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Challenges for Monetary Policy: Brazil and the International Context

Speech of Governor Henrique Meirelles at Conference

“The Impact of Brazil on the Global Scenario”

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1. In mature economies, the years from the beginning of the 1990s to mid-2007 were characterized by low GDP volatility and low inflation, circumstances that led prominent economists to name the period as the era of the “great moderation”. That environment resulted from better monetary policy – translating into credibility gains for central banks –, globalization and advances in productivity linked to information technology developments. At the time there was substantial consensus that the emergence of Asia, particularly of China and India, would contribute to keep global inflation permanently under control. Thanks to cheap labor and the intensive use of new technologies on the production process, China - and to a lesser extent India - exported deflation, or at least disinflation, to the world economy through a consistent decrease in their export prices.
2. There is now growing evidence that this era might have come to an end, with the recent sharp increase in raw material prices, a result of unbalances between the expansion of global demand and supply. Moreover, there are also signs of increasing labor costs in China, due to both changes in labor legislation and increasing shortages of specialized workforce.
3. In the benign environment that prevailed through mid-2007, central banks of mature economies engaged in neutral or even expansionary monetary policies for relatively long periods. Under these circumstances, the traditional pro-cyclicality of credit emerged once again, fuelling asset price inflation (particularly real estate prices in certain regions of the US and Europe) rather than consumer price inflation.



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4. In the past twelve months the scenario changed radically: a severe financial crisis, stemming from the US real estate sector, hit mature economies in general, whereas demand pressures over the availability of limited production factors led to mounting inflation in a global scale. Thus, central banks currently face a much more complex and challenging environment than during the years of the great moderation. Monetary responses have been initially diverse due to the nature of the problems that surfaced, but the priority on the need to preserve price stability prevails.
5. Led by the *Federal Reserve*, central banks of mature economies initially took measures to control the damage stemming from the mortgage sector on the overall credit market and to limit the impact of the financial crisis on the economy. In this context, monetary policy resumed an expansionary stance, which particularly aggressive in the US, where it aimed to counteract endogenous tightening of credit conditions, combined with the introduction of new types of intervention in the money markets, aimed at ensuring the convergence between short-term interest rates and the monetary policy instrument.
6. More recently, due to the clear intensification of inflationary pressures and the apparent reduction in systemic risk – even considering uncertainties about the overall losses in the credit markets –, monetary policies have tightened, as illustrated by the recent hike of the Euro zone reference rate.
7. Indeed, due to both increases in raw material prices and demand pressures, inflation accelerated sharply around the globe. In mature economies in general, marked by broader levels of idle capacity, higher commodity prices probably explain the bulk of the inflation upsurge. In emerging countries, including Brazil, domestic demand pressures have had a relatively more important role in stoking mounting inflation pressures. As a matter of fact, strong domestic demand in these economies created conditions which enabled initially isolated price pressures to become more widespread. Not surprisingly, monetary policy is currently more and more focused in moderating the pace of demand expansion and containing inflation pressures in the majority of the emerging world.



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8. There is now a reasonable degree of consensus among central bankers that the world economy must grow at more moderate rates. In other words, there are symptoms, such as the persistent rise in prices of several commodities, that as whole the global economy has overheated. National monetary authorities have the responsibility of balancing demand pressures over production capacity. The stance of each central bank will respect local economic conditions, but the absence of a coordinated action on a global scale cannot be an excuse for a lenient stance on the domestic inflation front. More specifically, the Brazilian Central Bank has not waited and will not wait for other central banks to act in order to start fighting domestic inflationary pressures. Not acting promptly would enable initial specific price pressures to contaminate inflation dynamics permanently, due to deteriorated inflation expectations of both price and wage setters.

9. In the beginning of 2008, the Brazilian Central Bank stressed in its regular publications that inflation risks had mounted, a fact that could require an adjustment in its monetary stance. This assessment surprised many analysts that expected inflationary pressures to be contained by a spontaneous slowdown in economic activity, an expectation that did not materialize. Other analysts seemed to believe that increases in commodity prices were temporary and that the Central Bank should wait for the complete materialization of inflationary pressures to finally start acting. It is clear now that this complacent approach would have had deleterious and long-lasting consequences for the economy.

10. As repeatedly stressed by the Central Bank, the balance of risks for inflation became less favorable, not only due to external factors, but also – and more importantly – due to domestic factors. On the external front, the contribution of imports to sustain a benign inflation scenario has become less effective. On the domestic front, fast aggregate demand growth continues to be an important source of inflation risks, particularly amid increasing evidence of limits to the expansion of supply – and despite the robust behavior of fixed-capital investment. Moreover, it is clearer now that additional increases in aggregate supply depend on increases in the investment rate of the economy, a process that requires time. In this context, the Central Bank evaluates that the consistent reduction of the unbalances between the pace of expansion of supply and demand continues to be crucial in the design of monetary policy.



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11. The Brazilian Central Bank adopts a strategy aimed at avoiding inflation volatility. This approach takes into account the time lags in the transmission mechanism and has proved to be the most adequate to deal with uncertainties intrinsic in the process of monetary policy formulation and implementation. Thus the importance of developing an appropriate analytical framework for monetary policy, including forecasts and the balance of risks to inflation, as well as the preemptive stance in the decision-making process of the Monetary Policy Committee.
12. In the current circumstances, there is a potential risk that economic agents start to attribute a higher probability that inflation increases will become persistent, a fact that would reduce the effectiveness of monetary policy. The Central Bank stresses that the performance of monetary policy tends to be more effective when the deterioration of inflation dynamics is in the early stages, rather than when it is more established. Thus, monetary policy should respond immediately in order to avoid that initially restricted inflation pressures translate into an enduring deterioration in inflation expectations.
13. Recent decisions of the Brazilian Central Bank should be understood in that context. Their effects over activity and inflation – potentially helped by some liquidity tightening in progress since the first months of the year – are cumulative and will undoubtedly produce effects in the coming quarters.
14. International evidence, as well as the Brazilian experience under inflation-targeting, shows that there are no advantages of sustaining high inflation rates for long periods. On the contrary, high inflation rates lead to higher risk premia, to shorter planning horizons and consequently to lower potential growth of the economy. Its most harmful outcome is the deterioration in income distribution, as low-income brackets are harder hit by the negative effect of inflation on their purchasing power. It is now clearer than ever that fighting inflation generates benefits in terms of decreasing poverty and reducing social inequalities. Thus, the Brazilian Central Bank has acted and will continue to act in order to bring inflation back to the midpoint target of 4.5% promptly, that is, during the course of 2009. This stance is designed to



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avoid the consolidation of a negative inflationary environment, in which monetary policy would lose efficiency.

15. It should be clear to the public that the Brazilian Central Bank will not have a complacent approach regarding inflation. The Bank is committed to act in order to bring inflation to the midpoint target during 2009. This is the approach that minimizes costs for economic activity and for the society at large, contributing to consolidate a sound, efficient, and fair economic structure.

Thanks for your attention!