Inflation Targeting Regime in Stormy Seas

Mirella Hirakawa

The inflation target functions as an anchor for the price formation of a country. The anchor forces a vessel to stay in a predictable location, avoiding possible deviations caused by winds or currents. Today, there are many winds and currents: a more challenging external scenario; fiscal risks; the risk of leniency from the Central Bank of Brazil (BCB); and, of course, lingering concerns about changing the inflation target.

Continuous Inflation Target Regime

The problem of changing the inflation target seems to have been partially resolved with the possible maintenance of the target at 3% for 2027, with a range of 1.5 percentage points above or below. An additional point would be the shift from a calendar year target to a continuous target. If a continuous target using the relevant monetary policy horizon is chosen, considering the 12-month accumulated inflation six quarters ahead from the July 31 meeting, it would be the first quarter of 2026 (Focus at 3.7%, above the center target of 3.0%). However, its implementation will possibly start in 2027.

Part of the de-anchoring problem would be resolved. The most relevant factor in this change will be how the continuous accountability will be conducted by the BCB. Currently, accountability is triggered by the calendar year; if the BCB does not meet the 12-month accumulated inflation target in December each year, it delivers an open letter to the Ministry of Finance. In this letter, the institution explains how it plans to bring inflation back to the target and when it expects to achieve it. An example of accountability for a continuous target would be delivering an open letter if the BCB does not meet the inflation target for six consecutive quarters. After the first letter, the BCB would have a two-quarter tolerance interval; if it fails again, it would deliver another letter justifying itself.

Looking at the historical record, the new rule for triggering the open letter would have been activated in eight IPCA releases: June 2002, December 2002, June 2003, December 2003, June 2016, December 2016, September 2022, and March 2023. Only one additional time compared to the calendar year methodology. Thus, a change with institutional gains without losing its main execution tool.

Center of the Inflation Target

Although the discussion about the center of the inflation target is natural and always present, the discussion is valid but lengthy and needs time to mature. In 24 years of the inflation targeting regime, Brazil missed the target seven times, and in the recent experience (2021-2022), it was a global event, mostly explained by external shocks rather than internal ones.

In the Argentine case, in 2017, then-President Mauricio Macri changed the inflation target for 2017 to 17% (from the 12%-17% range) and again changed the target for 2018 and 2019 to 15% (from the 8%-12% range) and to 10% (from 5%), respectively. This was one of the main factors that led to the spike in Argentine inflation to nearly 90%.

As in the Argentine case, changing the inflation target when there are doubts about the Copom's commitment to inflation stability makes its job even more difficult, potentially reversing the desired outcome of lower interest rates with higher growth. As pointed out by the BCB president in the June 2023 RTI press conference, modifying a long-standing target that is close to being achieved does not generate credibility.

The rules of the game are defined by the National Monetary Council (CMN), composed of the Ministers of Finance, Fernando Haddad, and Planning, Simone Tebet, as well as the BCB president, Roberto Campos Neto. The CMN has already set the inflation target until 2026 (2024-2026 at 3.0%). Consequently, if the neutral real interest rate is close to 5%, currently estimated by the Central Bank at 4.75% (market agents suggest 5.1% in the Focus Bulletin), with an inflation target of 3%, the structural nominal interest rate would be close to 8%.

The Cost of Credibility

What then prevents the nominal interest rate from reaching 8%? A significant part is explained by the credibility risk of the Copom (Monetary Policy Committee). Fixing this seems inexpensive, albeit laborious. The credibility of an institution is formed by the reputation of its members; thus, the independence of the Central Bank of Brazil (BCB), combined with the choice of a president known for being concerned about inflation, seems to be the recipe for success. Although former BCB president Henrique Meirelles (2003-2011) confirmed his complete independent actions when Lula was president, there have been other times in our history when the BCB did not have the same autonomy. Therefore, reinforcing the independence of the BCB (making it de facto and not just de jure) would be extremely important to shield this institution from future attacks, consolidating it as a state institution rather than a government institution.

The lack of Copom's credibility leads to high interest rates for longer periods without necessarily controlling inflation. Prolonged high interest rates have damaging consequences for an economy. Short-term demand deceleration is inevitable, but with higher interest rates, we also risk long-term growth through reduced investments. Additionally, there are some direct consequences of higher inflation levels.

The first is the loss of purchasing power for families, also caused by the inflation tax, which has a greater impact on low-income families. The second is through indexation; with a higher price level, there is an increase in inertia through increased indexation, meaning the high level of inflation feeds back into itself in subsequent years. Combining the effects of inflation and interest rates, and using the elasticity calculated by the BCB to estimate the Gross General Government Debt (DBGG), for each additional percentage point of PCA and Selic, the DBGG increases by 0.17 percentage points of GDP and 0.41 percentage points of GDP, respectively. Thus, in a scenario of de-anchoring by 0.60 percentage points of inflation, the impact would be R$19 billion on the DBGG, and each percentage point of Selic above 8% would have an impact of approximately R$45 billion.

An independent and credible BCB could shed even more light on the discussion of the inflation target. In this context, we can have deeper discussions, such as about the Laspeyres price index used in the IPCA, which needs frequent updates to its weighting to avoid overestimation, or the discussion about a target using core inflation instead of full indices.

Origin of De-anchoring of Inflation Expectations

Expectations measures have de-anchored across all horizons, whether calendar year or continuous using the relevant monetary policy horizon. Here, I highlight expectations from the relevant monetary policy horizon, thus extracting temporary and manageable effects, if necessary, by a credible monetary policy, such as the impact of the climate disaster in Rio Grande do Sul in May or currency depreciation.

Looking for the origins of these winds that de-anchor long-term inflation expectations, I find the first movements between December 2022 and January 2023 when expectations for IPCA 2025 rose from 3.0% to 3.2%, driven by fiscal risks, especially uncertainties about the new fiscal framework. In the December 2022 Copom minutes, the Committee discussed the risks of parafiscal policies or the reversal of structural reforms that could lead to less efficient resource allocation and could reduce the potency of monetary policy. The Copom noted that in an environment of a reduced output gap, the impact of significant fiscal stimuli on the inflation trajectory tends to outweigh the intended impacts on economic activity.

Recent Developments and the Cost of Credibility

From January 18, 2023, to March of the same year, expectations for the 2025 IPCA rose from 3.2% to 4% following a threat to change the inflation target. This threat raised doubts about the commitment to the targets for 2023 to 2026, as there is a living memory of past government changes to goals when they were not achieved, rather than reinforcing and improving the means to achieve them.

From March 2023 to June of the same year, the process of de-anchoring expectations was somewhat contained, and expectations for the 2025 IPCA remained stable at 4.0% after a combination of lower-than-expected inflation from March to May, accompanied by the BCB's threat to resume the interest rate hike cycle, demonstrating a commitment to the inflation target.

From June 2023 to July 2023, there was a re-anchoring process where expectations for the 2025 IPCA moved from 4.0% to 3.5%. It is difficult to isolate the individual effects of each de-anchoring factor on the inflation target by 100bps (from 3.0% to 4.0%), but there was an overall improvement in each of them. Therefore, despite showing partial re-anchoring, these factors still partially contributed to de-anchoring.

In the ongoing de-anchoring process, starting on May 27, 2024, until the present, expectations for the 2026 IPCA rose from 3.5% to 3.6%. This recent movement coincides with a dissenting vote in the May Copom meeting, casting doubts on the Committee's commitment to the inflation target.

Expectations for 2026 inflation indicate widespread de-anchoring caused by various factors. The solution, without incurring additional costs, seems to come from improving the Inflation Targeting Regime with reinforced execution, thereby mitigating the still-present risks of changing the inflation target. Additionally, inflation expectations could converge more rapidly towards the target with increased Copom credibility. The recipe for success or the solution without generating additional costs, though laborious, could create calm seas with predictable, anchored inflation and low interest rates for longer.