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# Implementing Inflation Targeting in Brazil: An Institutional Analysis<sup>1</sup>

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## 1. Introduction

What are the possible advantages and handicaps of implementing an inflation target (IT) regime? This paper aims to contribute to this debate and, in doing so it takes on a Post-Keynesian and, thus, an institutional stance. It is Post-Keynesian as long as it does not perceive any benefit in the mainstream split between monetary and fiscal policies (Keynes, 1936). And it is institutional insofar as it assumes that there are several ways of implementing a policy, such that the chosen one is determined by historical factors, as it will be illustrated by the Brazilian case.

As a matter of fact, we could even support IT policies if their targets were seen just as “focusing devices” guiding economic policy, notwithstanding other targets, as, chiefly – in the short run – output growth and employment and – in the long run – technology and human development (Wray, 1998; Bibow, 2005). Nevertheless, we must underline that an inflation target is not necessary, *although it can be admitted*, mainly if that target is kept hidden from the public, in order to increase the flexibility of the Central Bank (CB). For, in that case, the CB has no obligation to achieve any previously publicized target.

In such an example, we would have an implicit target, as some authors say is the current institutionality followed by the Federal Reserve (FED-USA). That does not mean that the FED could not be more flexible or more growth biased when implementing its monetary policies. But only that the FED is more flexible to attain its several aims if those inflation targets are not made explicit (Bibow, 2005; Johnson, 2005).

In that sense, it is important to highlight that currently it is still not possible to determine if countries which follow an IT have lower inflation *and* output variability than those which do not (Bernanke *et al.*, 1999:6-7). However, some economists, even Post-Keynesians and/or heterodox economists (Arestis *et al.*, 2002; Bibow, 2005), try to demonstrate empirically that IT can provide better results than other sets of policies, for instance, in terms of inflation volatility reduction and output-gap fluctuations, despite some opposing data and opinions (Muscatelli *et al.*, 2002). Mishkin and Schmidt-Hebbel (2002:182-3) affirm that IT helps countries to achieve lower inflation rates than they would in the absence of this regime, in spite of not yielding inflation below the rates of developed

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countries (DCs) which did not opt for IT; produces stronger capabilities to stand shocks; and reduces inflation persistence, turning expectations and policy making more forward looking and weakening the weight of the past (Vega and Winkelried, 2005:12).

Be as it may, in our view, it is essential that the policies chosen and the corresponding institutional framework must be flexible enough to achieve or approximate full employment, as well as look for low inflation rates (Svensson, 2005). This is why it is also important to stress the different possibilities concerning IT regimes and their institutionality. Such possibilities show us the extreme relevance of studying and understanding the impact of IT on the behavior and performance of economies. Moreover, in most of the IT debate there is a neglect of the relevance of institutional and historical roots for the design of policies *in real cases*.

We will deal theoretically and empirically with this disregard when presenting some of the main characteristics of IT implementation in Brazil. Just to mention what may be the most important aspect, we underscore the high interest rates *long before and after IT implementation*, in an example of predominance of financial interests producing the highest real interest rates in the world for a long time. Therefore, very ambitious inflation targets seem to be not adequate to a still quite indexed economy (chiefly when considered privatized utilities prices; Fraga *et al.*, 2003), with very liquid financial assets (mainly public debt), fiscal dominance (Blanchard, 2004) and liable to Balance of Payments (BP) shocks. This implies in a pernicious bias toward a mix of very high interest rates (to achieve the inflation targets and to manage some of the BP problems), huge public debt and its service costs, with little attention to this fiscal dominance and to the possibility of a more coordinated procedure among fiscal and monetary authorities.

In this paper, institutions are defined as rules and patterns of behavior or interaction among people verified in one (or part of a) society, rules and patterns which must acquire some stability, i.e., need to be repeated, even for a short time span. That is to say, institutions set up and restrict the choices of individuals – together with some ways of rewarding and with sanctions against deviating behavior – tightening what is socially recognized or considered acceptable and/or rational (Strachman and Vasconcelos, 2001). This does not mean that these individuals must be conscious of these norms and rules or of their meaning or function (Elster, 1989:99; Runde *et al.*, 2005).

The paper is structured as following. In Section 2, we consider the main aspects of IT regimes, their rationality and the evidence supporting (or not) the preference for this kind of regimes. Section 3 explains the main rationale underpinning the adoption of IT in Brazil, and

its specific institutional framework. In Section 4, we present some consequences for these choices. And in Section 5, we conclude briefly.

## 2. The Main Aspects of IT Regimes

In spite of remarks of many (monetary) policy-makers, e.g. Bernanke *et al.* (1999:ix), that “monetary policy is notoriously an art rather than a science...”, many practitioners insist to be excessively rigid in their prescriptions and in the policies which they follow (Greenspan, 2004). Would that be because of a flaw of the theories – “more art than science”– would demand strictness for some authors and/or practitioners, since one might try to equalize strictness to the pretense to be or seem scientific as a result of a feeble science? Or would that be a consequence of the general (institutional) environment in which these policies are implemented, with some environments requiring much more stringency than others? And in the specific case of IT, why do some countries try to achieve very low inflation rates despite many obstacles and lots of “market imperfections”, making this pursuit a serious hindrance to economic growth and development? We should always keep in mind that the very commonsensical trade-off between inflation and growth is just not always true (Chick, 1983:339; Bibow, 2005). In this paper, we will try to give some hints for these questions. However, we will focus in the analysis of IT regimes, *not in monetary policy in general*, for this would be beyond the scope of this paper. First, we need to know what IT is.

“Inflation targeting is a framework for monetary policy characterized by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons, and by explicit acknowledgement that low, stable inflation is monetary policy’s primary long-run goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of the monetary authorities, and, in many cases, mechanisms that strengthen the central bank’s accountability for attaining those objectives” (Bernanke *et al.*, 1999:4; see also Svensson, 2005:1). However, these same important supporters of IT regimes stress that IT is a *framework* not a *rule* for monetary policy, meaning that IT gives leeway to *constrained discretion*, in contrast with immutable rules (Bernanke *et al.*, 1999:5-6; Greenspan, 2004). *Constrained discretion* shall be understood as “*a conceptual structure and its inherent discipline on the central bank, but without eliminating all flexibility, [thus] inflation targeting combines some of the advantages traditionally ascribed to rules with those ascribed to discretion*” (Bernanke *et al.*, 1999:6, emphases in the original).

Mishkin and Schmidt-Hebbel (2002:174) state that “full-fledged inflation targeting is based on five pillars: absence of other nominal anchors, an institutional commitment to price stability, absence of fiscal dominance, policy instrument independence, and policy transparency and accountability. *While the second through the fifth of these pillars are necessary for effective conduct of monetary policy under any regime, they are particularly important prerequisites for effective policy under inflation targeting*” (our emphases). For Mahadeva and Sterne (2002:624, n.12) other definitions of IT also underline the absence of other explicit targets. Nevertheless, Svensson (2005:1-3) includes at least an explicit concern with output stability and growth besides the more obvious one with a low and stable inflation, as well as explicit decisions over *projections of target variables* (“forecast targeting”) and the *instrument rate* (the short nominal interest rate) to reach those targets.

The rationale supporting IT regimes rests on three main arguments: 1) economists and policy-makers are nowadays less confident in the capability of monetary policy (and economic policy, as a whole) to soften short run fluctuations in the economy without bad effects in the long run, except in cases of huge oscillations. Therefore, when monetary policy-makers determine that a low inflation rate is their main goal they would just be accepting the reality of what monetary policy can or cannot do, according to mainstream; 2) there is now *almost* a consensus that even moderate inflation rates can be very harmful to economic growth and efficiency, and, consequently, that low and stable rates of inflation are important for attaining other economic aims, in addition to being a prerequisite for an economic growth commanded by the private sector (a market-driven growth; Arestis *et al.*, 2002:528); and 3) IT would propitiate a simpler framework for the policy-makers to communicate their intentions and measures with the public as well as to provide “some degree of accountability and discipline on the central bank and on the government itself” (Bernanke *et al.*, 1999:10).

An IT would then serve as a nominal anchor for monetary policy. For example, it would consider only secondarily goals other than short run inflation stabilization, even in Svensson’s (2005) definition, and thus the policy-makers would need to present “consistency and rationality... that they might not otherwise exhibit” (Bernanke *et al.*, 1999:11). Moreover, IT can convey *transparency* and also *flexibility* to the general public (Svensson, 2005:1-2,15-7,20). A main issue is, of course, to combine these two characteristics of economic policies which are most of the time contradictory, since the most transparent policies are by and large non-contingent, in the sense that a sudden need to change policies because of a demand or supply shock must lead to precise and previously specified actions and be clearly transmitted to the public. On the other hand, flexibility requires that the CB ought to devise good

measures to respond to some unforeseen events (Bernanke *et al.*, 1999:26-7; Greenspan, 2004), i.e., transparency relates mainly with how to treat *ex-ante* events, while flexibility concerns how to respond wisely *ex-post* to these same occurrences.

We can append two comments to these three arguments: a) why should monetary or economic policy be constricted to the short run with no results in the long term? Why accept the Friedmanian statement that Phillips curve has an upward slope in the short run, but is vertical in the long run at NAIRU, or at a similar supply-side concept, as, for example, the output gap (Bernanke *et al.*, 1999:13-4; Kriesler and Lavoie, 2004)? For if inflation is harmful in the short run but meaningless in the long run, why would a policy-maker bother with policy-making, since in the long run everything would reach its natural equilibrium, even the growth rate? But which are these natural rates? Those, for instance, of Brazil, a little more than a 2% annual average economic growth rate, over a decade of low inflation rates or even considering the last 25 years, or *circa* 7% in the 50 years from 1930 to 1980? Or those of China, something close to an average annual growth of 9 to 10% over the same period, depending on the data source? Does these data not make clear that the long run may be the result of successive “short runs”?

We know, of course, the deleterious effects of high inflation rates whether on the short or long runs.<sup>2</sup> But these do not take us “naturally” to the totally opposite position, that any inflation rate, even low, is harmful and should be controlled with relentless effort, even that of permanent low economic growth and development. Indeed, what seems to be undeniable is the current death of the commitment, mainly by the mainstream, with full employment, although there is still a commitment, at least by some authors, with a satisfactory rate of employment (Greenspan, 2004). As asserted by Bernanke *et al.* (1999:16): “[t]o forestall confusion: Our criticisms of ‘policy activism’ does not imply that policy-makers should be reluctant to move the policy levers, but rather that doing so in an attempt to maintain continuous full employment is likely to be counterproductive. Indeed, a focus on price stability, as implied by the inflation-targeting approach, may require active manipulation of monetary policy instruments.” Furthermore, economic policies at large, including monetary policies, have important effects on output and employment, *both in the short and long runs*; potential output is not directly observable, making impossible any rather precise determination of the output gap; investment and the ensuing variation of the capacity (growth) level and capacity utilization are all determined endogenously, as explained long ago by Kalecki and Keynes (Chick, 1983); and, finally, there is no NAIRU and no supply-determined natural growth rate (Kriesler and Lavoie, 2004:6-8; Arestis and Sawyer, 2003:12). Instead,

any “natural” rate of growth is determined by the actual rate of growth (Chick, 1983) and the combined behavior of demand and supply which make this growth happen.

And b) why is it so important for the monetary policies to be understood by the public, in order to provide “a focus for the expectations of financial markets and the general public” (Bernanke *et al.*, 1999:11)? Albeit it would be very relevant that people should understand the economic policies which affect their own living, this is not the same as stressing that a simpler way of making policies and communicating them to the public implies that IT is the policy to be adopted. We are well aware that IT is not the worst policy set in the current macroeconomic theory shelves. For at least in many cases, IT policies, explicit or implicit (Greenspan, 2004), seem to be theoretically and empirically rather concerned with employment, as, for instance, in the cases of the US and the UK, in stark comparison to the examples of Germany (pre EU), EU and, of course, Brazil (Bernanke *et al.*, 1999; Bibow, 2005; Johnson, 2005). Nevertheless, we could offer a sort of list that would go, on one end, from policies explicitly concerned with full employment as their main objective, as in Wray (1998), to policies that follow a kind of double or triple goal (inflation, employment and economic growth), and to, on the other end, IT regimes (almost) entirely focused on inflation rates, etc.

In addition to those general themes concerning IT, however, there are also some operational issues. First, what measure of inflation should be used, i.e., what should be defined as the target, for instance, headline inflation or core inflation? Here again there is a trade-off between transparency and flexibility. A full price index, one with which people are acquainted and which is also broad-based and accurate, scores the highest in terms of transparency.<sup>3</sup> Nevertheless, an index which excludes price modifications in specific sectors and “one-time price jumps that are unlikely to affect trend or ‘core’ inflation – for example, a rise in a value added tax or in a sales tax” (Bernanke *et al.*, 1999:27) – would be the best choice regarding flexibility.

The chosen index, thus, should at least be isolated from the first-round effects of price changes in items such as food and energy, because of their vulnerability to supply shocks. The specification *ex-ante* of items which will be outside core inflation has the advantage of allowing no discretion for economic authorities to change prices indexes after a supply shock, preserving credibility. That is why they are more common than escape clauses (Mishkin and Schmidt-Hebbel, 2002:185). Furthermore, Arestis *et al.* (2002:531) show many problems connected with the choice of headline inflation, since in the presence of sticky prices and price shocks, targeting headline inflation can severely destabilize the output growth. For

monetary authorities ought to try to compensate the effects of well-known *ex-ante* or *ex-post* price shocks on headline inflation, by means of changes in the opposite direction in some of the sticky prices of the economy, usually with important reductions of the supply and/or demand in many markets (of goods, services, labor, etc.).

Second, what nominal value should the policy-makers choose for the target? One answer, not very practical, since it does not give a clear guidance, is a inflation rate so low that no agent would have to consider it in her/his decisions (Bernanke *et al.*, 1999). However, a very low inflation rate is not recommended for several reasons, as the difficulties to lower nominal interest rates in an eventual recession; risk of real deflation and the ensuing risks of liquidity and solvency problems. This explains the reasons why the majority or all CBs in DCs target rates from 1% to 3% per annum, i.e., an IT has a ceiling as well as a floor for the inflation rate, and the economic authorities shall heed deflations as well as high inflation rates. Moreover, CBs should also not be excessively obsessed with inflation rates at the expenses of output stability, for this can make them lose the public support.

Nevertheless, what should be the inflation targets in developing countries (DEVCS)? The same as those in developed ones? For there are many market imperfections in DEVCS, as potential or real shortage of supply of goods and services in many sectors and/or of foreign exchange, which can breed a higher inflation bias than in DCs. The process of trying to overcome these supply shortages by means of investment can generate a demand inflation bias which should be tolerated in order not to dampen the very process of economic development. Consequently, the benefits of an obsession with low inflation are unclear for DEVCS. As Fontana and Palacio-Vera (2004:2) expound, there are theoretical and empirical arguments showing that transitory but frequent changes in the level of aggregate demand may have permanent consequences on output and employment. According to Chang and Grabel (2004:185), “[n]umerous empirical studies suggest that moderate levels of inflation (which, depending on the study, range from 10 to 40 per cent) have little or no cost in terms of economic growth. These studies find that the economic costs of inflation are introduced only at very high levels of inflation (by which is meant inflation rates above 40 per cent per year). It is noticeable that this conclusion is shared by Robert Barro...”. Hence, there seems to be no costs for inflation rates under 20 per cent in DEVCS, in terms of long run growth, investment and inflows of FDI. Furthermore, annual inflation rates from 15 to 30 per cent can be sustained for a long time, and Colombia and mainly Brazil are clear examples of this behavior (Chang and Grabel, 2004:186).



Notwithstanding, the main issue is whether and when this inflation rate starts to be uncontrollable and begins to jump to levels above an annual maximum ceiling of, say, 40 or 50 per cent. In such cases and after long periods of unrestrained inflation, what should be the target or the maximum accepted inflation rate of an IT policy-maker or even of a non-IT one? We agree that after long periods of high inflation it is important to achieve credibility about price stability, in order to reduce uncertainty about inflation, returns on productive and financial investments, real exchange rates, etc. However, DEVCs are still prone to more instability than DCs, for the reasons stressed before, to which we should add the quite common foreign exchange crises these countries have been periodically subjected to. Hence, DEVCs should opt for higher inflation targets than DCs.<sup>4</sup>

Third, what should be the relevant time horizon? Bernanke *et al.* (1999:31) assert that ITs set beyond a range that goes from one to four years are meaningless, since either the time horizon would be too short, not giving enough leeway for the policies to achieve their aims, or too long, imparting little credibility to targets, policies and authorities. More flexible ways to achieve the targets are not to use calendar years for the inflation rates, but only cumulative months – for instance, the last 12 or 24 months – as in many countries. Furthermore, many CBs choose multi-year annual targets, such that inflation rates can gradually approach the targets (in the short, medium and long runs). Another alternative is to announce only a long run target and publish short and medium term inflation forecasts for future years, thus describing the expected inflation path toward the long term target, like in some DCs and in Chile. Svensson (2005) supports the idea of, at least in some cases, not fixing a rigid time horizon at which an inflation target should be met. He prefers instead to change it for an explicit intertemporal loss function, which would lead to an aim to minimize the *ex-ante* sum, through a determined period, of a composition between low levels of inflation and the lower achievable output gap.

Fourth, should the target be a point or a range? Fontana and Palacio-Vera (2004:18-20) have a strong case in favor of a quite wide range, so that the monetary authorities will choose more inflation volatility and less output volatility, not easily sacrificing output for gains in inflation rates. In this same sense, Mishkin and Schmidt-Hebbel (2002:186) emphasize the dangerous effects of mixing a too short time horizon with a narrow target, resulting in undesired output fluctuations. A too narrow range reduces CBs possibility to respond with minor adverse outcomes (output and employment variation) to unforeseen events, including inevitable errors in controlling inflation in spite of their best efforts, which can even drive actual rates outside this narrow range. Moreover, the damage to credibility of

missing an entire range is greater than that of missing a point, albeit these point targets are always accompanied by a range. Furthermore, through a widening of the target range, CBs would convey the unavoidable uncertainty surrounding IT and monetary policy (Greenspan, 2004) which would even support, according to some authors, ranges of 5 or 6 percent (Bernanke, 1999:32). However, once more, choosing a very wide range for the target can indicate a feeble commitment of a CB to low inflation rates, reducing its credibility.

This leads us to our fifth point: under which conditions should deviations from the target be permitted? Mahadeva and Sterne (2002) stress that, overall, escape clauses should be circumstance-specific and established *ex-ante*, making clear that the economic authorities are strictly following the rules. New Zealand incorporated formal escape clauses, allowing misses of the target range when there are significant supply shocks, as in terms of trade, changes in indirect taxes, and so on. Note that escape clauses are acquiesced only as reaction to supply shocks since, according to mainstream, these shocks can be completely exogenous, while demand shocks can be at least partially determined and (almost) completely offset by monetary policy. Thus, assenting demand shocks also to recur to escape clauses could undermine both CBs credibility and IT regimes.

Although these target revisions are generally comprehensive and made *ex-post*, they can also be made *ex-ante*, e.g., when the policy-makers know in advance that a shock will make them significantly miss the target. Brazil is an example of a country which uses these revisions, called *adjusted targets*. The difference between these adjusted targets and escape clauses are that the latter are set by CBs in advance, justifying a virtual non-fulfillment of a target, while adjusted targets are a forward-looking procedure, i.e., they can be used only in *ex-post* revisions of the targets, with the simultaneous definition of a new target and the accompanying explanation of how this new target was set (Fraga *et al.*, 2003:38).

It is essential to append that escape clauses and target revisions cannot be viewed as a solution to the inherent uncertainty concerning inflation forecasting, since the accuracy on inflation forecasting is an essential element of IT. Finally, missing the target should not be seen as a signal that the entire IT strategy is being or should be abandoned. In such cases, CBs must explain the reasons of that target missing, in order to maintain their credibility and keep the IT framework quite intact.

Sixth, what policies should be chosen in order to reach the target, be it a point or a range? The common policy used by CBs to affect general prices is to move upward or downward short nominal interest rates to counterbalance respectively a higher and lower inflation rate than desired (Svensson, 2005:1). The policies mainly consist in a careful

monitoring of inflation and in preemptive or ex-post “strikes” against unwanted movements in inflation rates, in order for these rates not to gather momentum. Notwithstanding, as Gaiotti and Secchi (2004), Kriesler and Lavoie (2004) and Bibow (2005) noted, a rise in interests may also cause a *rise* in prices, at least in the short run. Bibow (2005:16), for instance, shows that in the case of Euroland a rise in interest rates may cause an economic and productivity slump that pushes inflation *up*. Moreover, this rise in interest rates may also have other adverse consequences, namely, on fiscal expenditures, for it augments squandering with debt service and that, together with stagnation and a rise in unemployment, probably will raise total government spending (Chick, 1983:318-9), prodding unfavorable expectations for inflation. For the rise in fiscal spending can bring about expectations of higher taxes and/or cuts in subsidies, leading to a fiscal supply shock and, thus, to a shock on prices.

Furthermore, Gaiotti and Secchi (2004:7-11) demonstrates that rises in interest rates can engender higher costs on working capital and inventories, and not only “benign” (in the sense of “in the right direction”, i.e., downward) consequences over demand.<sup>5</sup> That implies at least a longer persistence of inflation, after corrective policies are put into use, resulting in a worsening of the commonly simple considered short run trade-off among output and inflation, and calling for more gradual policies to stabilize inflationary shocks. Another unwelcome effects are over mark-ups, which can go up to offset declining sales; and over productive capacity, moving supply curves to the *left*, since costs go *up* in the *short run*, reducing investments, with repercussions in the *long run* over capacity and productivity.

### **3. The IT Regime in Brazil: Rationale of Adoption and some Institutional Details**

In the beginning of 1999, the Central Bank of Brazil (CBB) was searching for a new nominal anchor to stabilize expectations, after an abrupt change in the monetary policy regime and in the exchange rate of the real against the dollar, that is to say, the nominal anchor was not anymore an over-appreciated and quite stable domestic currency.<sup>6</sup> The chosen option was an IT regime, which would turn the very inflation target into the new nominal anchor. Moreover, there was a spread of IT throughout the world and a spur for this new arrangement by the International Monetary Fund (IMF).

Therefore, Brazil adopted IT effectively since July 1<sup>st</sup> 1999. The main points of that framework are (Bogdanski *et al.*, 1999:11-3; CBB, 2000): a) the chosen index would be one of headline instead of core inflation. The Brazilian economy experienced several price index manipulations at least in the three preceding decades, what conducted monetary authorities to opt for a full index, to gain credibility, even though the Real Plan was entering its sixth year.

In addition, a consumer index was chosen, because it would be well understood by the public; b) the inflation targets would be established on the basis of a widely known price index, the Broad Consumer Price Index (IPCA); c) there would be no escape clauses at least for possible supply shocks, what is more amazing since Brazil chose a headline inflation rate.<sup>7</sup> Nevertheless, the CBB could adjust the target, taking into account some supply shocks as, for instance, the impact of administered prices and/or of market prices inertia.<sup>8</sup> Notwithstanding, the CBB only recurs to adjusting its targets when they clearly appear as unattainable, given current inflation rates. This behavior is in line with general prescriptions of IT theory, which dictates a trade-off among flexibility and credibility. However, the CBB has only adjusted targets in order to try to maintain its credibility, albeit purporting to show that it performs its functions flexibly; d) the National Monetary Council (CMN), based on a proposal by the Finance Minister, set the inflation target as well as the tolerance intervals; e) the CBB would choose a point target inside a range, some percentage points above and below that point target;<sup>9</sup> f) the targets – the point and the range – would refer to inflation during the period January-December of each year. i.e., according to the calendar year; g) the IT regime would begin with the targets for 1999, 2000 and 2001 set no later than June 30<sup>th</sup> 1999; and for 2002 and subsequent years, inflation targets would be set no later than June 30<sup>th</sup> for two years ahead; h) the CBB would be given responsibilities and means to achieve the targets; i) in case the targets are breached, the CBB Governor would issue an open letter to the Finance Minister explaining the causes of the breach, and the measures adopted and time span required to ensure that current inflation returns to the established range; and j) the Monetary Policy Committee (Copom) would meet regularly, deciding the interest rates by a majority vote of its nine members, and issuing minutes explaining its decisions.

#### **4. The Consequences of the Specific Characteristics of the Brazilian IT Regime**

As a preliminary remark, Bogdanski *et al.* (1999:12) explained that the rationale behind the adoption of decreasing targets for the first three years of the new regime, 1999-2001, but also for the next two years, 2002-2003 (see Table 1), is that there would be, in general, two causes for inflation: a) an inertial and, thus, protracted process; and b) a temporary inflation rise due to a shock, with a once and for all impact over prices. The rising inflation rates in the beginning of 1999 would be of the second kind, an outcome of a supply shock (exchange rate appreciation), with no further upward pressure. Nevertheless, they do not make clear why the shocks coming from the depreciation of the real would be once-and-for-all and not require a quite extended span for realignment of prices.

**TABLE 1**  
**BRAZIL: EFFECTIVE INFLATION RATES, TARGETS AND RANGES, IN PERCENTAGE POINTS**  
**(1999-2009)**

<b>YEAR</b>	<b>INFLATION TARGETS (CMN)</b>	<b>CHANGE IN INFLATION TARGETS (CMN)</b>	<b>ADJUSTED TARGETS (CMN)</b>	<b>RANGE (CMN)</b>	<b>EFFECTIVE INFLATION RATES (IPCA – IBGE)</b>	<b>TARGETS FULFILLMENT</b>
<b>1999</b>	8.00			±2.00	8.94	Fulfilled – upper limit
<b>2000</b>	6.00			±2.00	5.97	Fulfilled –central target
<b>2001</b>	4.00			±2.00	7.67	<b>Non-fulfilled</b>
<b>2002</b>	3.50			±2.00	12.53	<b>Non-fulfilled</b>
<b>2003</b>	3.25	4.00		±2.50	9.30	Fulfilled – upper limit
<b>2004</b>	3.75	5.50		±2.50	7.60	Fulfilled – upper limit
<b>2005</b>	4.50			±2.50	5.69	Fulfilled – upper limit
<b>2006</b>	4.50			±2.00	3.14	Fulfilled – lower limit
<b>2007</b>	4.50			±2.00	4.46	Fulfilled –central target
<b>2008</b>	4.50			±2.00	5.90	Fulfilled – upper limit
<b>2009</b>	4.50			±2.00		

Sources: Conjuntura Econômica, june 2007; Banco Central do Brasil; Agostini and Ohno, 2005; Fraga *et al.* (2003).

In addition to the option for accentuated decreasing targets, we should also oppose the inflexibility of all the main points of the framework, in Brazil. For, as we will show, the IT regime has been adopted in Brazil *as a rule, not as a framework*, in stark opposition to some of the principal proponents of that regime. That is to say, the BCB has not considered sufficiently the consequences of its choice of interest rates (Wray, 1998) over employment and economic growth in the short *and* long runs, clearly preferring to attain some minor gains in inflation rate – of one annual percent or even less – to try more stable policies in the long run, with more investment, growth, employment, productivity, fewer supply bottlenecks, etc., with all the consequences of these achievements over long run rates of growth and inflation. Moreover, it has not been considering the fiscal consequences of raises in interest rates, since: a) the total amount of financial expenditures augments; b) the burden of the debt also rises, together with a relative fall in overall tax revenues; c) disbursements because of unemployment increase; d) average GDP growth decreases, increasing the debt/GDP ratio and the risks of fiscal dominance, unless counterbalanced by strong measures to augment fiscal revenues (raises in tax burdens) and/or to diminish fiscal expenses (with steep and quite comprehensive reductions of government disbursements – Safatle and Romero, 2005a; 2005b), also because the government knows that beyond a threshold (that is lower for DEVCs, when compared to DCs and their international currencies) an “increase in the real interest rate also increases the probability of default on the debt... [making] domestic debt less attractive”(Blanchard, 2004:3).

We should also not forget the consequences of exchange rate fluctuations over inflation. Minella *et al.* (2003a:24-5) stress exchange rate volatility as one of the three most important challenges for monetary policy in DEVCs which adopt IT, together with the building up of credibility and some control over changes in relative prices. As we saw in section 2, domestic currency depreciation may have an important impact over prices, as an outcome of the pass-through from higher import prices of intermediary and final products as well as from higher demand and prices for *exports*. Another major effect of sudden depreciations of the domestic currency is over the balance sheets of domestic firms, because of the mismatch between revenues in domestic currency and debts in foreign currencies.<sup>10</sup> On the other hand, an appreciation of the currency, in spite of having short term advantageous consequences over inflation rates – because of symmetric downward impacts on import and export prices – can make the domestic economy less competitive, what might cause unfavorable expectations over CBs reserves on the medium or long runs, if this appreciation is not sustainable. Once more, the central theme here is that DEVCs do not issue reserve

currencies. This makes obligatory big and *stable* reserves in the long run, in order not to experience sudden and disrupting speculative movements against their currencies. As well known, the level of reserves functions as an insurance against major capital outflows in a financially integrated world, strongly reducing exchange rate volatility.

The neglect of these points might explain why the IT regime in Brazil did not achieve its targets in 2001 and 2002, and only attained it in 2003 and 2004 after significant upward revisions, *in the upper limit* of the new, adjusted targets. We should also stress that only in 2000 the CBB hit the central target, while in 1999 and 2005 only the upper limit was attained (with a minor and not needed adjusted target in this last year, given the unjustified quest of the CBB to reach the central target, through high interest rates and strong exchange rate appreciation). However, Minella *et al.* (2003b:116-23) can certainly affirm that IT in Brazil has been successful in anchoring expectations, reducing inflation persistence and, thus, controlling inflation rates with an accentuated upward bias.

The market expectations of rises in interest rates and of a dampening of any higher output growth introduce a very strong antigrowth bias, more puzzling when we consider that the country is a DEVC, thus with a more volatile macroeconomic environment (Fraga *et al.*, 2003:4,8,31). Another reason for this antigrowth bias is the asymmetric effect of supply shocks, with inflationary shocks having a greater repercussion over prices than deflationary shocks, as a consequence of the downward price rigidities. Consequently, this long run anti-growth bias is self-reinforcing, for the persistence of many bottlenecks together with lower productivity and more obsolete means of production result in higher prices and stricter limits to production growth and to policies, etc. Thus, it would be wise to prescribe higher central targets and/or wider ranges, which reflect not only higher past inflation but also a greater vulnerability to shocks.

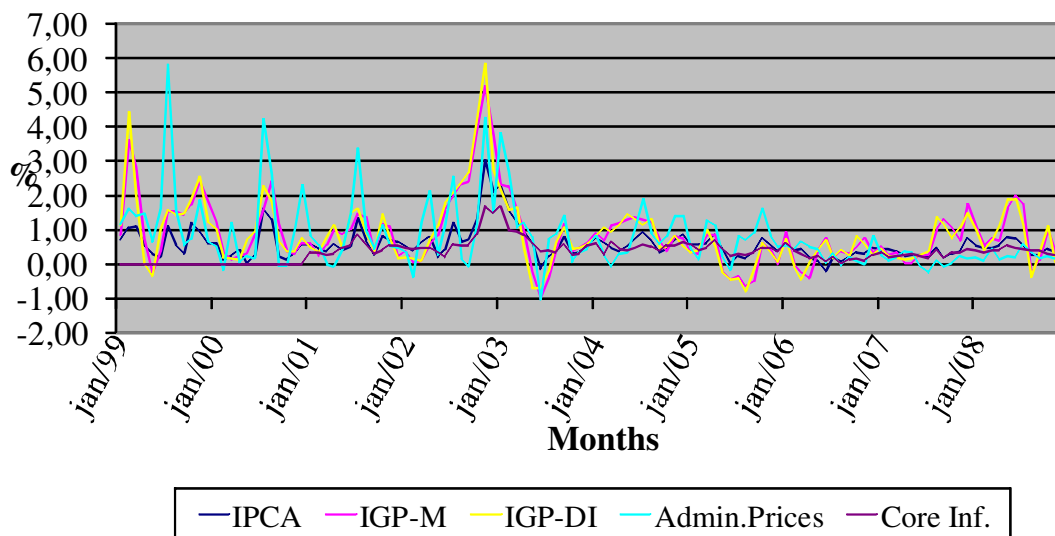
It is essential to return now to a point briefly mentioned in the introduction, namely, the high interest rates long before *and* after IT implementation, in an example of the predominance of financial interests, producing since long ago (even now, in February 2006) the highest real interest rates in the world. Agostini and Ohno (2005) highlight that, since March 1975, the nominal interest rate did not fall below 15%, but these high nominal interest rates have been many times a must in Brazil, in response to high inflation rates. Notwithstanding, the nominal annual interest rates remained above 19% during the whole first part of the Real Plan (July 1994 to December 1998), with *real* annual interest rates of no less than 15% in the entire period, with the exception of August 1998 (12.8%).

Initially, the reason for these unusual interest rates was that the economy was in the aftermath of the Real Plan and of a very long period of high inflation. But afterwards, a high real interest rate was considered essential to maintain a net capital inflow, in order to sustain the pegged exchange rate, transformed in nominal anchor of the Brazilian currency, until this over-appreciated anchor collapsed in January 1999. Subsequently, interest rates were set high to avoid an inflation/exchange rate depreciation spiral, with huge capital outflows. Since IT implementation, it was kept high to maintain inflation rates inside the range, if possible, as in 2005, hitting the central target in spite of the loss in economic growth. That is why it is useful to consider history and former institutions when analyzing some events, policies and institutional building-ups, especially when one considers that financial and banking interests have been given predominance among the Brazilian economy for a long time before the long process which almost led to hyperinflation and which began in the 1970s (Lessa and Fiori, 1983).

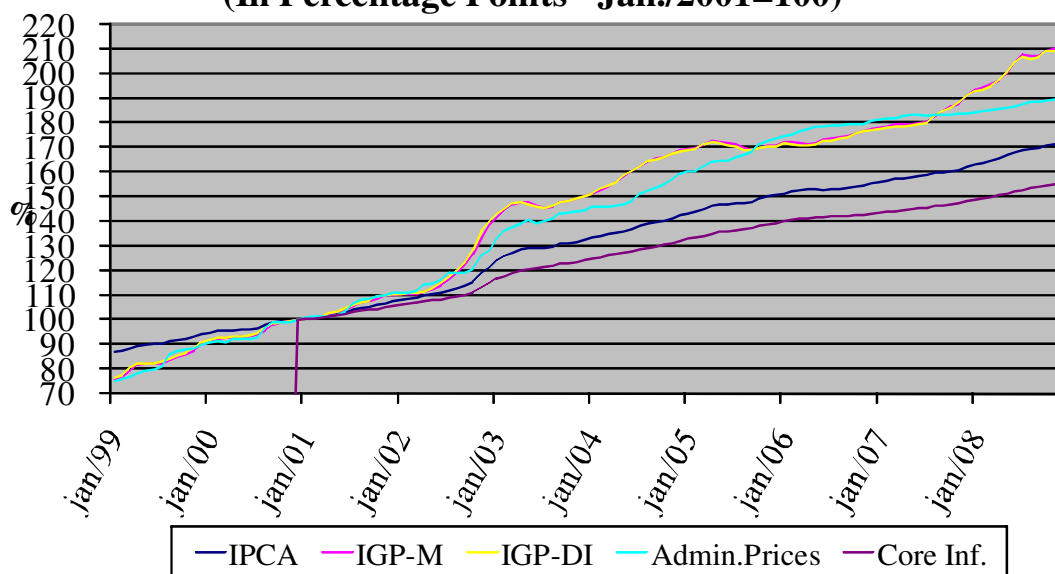
This is a way to understand the several institutional traps rigged in the outset of IT and the great obstacles, if not “impossibilities”, to surpass them. However, we would like to emphasize the crucial importance of three additional factors: 1) the huge deficits which led to a net public debt/GDP ratio of 52%, in the end of 2005, i.e., a fiscal, institutional and historical cause,<sup>11</sup> with consequences in terms of an already explained insatiable search for increases in fiscal revenues and for cuts in public expenditures; 2) the permanent difficulties in the BP, also a perennial institutional cause (Strachman and Vasconcelos, 2001); and 3) the indexation of administered prices to the General Price Indexes (FGV), “almost condemning [the economy] to the perpetuation of the prime interest rate in extremely high levels” (Agostini and Ohno, 2005:2). As the consequences of the first two causes are already clear, we now detail the third one.



**Graph 1**  
**Brazil - Price Indexes (01/1999-12/2008)**



**Graph 2**  
**Brazil - Accumulated Price Indexes (01/1999-12/2008)**  
**(In Percentage Points - Jan./2001=100)**



In Brazil, the pass-through of administered prices (of 25% after one year of depreciation) has been expected to be two times higher than that of market prices (12%; Minella *et al.*, 2003a:25). This is an effect of the contracts negotiated for the privatized utilities, some service firms and the prices of some other regulated sectors, that brought about the side effect by which the prices of oil by-products, fixed telephone, residential electricity

and public transportation are partly indexed to the US dollar, resulting in a higher degree of persistence of past inflation. As a consequence, these prices have risen persistently above market prices, contributing strongly towards higher rates of inflation *and* to a continuous misguided effort to decrease *market prices* to counterbalance the higher rates in the administered ones (see Figure 1).<sup>12</sup> This is another institutional component which has led to a permanent quest for low inflation in an environment in which a third of the prices, with a tendency towards augmentation, rise systematically above average inflation. Moreover, *these prices are not subject to the main effects of the anti-inflationary policies directed towards the other two thirds of the prices.* These institutional characteristics result in a permanent bias against investments and economic growth, besides bringing about an increased rejection to the inflexibility of IT in the country.

One additional feature is that the information and studies which underpin decisions about the prime interest rates are at least very feeble and at most non-existent. Nakano (2004) shows that the CBB have few or no information about many sectors, their costs, productivity, idle capacity and the consequences of these variables over general inflation, investments, the “output gap”, etc. The CBB resorts to studies made by big banks and financial institutions on prospective inflation, with minor participation of agents from the productive sector. These institutions are, thus, constituted as preferential interlocutors of the CBB, in a strange relation, since they are clearly favorable to high interest rates and want to know beforehand the future interest rates.

A final remark is that the CBB has lowered its level of transparency in its last months’ minutes, perhaps because of the difficulties to explain the incoherence of increasing interest rates even when current inflation is inside the target range *and not rising*. This is why many economists defend that the CBB should make public the models upon which it bases its policies, mainly because since September 2004 the minutes of the Copom meetings have become increasingly obscure and in contradiction with other minutes, having in many times accomplished a strange unanimity, even stranger when there is no reason to tighten the monetary policy. This is another example of the very biased institutional flexibility with which IT is followed in Brazil.

## 5. Conclusions

Several necessary institutional transformations appear as a logical conclusion of the previous sections. First, the CBB – as, for instance, the Bank of Canada – should announce only a range as its target, and not a point, for the pursuit of a point leads almost inevitably to

more frequent changes in monetary policies, with a more stringent bias. The CBB should thus use all the stipulated range to accommodate certain demand and supply fluctuations, etc., in order to achieve low levels of inflation without compromising economic growth by any margin *if not necessary*. Second, the definition of the very target should be more flexible, in order not to impair economic growth and development without necessity, also taking into account that Brazil is a DEVC.

Brazil should also pursue a core inflation target, with the exclusion of administered prices and, perhaps, of some food prices – as, for example, in the case of the USA – from the inflation target. A fourth suggestion is the adoption of sectoral indexes for price adjustments, as a current proposal by the Ministry of Energy. This measure could help to curb the rises of administered prices, bringing inflation down even if these prices continue to take part in the official inflation target. Fifth, it would be important to increase the flexibility of the temporal target, changing it from a calendar year to the accumulated inflation in 12 months or, better, with 24 or 36 months to converge the actual inflation rate to the target, as in New Zealand, Chile, UK and Canada.

Sixth, the CBB must improve its research scope and improve urgently its own prices forecasts, in order to stop depending on those from market institutions. At the same time, such improvement in its research base could bring new information and help to direct expectations to the inflation target.<sup>13</sup> Seventh, there should be an increase in the number of participants and a change in the composition of the Monetary Policy Committee (Copom). This would lead to the inclusion of participants from industrial sectors, trade unions, etc., widening the interests represented in the definition of monetary policies.

Eighth, CBB and Copom must urgently augment the level of transparency of their decisions, in order to be more in line with the prescriptions of the main proponents of IT. This would lead to an increase in credibility, mainly if combined with more flexibility and wisdom.<sup>14</sup> Ninth, we propose open individual votes in the Copom meetings, facilitating the identification of personal stances in terms of economic policy, what would help to increase the credibility of the CBB.

Tenth, we support the adoption of an IT regime with only implicit inflation targets, as currently in the USA and EU (Greenspan, 2004). This would allow more flexibility, for the CBB would pursue low inflation rates, *but with no obligation to achieve any target*.

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## Notes

<sup>1</sup> Preliminary versions are in the Proceedings of the EAEPE Conference 2005, in Bremen; 9th Workshop of the Research Network in Alternative Macroeconomic Policies, in Berlin; and AFEE 2006 Annual Meeting, in Boston, Mass.

<sup>2</sup> We can mention the diminishing efficiencies of product and labor markets and the lower effort than needed to be made to increase these efficiencies, since prices can always escalate; the difficulties in monitoring one's own costs and also suppliers' and competitors' prices; the reduction in real wages and thus, the distributional effects, since wages are not adjusted as fast as the majority of prices; the attempt of policy-makers to control inflation through a lasting deflationary policy, with high interest rates and conservative fiscal policies; the curtailment of the terms of financial assets, given the higher uncertainty about the future value of long term debts; the tax distortions and/or governments' fiscal difficulties; etc.

<sup>3</sup> Bernanke *et al.* (1999:28) stress that one way to achieve flexibility and transparency is to choose an index with data compiled by an agency completely independent of the monetary authorities.

<sup>4</sup> "[T]he Brazilian economy has been hit by frequent and large shocks. Most of them are related to its position as an emergent market economy – high volatility of country risk premium and of the exchange rate – and to some structural transformations that led to a change in relative prices. The volatility of the inflation rate and exchange rate in Brazil is still one of the highest in inflation targeting economies." (Minella *et al.*, 2003b:131). "Therefore, exchange rate volatility is an important source of inflation variability. The design of the inflation-targeting framework has to take into account this issue to avoid that a possible non-

fulfillment of inflation targets as a result of exchange rate volatility may reduce the credibility of the central bank.”(Minella *et al.*, 2003a:29).

<sup>5</sup> Thus, rising interests seem to “imply an overall adverse effect on prices... which would have partly counterbalanced the disinflationary effect operating through the demand side. While hardly enough to change the overall effect of monetary policy on prices over the medium run, this impact may not be without relevance.”(Gaiotti and Secchi, 2004:25).

<sup>6</sup> The average exchange rate moved from R\$ 1.21/US\$ 1 in the first days of 1999, to R\$ 1.96/US\$ 1 on Feb. 1<sup>st</sup> 1999, to R\$ 2.16/US\$ 1 on March 3<sup>rd</sup>, then dropped to R\$ 1.72/US\$ 1 on March 31<sup>st</sup>, some days after the new Board of Directors of CBB took office.

<sup>7</sup> Minella *et al.* (2003b:130). Bogdanski (*et al.*, 1999:13) add: “The combination of the use of headline inflation and the absence of escape clauses justifies the adoption of the relatively wide 2-percentage point tolerance interval around the central target, and certainly makes the announced targets much tighter than they may initially appear.” These remarks are astonishing since this “wide” 2% tolerance interval is designed for a DEVC, with, as we explained, a great possibility of supply shocks, because of bottlenecks, foreign exchange shortage, development requirements, etc. See also CBB (2000:92).

<sup>8</sup> Fraga *et al.* (2003:33). Another institutional issue in the IT framework in Brazil is the so-called administered (administered by contract and/or monitored) prices, which increased above the other (market) prices (see Figure 1). The administered prices are regulated by the federal government and/or public agencies, and include oil by-products, fixed telephone, residential electricity and public transportation. Its weight in the IPCA was 30.8% in June 2002. As a consequence of a flaw in the privatization process in Brazil, the inflation rate indexes which adjust administered prices are the IGP-M and the IGP-DI (General Market Price Index, composed with a weight of 60% by the Wholesale Prices Index – IPA, an index in which exchange rate variations and the international prices of many tradables, imported or exported by Brazil, have strong repercussions) (Minella *et al.*, 2003b). These choices of indexes occurred as a means to attract foreign capital and guarantee a more stable rentability (also for domestic capital), resulting in that important fluctuations in the exchange rate have significant consequences over the administered prices, although in many cases they do *not* have a significative participation in the costs of these firms. Thus, exchange rate fluctuations gather an unjustified momentum over the official index for the Brazilian IT regime, the IPCA, and even over the very IGPs, through the Consumer Prices Index – IPC, in a vicious circle. All this albeit it is common that costs of firms responsible for these administered goods and services are mainly in *reais*. Here we perceive the influence of economic interests over the

build-up of an institutional mechanism with many flaws, by no means properly regulated, *and with repercussions over inflation and, thus, growth of an entire country.*

<sup>9</sup> This band should not be too wide, in order not to be too lenient with inflation. But, as a result of the greater volatility of the exchange rate, interest rates, and risk premium in Brazil, the CBB broadened the tolerance interval from  $\pm 2\%$  to  $\pm 2.5\%$ , for 2003 and 2004 (Minella *et al.*, 2003b:130-1).

<sup>10</sup> “Depreciations in emerging market countries are particularly dangerous because they can trigger a financial crisis... These countries have much of their debt denominated in foreign currency; when the currency depreciates, the debt burden of domestic firms increases. Since assets are typically denominated in domestic currency and so do not increase in value, net worth declines. This deterioration in balance sheets then increases adverse selection and moral hazard problems, which leads to financial instability and a sharp decline in investment and economic activity.”(Mishkin and Schmidt-Hebbel, 2002:192)

<sup>11</sup> These deficits, though, had grown fast in a clear case of fiscal irresponsibility, in the first four years of the Real Plan and of Cardoso’s government. Afterwards, the federal government changed its fiscal policies in order to honor its debt.

<sup>12</sup> The weight of the administered prices in the IPCA grew from 17% in January 1991 to 28% in August 1999, reaching 30.8% in June 2002, and circa 1/3 in the first semester of 2005 (Minella *et al.*, 2003b). From June 1999 to May 2005, administered prices rose 124.3% against 54.3% of market prices, with great influences of the Wholesale Prices Index, with a weight of 60%. In addition, the rise of administered prices in 2005 was 9%, against an inflation rate of 5.7%; and, finally, for 2006 the expected rise in those prices is 5.3%, against an inflation target of 4.5%.

<sup>13</sup> See similar prescriptions for the Bank of England made by Keynes (1981:263-267), in the Macmillan Committee (1929-31).

<sup>14</sup> Greenspan (2004); Keynes (1981:262-263).

### ABSTRACT

The paper shows the advantages and handicaps of implementing an inflation target (IT) regime, from a Post-Keynesian and, thus, an institutional stance. It is Post-Keynesian as long as it does not perceive any benefit in the mainstream split between monetary and fiscal policies. And it is institutional insofar as it assumes that there are several ways of implementing a policy, such that the chosen one is determined by historical factors, as it is illustrated by the Brazilian case. One could even support IT policies if their targets were seen just as “focusing devices” guiding economic policy, notwithstanding other targets, as, in the short run, output growth and employment and, in the long run, technology and human development. Nevertheless, *an IT is not necessary, although it can be admitted*, mainly if the target is hidden from the public, in order to increase the flexibility of the Central Bank.

### RESUMO

Mostram-se as vantagens e desvantagens da implementação de um regime de metas de inflação, de uma perspectiva pós-keynesiana e institucional. Pós-keynesiana pois não crê em benefício na separação entre políticas monetária e fiscal prescrita pelo *mainstream*. E institucional porque assume que há vários modos para implementar políticas; assim, o escolhido é determinado por fatores históricos, como ilustrado pelo caso brasileiro. Pode-se até apoiar metas de inflação, desde que estas sejam vistas apenas como “*focusing devices*”, guiando políticas, mas considerando outros objetivos, como, no curto prazo, o produto e o emprego e, no longo, o desenvolvimento tecnológico e humano. Ressalte-se que *metas de inflação não são necessárias, apesar de serem admissíveis*, sobretudo se mantidas escondidas do público, funcionando apenas como um *foco* e dando flexibilidade aos BCs.