THE STATE OF THE ART OF **MONETARY POLICY** IN BRAZIL

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INTRODUCTION

Since 1999, an economic policy regime called the "macroeconomic tripod" has been in force in Brazil. It establishes the general guidelines for the three macroeconomic policies: fiscal policy, exchange rate policy and monetary policy. The policy consists of the simultaneous adoption of three policies: the primary surplus target regime (fiscal policy); the floating exchange rate regime (exchange policy); and the inflation targeting regime (monetary policy).

This report aims to present and discuss the state of the art of monetary policy debate in the country. However, from a practical and methodological point of view, the monetary policy is embedded in a much broader context. On the one hand, the discussion of monetary policy should not be seen separately from other economic policies, as the full understanding of the role and limits of monetary policy requires contribution from the entire macroeconomic regime in which it is inserted. On the other hand, economic policy propositions, including monetary policies, derive directly from the assumptions (or "world view") and the objectives of their authors, explicitly or implicitly. Therefore, the approach proposed here is broad, diverse, and plural, given the nature of the object under discussion.

To achieve these objectives, the report is subdivided into four sections in addition to this introduction and final considerations. Section 2 discusses what the "macroeconomic tripod" is, focusing on theoretical aspects and the Brazilian macroeconomic model. Section 3 discusses alternative macroeconomic views and criticisms of the "macroeconomic tripod", focusing on three views: new developmentalism, social developmentalism, and functional finance. Section 4 discusses the history of monetary policy from 1999 to the present day. Finally, section 5 analyzes some current debates on Brazilian monetary policy.

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WHAT IS THE MACROECONOMIC TRIPOD?

"Macroeconomic tripod" consists of the simultaneous adoption of regimes for the three macroeconomic policies: inflation targets in monetary policy, floating exchange rate and fiscal rules, with emphasis on the primary surplus.

Although the "macroeconomic tripod" is not directly derived from economic policy prepositions of a single theoretical current in economics, it is clear that its theoretical foundation is based on the so-called New Macroeconomic Consensus (NCM) or New Neoclassical Synthesis, a convergence of macroeconomic ideas from New-Classic and New-Keynesian Economics that emerged within the scope of *mainstream* economics, that is, from the dominant centers of economic thinking, in the mid-1990s.

Regarding its theoretical structure, Teixeira & Missio (2011)[1] summarize the central propositions of the NCM in five points: (i) the neoclassical notion of the economic growth process, that is, that the determination of real output in the long run occurs via Offer factors; (ii) the existence of a *trade-off* between inflation and unemployment in the short term, that is, controlling inflation requires unemployment; (iii) the lack of a *trade-off* between inflation and unemployment in the long run; (iv) the expectations of economic agents are sensitive to economic policy movements; (v) the decrease in the interest rate increases the aggregate demand in the short term.

Presuming the above assumptions are valid, the function of economic policy becomes restricted to guaranteeing "macroeconomic stability". This concept can be translated in several ways, but here it is understood as a synonym of price stability (inflation within the stipulated target), external stability (balance of external accounts via exchange rate changes) and fiscal stability (public debt growth stability). Under this paradigm, the economic policy is not responsible for directly promoting economic growth, job creation, income distribution or the guarantee of human rights.

According to Rossi, Welle & Gonçalves (2020)[2], the NCM is based on a neoliberal notion in which "market forces" have a leading role, that is, the State has less relative importance in economic matters. As a result, the economic policies proposed in this theoretical framework converge in the sense of limiting the State's actions, reducing discretion and valuing predictability and transparency.

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[1] TEIXEIRA, A.; MISSIO, F. J. . O Novo Consenso Macroeconômico e Alguns Insights da Crítica Heterodoxa. Economia e Sociedade (UNICAMP. Impresso), v. 20, p. 273-297, 2011.

[2] ROSSI, P.; WELLE, A.; GONCALVES, R.. REGIME MACROECONÔMICO E DESENVOLVIMENTO: É NECESSÁRIO REVER O TRIPÉ MACRO. In: Fundação João Mangabeira Partido Socialista Brasileiro. (Org.). Por Uma Economia Política Inclusiva, Criativa e Sustentável. 1ed.Brasilia: Fundação João Mangabeira Pa, 2020, v. 2, p. 43-69.

Once the theoretical assumptions that support the "macroeconomic tripod" are understood, the second step is to discuss how these policies have operated in the Brazilian case since 1999. As Nassif (2015)[3] highlights, the NCM's theoretical framework guides economic policies by the notion of "one objective, one instrument". The fiscal regime aims to stabilize or reduce the public debt/GDP ratio through the generation of primary surpluses. The goal of the adjustment on external accounts would be achieved through the floating exchange rate, in association with external market opening. Price stability, in turn, would be achieved through management of the base interest rate in an inflation targeting regime. Therefore, each economic policy has a central objective and an instrument to achieve it. The following presentation details the regimes in force in Brazil, based on the contribution of Rossi, Welle & Gonçalves (2020).

Primary Surplus Rule

According to Rossi, Welle & Gonçalves (2020), the **primary surplus rule** determines that, excluding public debt interest expenditures, government revenues must be higher than expenditures (in other words, the primary result must be positive). From a theoretical point of view, this policy is based on assumptions from neoclassical theory, in particular, the *Ricardian equivalence*[4]. Following this theoretical assumption, economic agents perceive that any government debt will result in an increase in taxes in the future, as there will be a need for the government to increase tax collection to face the new indebtedness. In response to the expected future increase in taxes, economic agents chose to increase their private savings, that is, they reduced current expenditures in order to save resources for the future to deal with the increase in taxes.

Therefore, if, on the one hand, higher government indebtedness would imply an increase in aggregate demand, the desire to expand private savings would act in the opposite direction. given to *Ricardian equivalence*, these two forces of opposite direction, would cancel each other out, that is, **the impact of the fiscal deficit on the economy would be null**. In this scenario, fiscal policy would be ineffective as an instrument for promoting long-term economic growth.

3 NASSIF, A. As armadilhas do tripé da política macroeconômica brasileira. Revista de Economia Política (Online), v. 35, p. 426-443, 2015.

4 The *Ricardian equivalence*, originally proposed by David Ricardo, postulates that a fiscal deficit policy is ineffective for economic growth, not resulting in impacts on aggregate demand.

Accepting the assumption of the *Ricardian equivalence*, fiscal policy should be oriented towards fiscal balance, not the promotion of economic growth. Fiscal stability is generally understood as the maintenance or decline of public debt as a proportion of GDP. To this end, the primary surplus policy is recommended, with a view to limiting the degree of discretion in fiscal policy, guaranteeing a positive primary result for interest payments, and curbing expenditure increases. The ultimate goal is long-term public debt sustainability.

The primary result target regime came into force in Brazil with the introduction of the Fiscal Responsibility Law (LRF) in 1999. The establishment of primary surplus targets aims to guarantee resources for the payment of interest on the public debt and control the trajectory of the debt/GDP ratio. Subsequently, Constitutional Amendment No. 95/2016 established the New Fiscal Regime, or Spending Cap, in which the growth of the Union's primary expenditures cannot exceed the inflation rate of the previous year until 2036. The primary result target regime was kept, and both are in effect today.

Floating Exchange Rate Regime

Second, there is the adoption of a **floating exchange rate regime**, in which the value of foreign currency is mostly determined by the market, even though the Central Bank may operate in the foreign exchange market. There is no explicit target or band for the exchange rate. This policy is supported by the theory that, given the external market opening, capital flows would promote the adjustment of the exchange rate to the level of balance of the external accounts. Furthermore, given the Trilemma, or "impossible trinity"[5], understood as the impossibility of reconciling free flow of capital, fixed currency exchange rate and autonomous monetary policy, the floating exchange rate regime would be the option to guarantee the autonomy of domestic monetary policy in a financial globalization context.

The floating exchange rate regime was adopted by the Central Bank of Brazil in 1999. According to Prates (2015)[6], in the exchange rate regime adopted in Brazil, the exchange rate is mostly determined by "market forces", but the Central Bank con-

5 The "impossible trinity" postulates that it is not possible for a country to simultaneously have a fixed exchange rate policy, free flow of capital and monetary policy autonomy, requiring that two of these points be chosen, renouncing a third. In the current macroeconomic situation, including in Brazil, countries allow the international flow of capital keeping the autonomy of domestic monetary policies, thus making it necessary to adopt a floating exchange rate policy.

6 PRATES, D. M.. O regime de câmbio flutuante no Brasil : 1999 - 2012 : especificidades e dilemas. 1. ed. Brasília: Instituto de Pesquisa Aplicada, 2015. v. 1. 188p .

tinues to intervene in the currency exchange market, which leads this regime to be called “dirty float”.

Inflation Targeting Regime

Finally, in the **inflation targeting regime, also implemented in 1999**, there is the public announcement of an annual inflation target, which is pursued by the Central Bank through changes in the base interest rate. The target is stipulated by the National Monetary Council (CMN), formed by the Minister of Economy, the President of the Central Bank and the Special Secretary of Finance of the Ministry of Economy. The goal has a central value, a core, and symmetric bands for plus and minus. The price index chosen to compose the target is the Broad Consumer Price Index (IPCA), a full index, that is, one that comprises a large range of products, including those with greater price volatility. The inflation target has a twelve-month horizon, that is, it refers to the level of inflation accumulated in 12 months considering the calendar year from January to December to measure whether or not the target has been met.

To ensure that inflation converges to the stipulated target, the Monetary Policy Committee (Copom), formed by the president and directors of the Brazilian Central Bank, stipulates a target for the base interest rate, “SELIC” in the portuguese acronym. The convergence of the SELIC-target to SELIC-effective occurs through operations in which the Central Bank buys and sells government bonds. **Therefore, the Inflation Targets Regime has an objective, the inflation target, and an instrument, the base interest rate.** This monetary policy is based on a theoretical assumption arising from the New Macroeconomic Consensus: if in the long term the currency is neutral, then the decrease in interest rate is ineffective in generating economic growth, it is possible to temporarily reduce (or increase) unemployment in the short-term term with this policy.

Breaking down this assumption, in the short term it would be possible to temporarily reduce unemployment through an expansionary monetary policy, carried out by lowering the base interest rate. A low interest rate means that private stakeholders will have more incentive to invest, compared to saving up to earn interest, which is not as profitable. Banks, in turn, will be more willing to lend money, facilitating access to credit for families. Greater investment and the circulation of credit in the economy means more consumption, employment and economic growth. On the other hand, when the government wants to control inflation, the solution would be to cause unemployment and reduce economic growth, through an increase in the interest rate.

Despite these possible short-term gains, in the long-term, according to the NCM, the fall in interest rates is unable to affect the product, due to the supposed *currency neutrality*[7]. Inflation is understood as a phenomenon derived exclusively from

[7] *Currency neutrality* it is the notion that monetary policy (or the quantity of money) is not capable of affecting real variables, such as economic growth, only affecting nominal variables, such as inflation.

excess demand in relation to the potential output, called “demand inflation”. That is, the economy is always exhausted at its product supply capacity, so any boost to the economy via a reduction in long-term interest rates would result not in a stimulus to the economy, but in a higher price level and a return to the natural rate of unemployment.

The logical conclusion of this assumption is that using the interest rate to promote employment and income is useless. Therefore, in order to prevent the monetary policy from being used inappropriately for political interests, its management should take place through experts at an independent Central Bank, precisely to contain the inflationary bias of using the decrease in the base interest rate. But given that, in the short term, the policy is considered effective, when inflation, or expected inflation, is above the target - which is defined, publicly announced and pursued by the Central Bank - the monetary authority would choose to raise the base interest rate, which would result in a retraction of aggregate demand and a reduction in price levels.

CRITICAL VIEWS TO THE MACROECONOMIC TRIPOD

The most emphatic defense of the macroeconomic tripod has been made by economists from the liberal-orthodox field, with great influence and space in the media and politics. The ideas of flexibilization or overcoming of the macroeconomic tripod paradigm occur mainly in research centers associated with the heterodox economic approach, such as IE-UNICAMP, IE-UFRJ, EESP-FVG, among others.

Critics of the tripod, such as Rossi, Welle & Gonçalves (2020), point out that although the macroeconomic tripod has been successful in controlling inflation in Brazil's recent history, this regime has proved inadequate in terms of creating a macroeconomic environment conducive to sustained growth, with income distribution, and a reduction in inequality - as well as not resulting in the "macroeconomic stability" suggested by its advocates.

There would be three evidences of its failure: (i) the Brazilian economy has faced high nominal interest rates, explained neither by the trajectory of domestic inflation nor by the level of public debt; (ii) the Brazilian exchange rate, in relation to USD, is one of the most volatile in the world, with cycles of valuation and devaluation guided by oscillations in the international market; (iii) the fiscal regime, especially in relation to the primary surplus targets, is pro-cyclical and incapable of guaranteeing the stability of the public debt/GDP ratio.

Next, three economic policy alternatives critical to the macroeconomic tripod proposed specifically for the Brazilian case are described.

New-developmentalism

One of the critical views of the Brazilian macroeconomic tripod is the new-developmentalist theory, whose main exponent is Luiz Carlos Bresser-Pereira (EESP-FGV). This theory combines elements of classical developmentalism, post-Keynesian macroeconomic theory, and the chronic exchange rate overvaluation hypothesis[8].

New-developmentalism understands that persistent fiscal deficits are harmful to the economy, being defined as "fiscal populism". The recommendation is that fiscal policy be managed with a view to balancing public expenditure over the long term while maintaining the public debt at an acceptable level and preserving the capacity for public investment. In the short term, however, fiscal policy should be guided by countercyclical action – thus diverging from the policy advocated by the orthodox groups, in which any countercyclical policy is

[8] The idea that, as a result of export revenues from primary products or the excessive inflow of short-term capital (generally driven by high interest rates), the exchange rate of middle-income economies would show a chronic trend of valorization, interrupted by currency and financial crises.

doomed to failure. One of the reasons for the need to maintain fiscal balance in the long term is its repercussion on the current account balance[9]. On the revenue side, the defense is for a relatively high tax burden, capable of financing social spending.

Exchange policy is one of the main points of new-developmentalism. It is argued that the exchange rate should be at the level that promotes competitiveness among national productive enterprises. As for the interest rate, the recommendation is to keep the threshold low, in order to stimulate productive investments. However, it also places a low inflation rate among the goals.

According to Bresser (2020)[10], the chronic tendency towards cyclical overvaluation of the exchange rate has four fundamental causes, three of which are associated with monetary policy. First, high interest rates tend to attract speculative capital flows, interested in short-term gains in domestic financial investments. This inflow of capital leads to currency exchange rate appreciation, as there would be an excess of foreign exchange. Currency exchange rate appreciation, in turn, contributes to reducing inflation. As in the case of the first phase of the Brazilian Real (BRL), exchange rate appreciation promotes price competition between domestic and imported products, as well as making the import of inputs cheaper. Through these mechanisms, there is a reduction in Brazilian inflation during periods of currency appreciation. This situation creates the opportunity for "foreign-exchange populism": by allowing exchange rate appreciation to reduce inflation and increase real wages in a supposedly artificial way.

In short, the macroeconomic proposal of new-developmentalism involves the search for a devalued exchange rate, facing the tendency of exchange rate appreciation, associated with an expansionist monetary policy, via a reduction in the interest rate. In new-developmentalist literature, there is a clear criticism of maintaining the perverse combination of an appreciated exchange rate and a high interest rate. In conclusion, the proposed macroeconomic regime involves a structural interest rate reduction strategy, in line with the fight against "fiscal populism" and "foreign-exchange populism".

Therefore, in this view, there is room for an expansionist monetary policy in the Brazilian economy, making the commitment to price stability compatible with a policy of growth with income distribution. In Bresser-Pereira's conception, the reasoning behind the Brazilian option for the binomial formed by valued exchange rate and high interest rate would be related to arguments of Political Economy, associated with the defense of rentier capitalists, who profit from high interest rates, by liberal economists. Therefore, it is important to emphasize that, although there is room for an ex-

[9] Economy growth tends to worsen the balance in transactions, given the increase in imports. The idea is that fiscal deficits increase aggregate demand.

[10] BRESSER-PEREIRA, L. C. Novo Desenvolvimento - Um Segundo Momento do Estruturalismo Latino-Americano. Revista de Economia Contemporânea, v. 24, p. 1, 2020.

pansionist monetary policy from an economic point of view, there must also be political space, as a structural change in the level of interest rates would affect the interests of a considerable part of the capitalist class.

Social-developmentalism

A second heterodox strand that proposes an alternative macroeconomic regime to the current one is social-developmentalism. Mainly, it was developed by economists associated with IE-UNICAMP. According to Rossi (2014)[11], social-developmentalism consists of a development strategy that seeks to reconcile economic dynamism, the expansion of social infrastructure and income distribution through State intervention in the economy. In this view, the macroeconomic regime should be guided by two main objectives: guiding macroeconomic policy towards countercyclical action and encouraging productive investment.

Starting from premises of the post-Keynesian macroeconomic theory and advocating for a certain degree of discretion in the performance of the State, social-developmentalism proposes not an absolute break with the macroeconomic tripod, but reforms that reconcile it with the post-Keynesian precepts.

In the fiscal area, it proposes adding a countercyclical component to the fiscal regime. Due to its characteristics, the fiscal regime centered on the primary surplus is essentially pro-cyclical[12], which highlights the mistake of dealing with annual targets to achieve a long-term result, disregarding the effects of cycles and the relationship between growth and public spending. Two ways of making the primary surplus fiscal regime compatible with countercyclical action are suggested: the first is abdicating the annual target to make the management of cyclical fluctuations possible; the second is to define a set of spending rules based on countercyclical action, that is, public spending, especially in the form of investments, should increase in periods of retraction in private spending.

Within the scope of foreign-exchange policy, the floating exchange rate regime allows for greater flexibility and capacity to absorb external shocks, reducing impacts on the domestic economy. Thus, on the one hand, the floating exchange rate regime brings advantages to the domestic economy in an environment of market globalization. On the other hand, market forces, if allowed to act freely, do not promote exchange rate convergence to the level compatible with development. In conclusion, there are reasons for an active foreign-exchange policy to deal with issues related to threshold and volatility of the exchange rate.

11 ROSSI, P.. Regime Macroeconômico e o Projeto Social-desenvolvimentista. In: Calixtre, A.; Biancarelli, A.; Cintra, M.A.. (Org.). Presente e Futuro do Desenvolvimento Brasileiro. 1ed.Brasilia: IPEA, 2014, v. , p. 195-225.

12 Pro-cyclical in relation to the economic cycle, that is, when GDP grows, fiscal policy is expansionary. A countercyclical regime would be for fiscal policy to be expansionary in periods of lower GDP.

In the case of monetary policy, it would be possible to reconcile the inflation targeting regime with the propositions of social-developmentalism. However, this would occur from the consideration of three points, neglected in the current management model: (i) the inflation target cannot be the sole objective of monetary policy; (ii) the inflation target must be flexible to the point of accommodating inflationary supply shocks and pressures inherent to the economic development process; and, (iii) the interest rate cannot be the only instrument for conducting monetary policy, opting, in each case, for the most appropriate instrument. In terms of the interest rate threshold, the target regime should be compatible with a structural reduction in the interest rate, stimulating productive investment and credit incentives while discouraging rentiers.

Functional finance in the effective demand economy

A third critical theoretical strand of the NCM that we can highlight is the Modern Monetary Theory (*MMT*). This analysis is focused on combining the MMT with the assumptions of the economy of effective demand, defended, above all, by economists from the IE-UFRJ[13]. In terms of the applications of this theoretical contribution to the Brazilian case, the work of Serrano & Pimentel (2017)[14] stands out.

The authors' central contribution is to demonstrate that in countries issuing sovereign currency[15], the government is not exposed to the risk of insolvency (or *default*), that is, at the risk of not paying its financial obligations, for debt in domestic currency. This would happen even in countries such as Brazil, where there is a prohibition on direct financing of the National Treasury by the Central Bank. The reason would be that the government is itself the issuer of the currency and can always finance itself at short-term inte-

13 In the Effective Demand Macroeconomics approach, Summa & Serrano (2019) add three theoretical pillars to the assumptions of MMT/Functional Finance: the exogenous interest rate approach, in which the government does not face solvency problems in debts denominated in its own currency and the Central Bank autonomously determines the base interest rate; the extension of the principle of effective demand for the long term; and, finally, the notion of inflation of cost and via distributive conflict.

14 SERRANO, F.; PIMENTEL, K. Será que acabou o dinheiro? Financiamento do gasto público e taxas de juros num país de moeda soberana. Revista de Economia Contemporânea, v. 21, p. 10.1590/1980552, 2017.

15 Monetary sovereignty is the ability of a state to issue a national currency with a legal tender.

rest rates, set autonomously by the Central Bank.

In the Brazilian case, the convergence of the SELIC rate target to the effective SELIC rate[16] is guaranteed through the Central Bank's role in the daily management of liquidity, buying and selling government bonds (mainly in the so-called "repurchase agreements" or "repo operations") in the bank reserve market. In countries, such as Brazil, where the Central Bank is willing to ensure that the effective interest rate converges to the target, the government can finance itself through the issuance of debt securities, as any pressure on interest rates arising from the bonds issued by the Treasury will be corrected by the Central Bank.

Therefore, monetary policy would have greater freedom of action, given the Central Bank's ability to choose the short-term base interest rate, via its operation in the bank reserve market. This understanding is complemented by the notion that, in the case of Brazil, inflation must be a phenomenon explained, in most cases, from the point of view of supply and not derived from excess demand. Therefore, interest rate cuts that would lead to increases in aggregate demand would not have inflationary impacts, as the NCM puts it. The causes of inflation, from this point of view, would be the distributive conflict – one between profits and wages as a share of income – and shocks in costs (or prices of production supplies) and not the result of increased demand. Therefore, there would be room for an expansionary monetary policy, starting mainly with a reduction of interest rate.

16 The Monetary Policy Committee, Copom, determines a target for the SELIC interest rate. Once this target is defined, the Central Bank carries out purchase and sale operations of government bonds in order to converge to the established interest rate (SELIC-effective). Therefore, the simple announcement of the interest rate target by Copom does not guarantee that this interest rate is the effective one. The Central Bank must act in the market to guarantee this interest rate.

MONETARY POLICY IN BRAZIL (1999 – 2021)

Historical Background (1994-1999)

The adoption of the macroeconomic tripod was due to the unsustainability of the foreign-exchange band regime in force in the first phase of the Brazilian Real (1994 – 1999). It is well known that "Plano Real" was successful in its main objective, controlling the inflationary process that had affected the Brazilian economy for years. However, it produced serious side effects[17], with emphasis on the external and fiscal imbalance. These imbalances were indirect results of the inflation stabilization strategy itself, which relied on an overvalued managed foreign-exchange rate and a restrictive monetary policy, with high interest rates.

During this period, exchange rate policy was at the center of the price stabilization strategy. First, it was necessary to ensure a stable relationship between the value of the new domestic currency, the Real, and the US Dollar, which resulted in a regime with a currency band[18]. Second, the foreign-exchange rate should be kept at a valued threshold, with the aim of containing the prices of imported products and inputs and creating price competition between domestic production and imports. As a result, the country started to record deficits in current account balance, which means that more dollars were leaving than entering Brazil[19].

To deal with this external imbalance, which threatened to lead to devaluation of the Real against the US dollar, Brazil practiced high interest rates in order to attract dollars through short-term speculative capital flows. The entry of funds in foreign currency required the realization of *sterilization operations*. Sterilization operations aim to neutralize changes in the monetary base resulting, in this case, from the inflow of capital. Dollars entering the country to obtain domestic assets are first converted into Real on the foreign exchange market, as domestic assets, such as stocks on the Bovespa and government bonds, are quoted in Real. Therefore, at first, the inflow of foreign capital changes the monetary base in reais. In response, the Central Bank may issue government bonds as a way to contain this excess liquidity. As a result, there was an expansion of the public debt and an increase in its cost, given the high interest rates.

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17 Giambiagi *et al* (2021)

18 Under the currency band regime, the Central Bank is committed to ensuring the value of the foreign-exchange rate within a publicly announced range.

19 Current account balance corresponds to commercial transactions, goods and services, primary income (income from labor and investments) and secondary income ("unilateral transfers").

Therefore, despite achieving success in the main objective, price stability, "Plano Real" created other macroeconomic imbalances. The positive results depended on an overvalued foreign-exchange rate and a high interest rate, which resulted in fiscal and external imbalances. With the reversal of the international liquidity scenario, which led to a decrease in the inflow of capital to Brazil, and the successive exchange rate crises in emerging countries, the country was forced to abandon this regime in 1999, when the Real was targeted of successive speculative attacks.

The country then adopted the so-called "macroeconomic tripod" in 1999, which sought to correct the imbalances arising from "Plano Real":

- **Floating exchange rate regime**, which states that there is no explicit target for the value of the foreign currency, which is mostly determined by the market, even though the Central Bank may intervene by buying and selling foreign currency. The floating exchange rate regime would supposedly allow the adjustment of external accounts gradually, without the need for internal contractionary policies to achieve the external adjustment;

- **Inflation targeting regime** for monetary policy. Combined with the devalued foreign-exchange rate, the inflation targets mean that monetary policy could turn to internal objectives, as it would be free from the commitment to guarantee the inflow of capital necessary to maintain the artificially valued exchange rate;

- **Fiscal regime oriented to the generation of primary surpluses**, with the objective of safeguarding resources for the payment of interest and stabilizing the ratio between public debt and GDP.

As pointed out by Arminio Fraga[20], president of the Central Bank during the period of introduction of the "tripod", inflation, previously controlled by the exchange rate, would become the goal of monetary policy and external balance, which was previously achieved with high interest rates, would become the objective of exchange policy.

General behavior of inflation and of interest rates in Brazil

Despite changes in government and economic policy orientation during the period the macroeconomic tripod was in effect, the core of monetary policy has been constant over the last two decades. As discussed earlier, this economic policy aims to achieve a target for the inflation rate, by manipulating the base interest rate, or SELIC. In short, this monetary policy has one main objective, to ensure a low rate of inflation, and one instrument, the base interest rate.

Therefore, in the first place, it is necessary to assess the effectiveness of the monetary policy, in terms of its ability to meet the proposed objective. Graph 1 and Table 1 show the evolution of the inflation target, considering the oscillation bands, stipulated by the National Monetary Council (CMN), including for the coming years.

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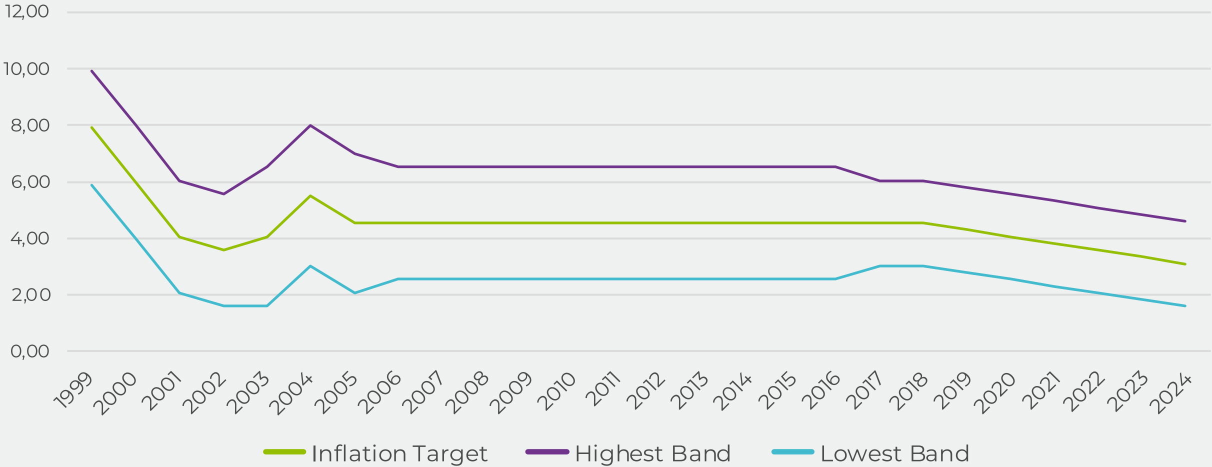
[20] "*Roda Viva*", *TV Cultura* channel, 14/06/1999.

When considering the entire period, it is possible to analyze two movements. At first (1999-2002), the inflation target tended to fall, with the bands remaining at 2% upwards or downwards. After a period of temporary ascent (2002-2004), there is a phase of stability of the inflation target and bands: between 2006 and 2016, the CMN maintained the same pattern for the inflation target, being the center of the 4.5% target, with 2.0% bands upwards or downwards. As of 2018, the CMN adopted a stricter posture in relation to the goal, stipulating a falling goal and narrowing the bands.

Graph 1 - Inflation target



Source: Central Bank of Brazil

Table 1 - Inflation Targets in Brazil

Year	**Inflation target**	**Band**	**Upper limit**	**Lower limit**	**IPCA**	**Result**
1999	8,00	2,00	10,00	6,00	8,94	Within the target
2000	6,00	2,00	8,00	4,00	5,97	Within the target
2001	4,00	2,00	6,00	2,00	**7,67**	**Off the target**
2002	3,50	2,00	5,50	1,50	**12,53**	**Off the target**
2003	4,00	2,50	6,50	1,50	**9,30**	**Off the target**
2004	5,50	2,50	8,00	3,00	7,60	Within the target
2005	4,50	2,50	7,00	2,00	5,69	Within the target
2006	4,50	2,00	6,50	2,50	3,14	Within the target
2007	4,50	2,00	6,50	2,50	4,46	Within the target
2008	4,50	2,00	6,50	2,50	5,90	Within the target
2009	4,50	2,00	6,50	2,50	4,31	Within the target
2010	4,50	2,00	6,50	2,50	5,91	Within the target
2011	4,50	2,00	6,50	2,50	6,50	Within the target
2012	4,50	2,00	6,50	2,50	5,84	Within the target
2013	4,50	2,00	6,50	2,50	5,91	Within the target
2014	4,50	2,00	6,50	2,50	6,41	Within the target
2015	4,50	2,00	6,50	2,50	**10,67**	**Off the target**
2016	4,50	2,00	6,50	2,50	6,29	Within the target
2017	4,50	1,50	6,00	3,00	**2,95**	**Off the target**
2018	4,50	1,50	6,00	3,00	3,75	Within the target
2019	4,25	1,50	5,75	2,75	4,31	Within the target
2020	4,00	1,50	5,50	2,50	4,52	Within the target

Source: Central Bank of Brazil

As shown in Table 1, in the first years of the new regime, it is not possible to state that its results were positive. Between 1999 and 2003, inflation, measured by the IPCA, exceeded the upper limit of the target on three occasions (in 2001, 2002 and 2003).

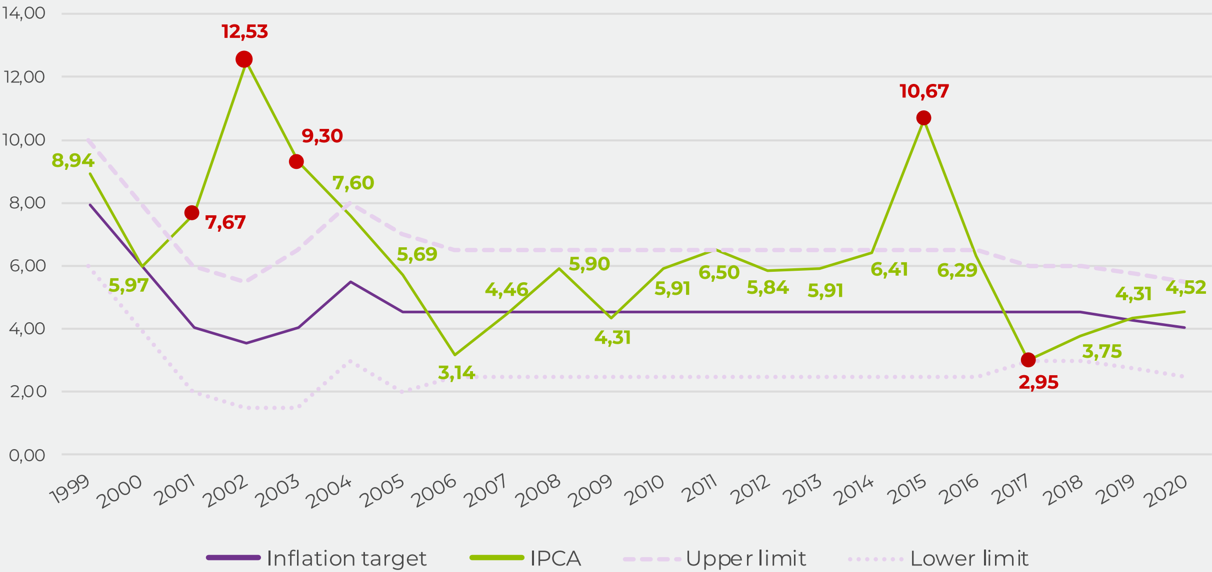
However, in the following years, there was a great period in which the effective inflation was within the stipulated target. Inflation exceeded the upper limit of the target only in 2015. According to the Central Bank[21], this negative result reflected the adjustment of administered prices (which were previously restricted as a policy to con-

[21] In an open letter dated January 8, 2016, due to non-compliance with the inflation target and in compliance with the sole paragraph of art. 4 of Decree No. 3,088, of June 21, 1999.

trol inflation) and the realignment of domestic prices in relation to international prices, as a result of the foreign-exchange rate devaluation. Again, in 2017, the Central Bank of Brazil failed to meet the inflation target, however, this time, it was because the effective inflation was lower than the target's lower limit.

Therefore, **the Central Bank of Brazil failed to meet the inflation target in five years out of the twenty years of validity of the new regime, that is, in 25% of cases**. Despite this non-compliance, it is possible to affirm that the inflation targeting regime is effective in the Brazilian case, since there was no persistent inflationary episode or significant inflationary peaks. Graph 2 illustrates the performance of effective inflation versus the inflation target, highlighted in red for the years in which the target was not met.

Graph 2 - Inflation and Effective Inflation Targets (IPCA)

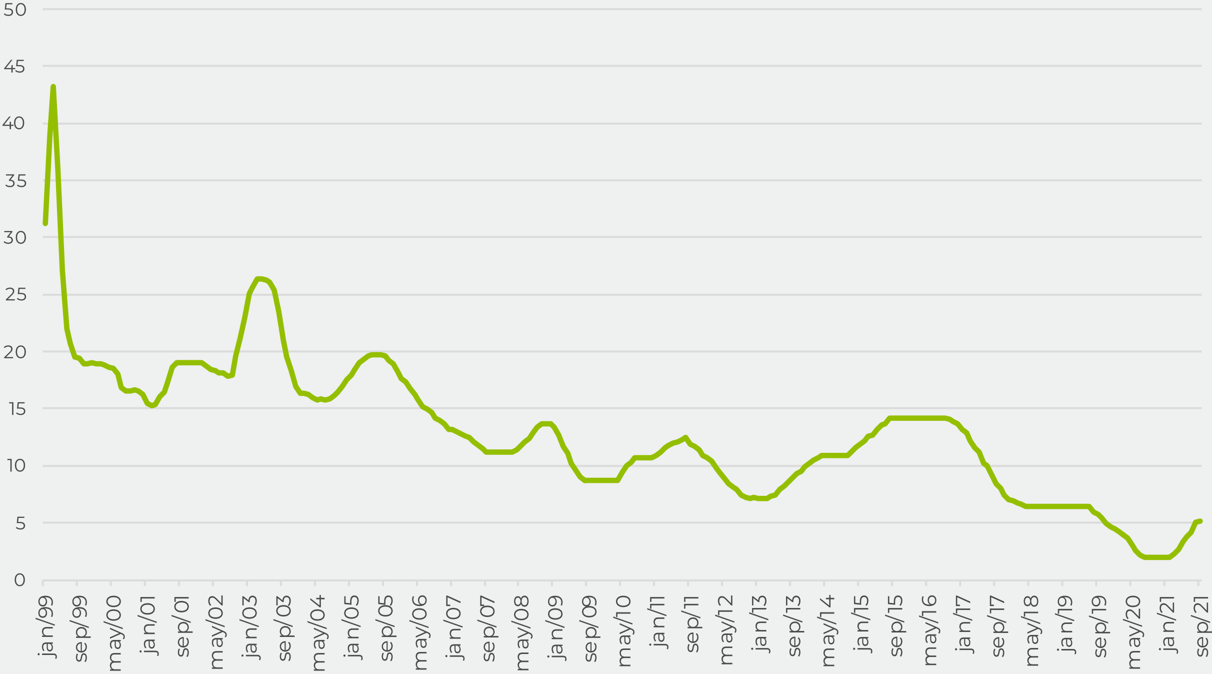


Source: Central Bank of Brazil

Would the positive results, in terms of controlling the inflationary process, be sufficient to determine the success of the inflation targeting regime? Unfortunately, not yet. In fact, the inflationary process was relatively contained, but the result was due to the maintenance of a high threshold for interest rates in the period, to the detriment of other economic objectives, as we will see in the next section.

Graph 3 shows the evolution of the SELIC over the period of the inflation targeting regime. In terms of dynamics, there is a general downward trend in nominal interest rates. The period between 1999 and 2002 was one of great macroeconomic instability, with successive currency crises. In order to attract speculative foreign capital to meet the need for external financing, Brazil adopted a restrictive monetary policy, with very high nominal interest rates. The improvement in the external scenario, combined with a partial change in domestic macroeconomic policy, allowed for a downward trend in interest rates between 2003 and 2013, despite the easing and tightening monetary cycles in the period. In 2015, there was a reorientation of economic policy under Dilma Rousseff's administration, with a real *recessive shock*[22] compounded by austerity measures such as the drop in public spending, the increase in administered prices, the sharp devaluation of the foreign-exchange rate and increase in interest rates. More recently, however, the nominal interest rate has again taken a general downward path, reaching historic lows.

Graph 3 - Base interest rate, SELIC



Source: Central Bank of Brazil

22 Joint Center for Political and Economic Studies – CECON, "*Choque recessivo e a maior crise da história: A economia brasileira em marcha à ré*".

A similar behavior can be observed in the real interest rate, the one that considers the effects of inflation[23] (see Graph 4).

Graph 4 - Real interest rate

Source: Central Bank of Brazil

Despite a general downward trend, since the adoption of the inflation targeting regime, the Brazilian economy has presented high interest rates in terms of international standards. Based on BIS data, in an analysis of 166 countries and considering the period between 1999 and 2016, Brazil had the second highest average real interest rate in the group, only behind Zimbabwe.

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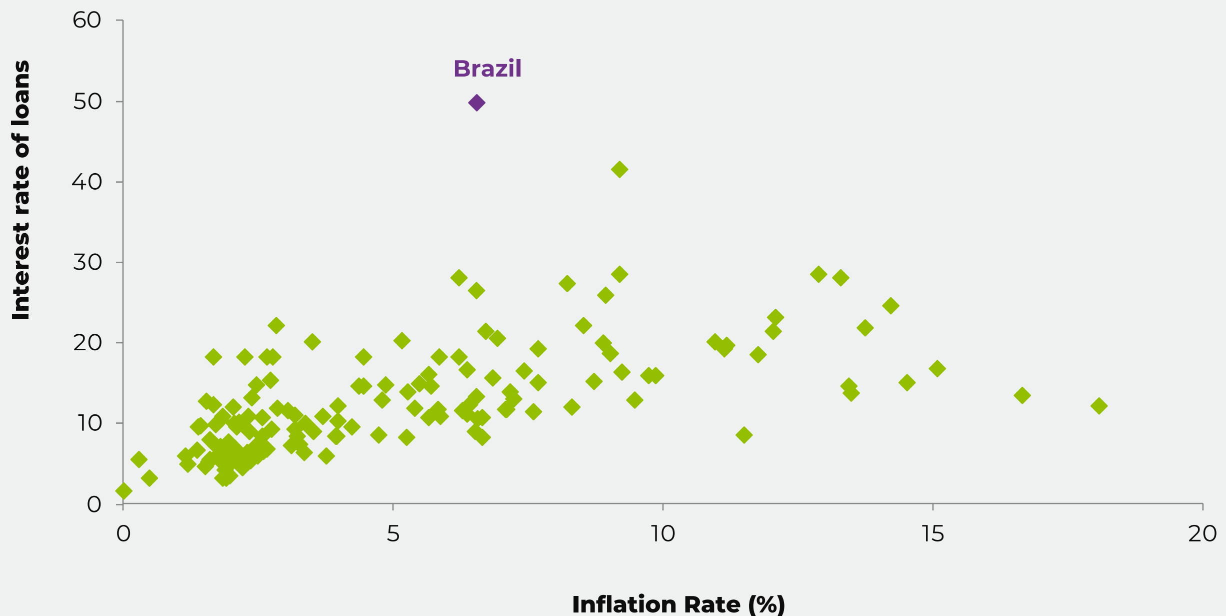
23 The concept of real interest rate was used *ex-post*, which considers the effective SELIC rate accumulated in the last 12 months, discounting the inflation accumulated in the period, as suggested by the Central Bank of Brazil.

Effects of high interest rates on the economy

The high interest rate causes negative macroeconomic repercussions on the Brazilian economy. Here we will analyze three: access to credit; the increase in the cost of public debt; and investments.

First of all, **Brazil has one of the highest lending rates in the world**, even with a relatively moderate inflation rate, as can be seen in Figure 5. The high cost of credit harms families and businesses, being an obstacle to economic growth and job creation.

Graph 5 - Loan interest rate and inflation rate (%, average 1999 – 2016)



Source: World Bank. Data prepared by Rossi, Welle & Gonçalves (2019).
Note: 159 countries were considered in the sample.

Regarding companies, a 2005 survey[24] concluded that business credit is underdeveloped: interest rates are exorbitant and access to credit is very restricted. Among medium-sized enterprises, around 30% do not have short-term financing during the period, while approximately 16% do not have long-term indebtedness. In an international comparison, Brazilian credit is far below the standard of countries at a similar

24 ANTONIO GLEDSON DE CARVALHO. Bankruptcy Law, Credit and Interest Rates in Brazil. Political Economy Journal (ISSN Print: 0101-3157 ISSN Digital: 1809-4538), vol. 25, no. 1 (97), p. 131-153, January-March/2005.

level of development: the Brazilian average volume of bank credit as a proportion of GDP is 46.7%, while countries at a similar stage of development present values around 150%.

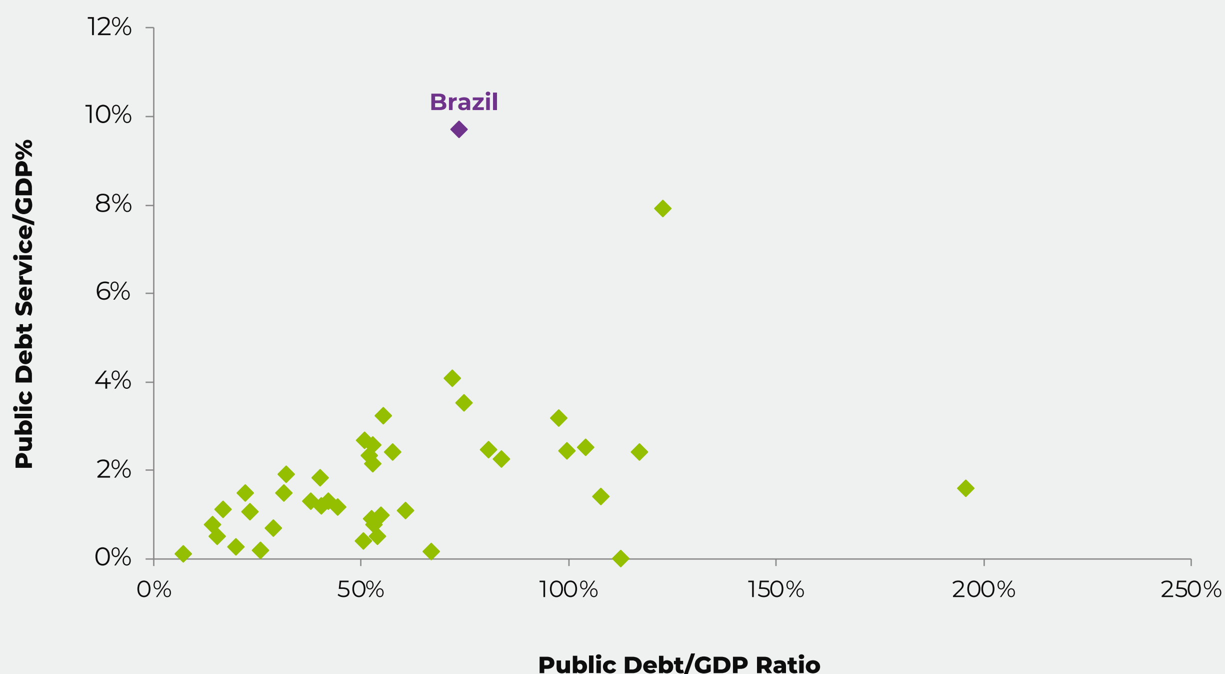
For credit to families, a study[25] which analyzed the moment of the so-called "Batalha dos Spreads" (free translation: "Spreads Battle" - analyzed in previous section) came to the conclusion that the decrease in interest rates in the period led to an increase in credit and an increase in the participation of younger agents, with lower income and relatively newer bank accounts in the credit market.

A second relevant economic aspect is the **high cost of public debt**, arising from the fact that the National Treasury needs to finance itself with bonds linked to high interest rates.

The higher the interest rate, the higher the cost of debt and the resources earmarked for interest payments. Even with a moderate debt/GDP ratio, **Brazil has the highest debt service in an international sample of 42 countries**, according to data from the World Bank. Countries like the United States and Japan, for example, had a debt/GDP ratio of 99% and 196%, respectively, however, the debt service to GDP was only 2% in 2016. **In Brazil, also in 2016, even with the federal public debt stock at 74% compared to the GDP, the debt service got to 10%**. This is due to the high Brazilian interest rate, especially when compared to the interest rate of central countries such as Japan and the United States. The consequences of high debt service will be explored in the next section.

25 Felipe Alves FONSECA. Paulo Augusto P. de BRITTO. Exploratory Effects Analysis of The Bank Interest Rates Reduction in Brazil In 2012: The Case of a Large Public Bank. Electronic Journal of Administration (Online) ISSN: 1679-9127, v. 15, n.2, ed. 29, Jul-Dec 2016. 29, July-December 2016.

Graph 6 - Public Debt Service/GDP and Public Debt/GDP (%)



Source: World Bank. Data prepared by Rossi, Welle & Gonçalves (2019).
Note: 42 countries were considered in the sample and the reference year is 2016.

Finally, a scenario of high interest rates discourages productive investment. The high interest rate, as described above, contributes to the valuation of the Brazilian exchange rate, **harming domestic industrial production and export sectors**. In addition, it discourages investment because of the direct competition with the profit rate: for private investment to be worthy, the profit rate must be greater than the interest rate, an income that can be earned by buying SELIC-linked securities. The lack of investments compromises the capacity to generate employment and income.

A study[26] compared the Brazilian real interest rate with the Gross Fixed Capital Formation, which portrays the investment made in the economy, and concluded that in the period 2003-2018 there is a tendency for investment to increase when the interest rate is reduced. The study also shows a trend of equivalence of the variation in GDP per capita with investment, corroborating the theories that investment is one of the main instruments that contri-

26 Josiane Zanette Batista and Gilson Batista de Oliveira (2021): "Decision to Invest, Interest Rate and Economic Growth: A Comparative Study Between Brazil and South Africa". Journal: Contribuciones a la Economía (Vol 19, No. 1 January 2021, p. 3). 16-27 Available at: https://www.eumed.net/es/revistas/contribuciones-economia/ce-enero21/crescimentoeconomico

bute to economic growth. Finally, other studies prove the relationship between interest rate reduction and investments, such as Sonaglio, Braga and Campos (2010)[27] and Bresser Pereira (2003)[28], the latter claiming that the high interest rate policy adopted in Brazil for inflation control is the main factor for the inconsistency and volatility of the Brazilian investment rate.

The new macroeconomic matrix (2011-2014)

After this overview of the behavior of monetary policy since the implementation of the macroeconomic tripod, a more in-depth analysis of the last attempt to change the conduct of monetary policy is needed, and it is related to the "New Economic Matrix" (NME), adopted during the first term of Dilma Rousseff (2011–2014).

According to Marcio Holland (2017)[29], former secretary of Economic Policy at the Ministry of Finance during Dilma Rousseff's administration, the term emerged to describe a macroeconomic policy associated with lower interest rates and a devalued exchange rate. This move would be an attempt to solve a macroeconomic issue of the Lula administration that has raised criticism: the combination of high base interest rate and a valued foreign-exchange rate. However, according to the former secretary himself, the NME would not replace the economic policy tripod in force since 1999.

In Singer's (2015)[30] view, the NME consisted of a broader set of economic policy changes. First, the structural reduction of the base interest case, compatible with the international level, would be the main pillar of the NME. Associated with the reduction of the base interest rate, the government adopted other measures to stimulate credit, such as the use of public banks to promote a general reduction of the *spreads* of commercial banks (as will be discussed in the next topic) and the expansion of BNDES credits with resources from the National Treasury.

In conjunction with an expansionist monetary policy, by reducing interest rates, the NME proposed a more undervalued threshold for the exchange rate, a measure to stimulate growth via exports and via the effect of competition between domestic and imported production. The exchange rate threshold management strategy also included capital control instruments (changes in IOF rates on foreign portfolio investments, control over foreign funding by residents, payment on bank positions in the foreign-exchange spot market and greater control over operations with foreign exchange derivatives). Finally, in the

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27 Cláudia Maria Sonaglio. Marcelo José Braga Antonio Carvalho Campos. Investimento Público e Privado no Brasil: Evidências dos Efeitos Crowding-In e Crowding-Out no Período 1995-2006. Revista EconomiA. Maio/Agosto 2010.

28 BRESSER – P.L. C. Macroeconomia da estagnação: crítica a ortodoxia convencional no Brasil pós 1994. Análise econômica. Ano 21, n. 39, Março. Porto Alegre. 2003.

29 HOLLAND, M. A Matriz da Discórdia. Conjuntura Econômica, 2017.

30 SINGER, A. Cutucando onças com varas curtas. Novos Estudos. CEBRAP, v. 102, p. 43-71-71, 2015.

fiscal field, the proposal was for "fiscal consolidation", that is, a policy to contain spending. NME's strategy was to boost private investment, especially in the industrial sector, aiming at a new economic development strategy, with support, at least initially, from part of the national bourgeoisie.

The economic policy strategy began to incorporate other elements over time: intervention in the energy sector (oil and electricity), by imposing a price control policy, and the use of public banks to promote the reduction of *spreads*.

Economists with a liberal-orthodox orientation, Fernando de Holanda Barbosa and Samuel Pessoa, claim that the NME meant the abandonment of the macroeconomic tripod, being characterized by a veiled abandonment of the Central Bank to the inflation targeting regime (stipulating interest rates lower than that those that would be compatible with the inflation target), expansion of credit by state banks, veiled abandonment of the flexible exchange system and interventions in the oil and electricity sectors (Barbosa, FH, 2015[31]; Barbosa, FH; Pessoa, S., 2014[32]). However, it should be noted, as explained in the previous section, that in the period, with the exception of 2015, the Central Bank met the inflation targets.

31 BARBOSA, F. H. Crises econômicas e política de 2015: origens e consequências. Revista Conjuntura Econômica, 69(9), 53, 2015.

32 BARBOSA FILHO, F. H.; PESSOA, S. Desaceleração recente da economia. In: CENTRO de Debates de Políticas Públicas. Sob a Luz do Sol, Uma agenda para o Brasil: a Política Econômica do governo Dilma: a volta do Experimentalismo. CDPP, p. 15-30, 2014.

In summary, in terms of monetary policy, the first Dilma term stands out for the reduction of the base interest rate, which in fact was effective, but which had a short duration, with partial reversals in 2013 and definitive in 2015, the use of control of administered prices (such as energy and gasoline) to control inflation and the effort to reduce bank *spreads*. Overall, the policy was not effective in promoting economic growth, although it did not lead to uncontrolled inflation.

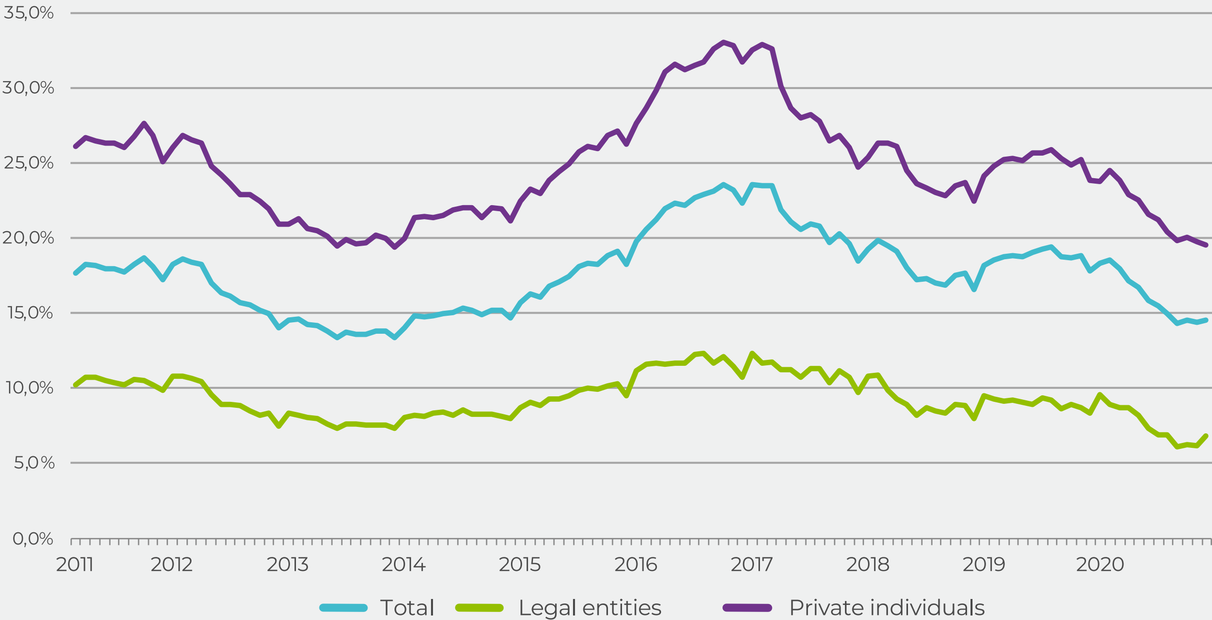
Spreads Battle

A second important monetary policy theme of the Dilma Rousseff administration was the deliberate intention to reduce bank *spreads*[33], the so-called "*Batalha dos Spreads*", or "Spreads Battle" by Singer (2015). According to the author, Rousseff's administration took a confrontational stance on several fronts. In the field of monetary policy, alongside the reduction of the base interest rate, the government implemented active measures to reduce the *spreads* practiced by the Brazilian banking sector. In fact, the *spreads* practiced in the Brazilian economy are high when compared to the international standard. Public banks served as an instrument for the policy to reduce bank *spreads*, especially via the competition mechanism. In practice, Banco do Brasil and Caixa Econômica Federal started to practice lower *spreads*, forcing a backlash from private banks to avoid losing market share.

33 Bank *spread* consists of the difference in the interest rate at which the bank finances itself (or pays depositors of funds) and the rate that banks charge on their loans.

According to Mello & Rossi (2018)[34], the "Spreads Battle" meant a confrontation between Rousseff's government and the financial sector. As a result, the policy was successful in reducing the cost of credit for families and companies, but there was a later reversal, especially from 2015, when the spreads returned and surpassed the threshold in force before the policy.

Graph 7 - Bank spread (%)

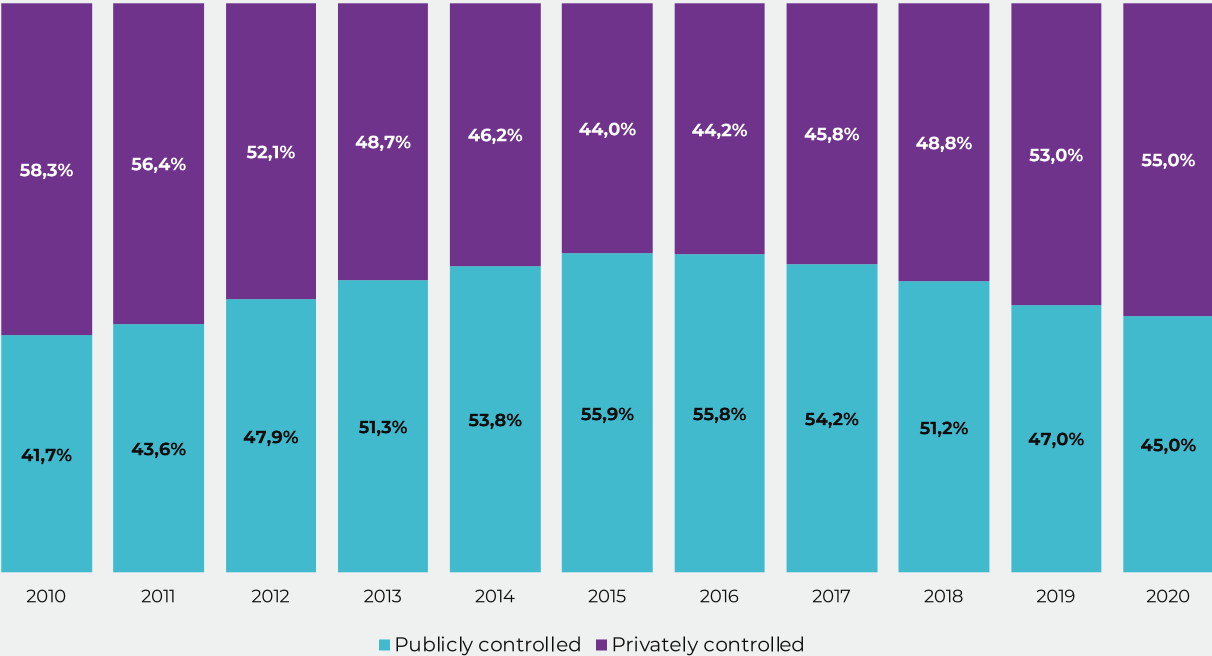


Source: Central Bank of Brazil

34 MELLO, G. S. ; ROSSI, P. . Do industrialismo à austeridade: a política macro dos governos Dilma. In: Carneiro, R.;Baltar, P.; Sarti; F.. (Org.). Para além da política econômica. 1ed.São Paulo: Unesp, 2018, p. 245-282.

A second consequence was the expansion of the participation of public banks in the total credit portfolio, intensifying a movement that had been taking place since the 2008 international financial crisis. The loss of *market share* of private banks created political conflicts relevant to Dilma's government, being a clear factor of displeasure in the financial sector, one of the sectors that supported the successful impeachment request of the president in 2016.

Graph 8 - Market-share, in relation to the credit balance, of public and private institutions



Source: Central Bank of Brazil

DEBATES ON MONETARY POLICY IN BRAZIL

This subsection is dedicated to exposing two specific and extremely relevant discussions that have entered the agenda of the contemporary Brazilian debate on monetary policy: the independence of the Central Bank and the fiscal cost of monetary policy.

Central Bank independency

The Independent Central Bank's thesis is directly articulated with the theoretical precepts of the inflation targeting regime. The notion that an expansionist monetary policy is capable of reducing unemployment in the short term, but that in the long term it would only result in an increase in inflation, gives rise to the possibility of political use of the Central Bank, which, under pressure from populist politicians, would adopt an interest rate lower than that indicated for the fulfillment of the inflation target.

As a way to shield the Central Bank from such pressures, the recommendation of orthodox economists is for it to act independently (or with a high degree of autonomy) and be composed exclusively of technical experts who are averse to inflation. According to its supporters, autonomy contributes to fighting inflation, gaining credibility by the monetary authority and reducing interest rates.

From a critical point of view, it is important to emphasize that the Central Bank's autonomy reduces the capacity to coordinate economic policies, in addition to the lack of conclusive evidence that autonomy generates benefits for society. Finally, the autonomy of the Central Bank moves monetary policy decisions away from the spheres of control of democracy, and, consequently, from society. At the same time, it contributes to the domination of the Central Bank by private sector interests, especially banks.

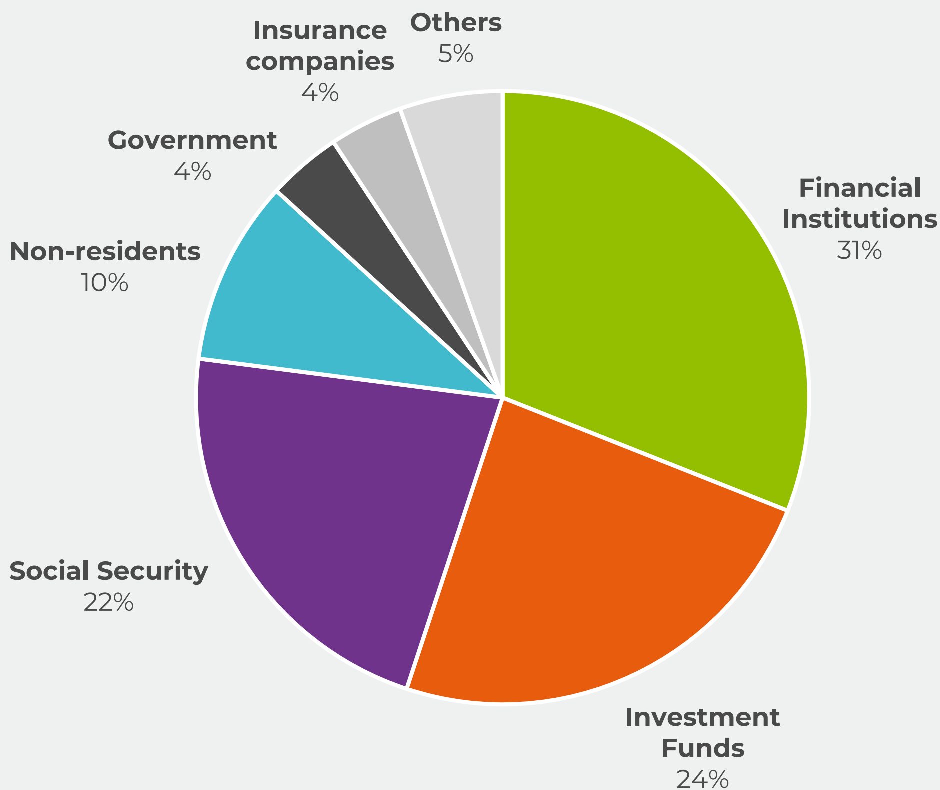
In the Brazilian case, the topic of Central Bank autonomy/independence is recurrent. Recently, a new chapter in this debate took place due to the approval, in 2021, of the bill that guarantees the autonomy of the Central Bank. In practice, the Central Bank of Brazil already had operational independence, *in fact*, but with law it becomes *de jure*. Additionally, fixed mandates that do not coincide with the mandates of the federal executive were established, as a way of not coinciding with political cycles. Finally, a six-month quarantine instrument was also established between the end of the term of office at the Central Bank and employment periods in private financial institutions - an instrument criticized for not being sufficient to ensure that directors have close relations with the sector.

Fiscal cost of monetary policy: public debt

Monetary policy decisions, or, in short, the fixing of the base interest rate, have effects on the entire economic system. As highlighted, there are impacts on aggregate demand (via household consumption and investments), on the exchange rate, on credit and, indirectly, on income and prices of financial assets.

There is also a fiscal cost, as rising interest rates make public debt management more expensive. Most government bonds have a yield indexed to the SELIC. In this case, an increase in the interest rate means a higher yield for the holders of these bonds and a higher cost of debt on the part of the Brazilian State. In other words, an increase in the interest rate means that the government is financing itself via debt, more expensively, and paying higher yields to those who hold the papers. This also has redistributive impacts, since, as can be seen in Graph 9, most debt holders (55%) are financial institutions and investment funds, controlled by the Brazilian economic elite.

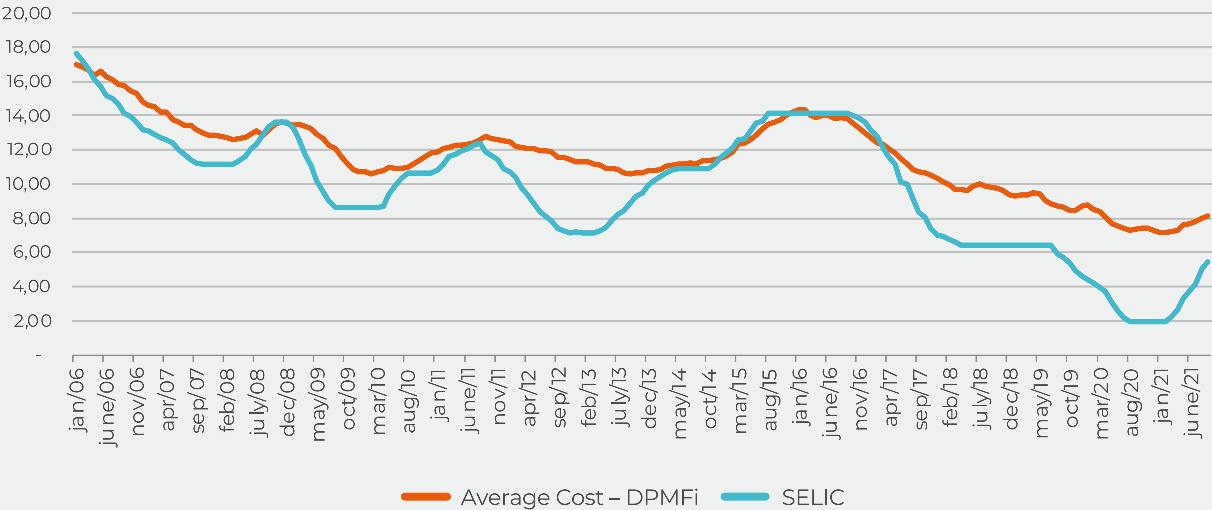
Graph 9: Holders of Domestic Public Debt Securities



Source: National Treasury. Monthly Public Debt Report (RMD), August 2021.

Graph 10 shows the unequivocal relationship between the average cost of the internal federal public debt (DPMFi) and the base interest rate, the SELIC. The increase in the base interest rate, in this case, is directly associated with a higher average cost of the internal federal public debt, on the other hand, moments of lower interest rates contribute to a reduction in the debt cost. This finding has very relevant implications for the importance of coordination between economic policies and the need to consider the multiple effects of a restrictive monetary policy on the Brazilian economy.

Graph 10 - Average cost of DPMFi and SELIC (%)



It is important to mention that the public debt is a legitimate and very important instrument for the financing of all National States, being no different in the Brazilian case. As described in subsection 3.3, for a country issuing a sovereign currency, such as Brazil, the State does not face financing problems in its own currency, as long as the Central Bank and the National Treasury act in cooperation. Furthermore, the high amount of interest payments does not result from a high debt stock, but from a high interest rate. As alerted by the National Treasury, countries like the United States and Japan have debt stocks much higher than Brazil's, but the total cost of debt is much lower, precisely because these countries have lower interest rates.

The problem, in this sense, is not in the formation of the debt itself, but in its distributive effects, given the rise in interest rates. Furthermore, given the influence of the interest rate on the cost of public debt, the monetary policy ends up creating budgetary constraints for the management of fiscal policy, as the cost of debt is used as a justification for the need to create primary surpluses or other restrictive tax rules.

In short, State financing through the issuance of public debt is correct, justifiable and is present in all organized economies in the world – being a fundamental instrument of economic policy. Comparing to other nations, Brazil does not have a high stock of public debt, in relation to GDP, which once again confirms that the country does not face a fiscal restriction that prevents debt from increasing. However, as the country has one of the highest interest rates on the international scene, it becomes the champion in the category of interest payments in relation to GDP. Therefore, the budgetary constraint, in the Brazilian case, is derived from the restrictive monetary policy, that is, from the policy of high interest rates.

FINAL CONSIDERATIONS

This report discussed the state of the art of the debate on economic policy in Brazil, with an emphasis on monetary policy. To fulfill this objective, the report adopted a broad vision, considering the entire Brazilian macroeconomic context in which the monetary policy is inserted.

Since 1999, a "macroeconomic tripod" has been in force in the country, with the simultaneous adoption of the floating exchange rate regime, the primary surplus regime and the inflation targeting regime. Regarding monetary policy, there is the public announcement of an inflation target, which is pursued by the Central Bank through changes in the base interest rate. In terms of results, the targeting regime is successful in fighting inflation, but the country had high real interest rates compared to other countries. A high interest rate has consequences for economic growth, access to low-priced credit and investments.

There is, without a doubt, a tendency towards conservatism in Brazilian monetary policy, with strong resistance to a structural change in level. From a historical point of view, this is visible in the episodes of the "New Macroeconomic Matrix" and in the "Spreads Battle", when attempts were made to reorient the monetary policy, but faced strong resistance.

From a propositional point of view, critical alternatives to the macroeconomic tripod highlight the need to adopt a new monetary policy (and macroeconomic policy in general) oriented towards economic growth, job creation and income distribution. **It is necessary to adopt a broader vision: the monetary policy should not have as its sole objective the fight against inflation, just as the fight against inflation should not depend only on monetary policy.**

Controlling the inflationary process should never be neglected, especially when it directly affects the income of the working class and groups in economic and social vulnerability. An inflationary policy, however, should not only rely on monetary policy as a single instrument. It should also consider macroprudential policies, income policy, exchange rate policy, tax policy and administered price policy.

Finally, monetary policy should be oriented towards creating jobs, generating and distributing income and protecting rights. These results involve a reorientation of monetary policy, with structurally lower interest rates, that is, an expansionary monetary policy; as well as limiting the constraints on fiscal policy arising from monetary policy, while controlling the possible inflationary and redistributive impacts of expansionary policies. However, it is noteworthy that this change would require a complete reorientation of the macroeconomic regime, associated with a policy of economic and social development.

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