazilian central bank to cut its base rate like other central banks. Interest rates may fall temporarily to levels below what would be considered sustainable equilibrium. When the world economy recovers, interest rates will return to equilibrium both in Brazil and abroad.

Equilibrium

Measures to reduce the feedback of past inflation into current inflation could indeed help to bring the real equilibrium interest rate toward more normal international levels. Negotiated de-indexation of contracts (in effect in the privatized utility sector) could be a great help. Abandoning the inflationary culture will take longer — a large number of Brazilians still have indexation in their minds as a consequence of long years of high inflation and widespread indexation of the economy. The proposal to reduce taxes on financial transactions could also help to reduce the interest rates paid by borrowers.

We must consider, in conclusion, that positive and relatively high real interest rates and a solid financial system could represent a trump card for the Brazilian economy in times of international crisis. Brazil might be seen as an attractive destination for international financial investment. In this case, higher external current account deficits would be easier to finance. In a world where capital is scarce and credit more restricted, that would be an advantage not to be ignored. However, Brazil as a preferential destination for foreign investors is a conjecture yet to be validated. So far, what we have seen is money running toward the epicenter of the crisis, the US. Even though the interest on US Treasury bonds is very low, they are still regarded as the least risky investment option. ■

Economist and business consultant