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By whom does interest rate in Brazil double?

Por quem os juros dobram no Brasil?

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RESUMO

Este artigo tem como objetivo discutir as razões para a taxa de juros cronicamente elevada no Brasil. Argumenta-se que a alta taxa de juros é a causa, e não a consequência, do desequilíbrio fiscal do Brasil nos últimos 3 anos. Um nível elevado para a taxa de juro é o resultado de muitas razões estruturais e institucionais. Do lado estrutural, a economia brasileira ainda apresenta um alto nível de indexação de preços devido à estabilização inacabada feita pelo Plano Real. Do lado institucional, a rigidez do Arranjo Institucional do Regime Brasileiro de Metas de Inflação, expressa em metas irrealistas para a inflação e o uso da inflação global em vez da inflação subjacente na definição da meta de inflação, cria um viés para o Banco Central aumentar a taxa de juros mesmo quando o comportamento da inflação real não predefine nenhuma pressão ascendente consistente, como é o caso ao longo do ano de 2024

Palavras-chave: Taxas de juros; indexação de preços; Metas de Inflação; Capitalismo Rentista; Brasil.

JEL: E31, E42, E43, E52.

ABSTRACT

This article aims to discuss the reasons for the chronically high policy interest rate in Brazil. It is argued that high interest rate is the cause not the consequence of Brazil´s fiscal unbalance ion the last 3 years. A High level for the policy interest rate is the result of many structural and institutional reasons. For the structural side Brazilian economy still present a high level of price indexation due to the unfinished stabilization made by Real Plan From the institutional side, the rigidity of the Institutional Arrangement of the Brazilian Inflation Targeting Regime, expressed in unrealistic targets for inflation and the use of headline inflation instead of core inflation in the definition of target inflation, creates a bias for Central Bank to increase interest rate even when the behavior of actual inflation does not preset any consistent upward pressure as it is the case along the year of 2024

Keywords: Interest Rates; Price Indexation; Inflation Targeting; Rentier Capitalism; Brazil.

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1. Introduction

Since the beginning of his third term, President Luis Inacio Lula da Silva has publicly spoken out against the high level of the policy (Selic) interest rate, a problem that is not new, but has been appeared in the Brazilian economy since the Real Plan. President Lula's indignation is justified. In fact, in the 12 months accumulated up to August 2024, the payment of interest on the debt of the consolidated public sector (Union, States, Municipalities and State-Owned Companies) summed 855 billion reais (equivalent to 7.55% of GDP) according to information published on the website of the Central Bank of Brazil[1]. In the same period, the primary deficit of the consolidated public sector was 256.3 billion reais, a figure that includes 90.7 billion reais of the so-called "precatórios" and RPV's (Small Value Requisitions) that were subject to default during the Bolsonaro government through EC 23/01[2]. This means that the interest payment on the consolidated public sector debt is 3.40 times higher than the primary deficit. In view of these numbers, any sensible person would say that the main cause of the Brazilian fiscal imbalance is financial and would seek ways to reduce the amount of spending on debt interest payments. Unfortunately, public spending on interest payments has become an "hidden expense" in the Brazilian debate on fiscal adjustment (MAGALHÃES; COSTA, 2018).

The debate on fiscal adjustment, until recently, was exclusively centred on the reduction of mandatory expenses such as social security expenses - which was the one done through the 2019 Social Security Reform during the Bolsonaro government - expenses with wages and salaries of federal public servants - which were left without any type of inflation adjustment in the 2020-2022 period - and expenses with social assistance, which were the subject of a study of reduction in the Bolsonaro government through the deindexation of social benefits such as the BPC (Beneficio de Prestação Continuada) from the minimum wage. It was only in 2023, during the introduction of the New Fiscal Framework by Minister Fernando Haddad, that the federal government began to emphasize the tax revenues lost over the years through tax exemptions made without a careful analysis of cost and benefit, which only served to feed privileges to those who are already privileged for a long time in the Brazilian social class structure. In this context, President Lula had the merit of introducing into the public debate, since the beginning of his third term, the elephant in the room that consists of the exorbitant payment of interest on the public debt.

President Lula is also correct in his perception that the current behaviour and future inflation forecasts, even those released by the controversial Focus Bulletin, do not justify a new cycle of interest rate increases. Monetary policy, contrary to what financial market agents and many mainstream media outlets want to make it seem, is far from having the scientific foundation that exists in the so-called hard sciences such as Physics. If that were the case, it would be enough to feed a state-of-the-art macro econometric model with the data of the Brazilian economy in some super-powerful computer so that it would be able to show, with precision to several decimal points, what the behaviour of future inflation will be given the policy (Selic) rate existing today and thus decide if and in what magnitude the policy interest rate should be changed so that inflation remains within the tolerance range of the inflation targeting regime. However, decisions on the policy interest rate are made by nine people in a collegiate body, the Monetary Policy Committee (COPOM), in a

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[1] https://www.bcb.gov.br/estatisticas/estatisticasfiscais

[2] https://www.gov.br/secom/pt-br/assuntos/noticias/2023/12/governo-libera-mais-de-r-90-bilhoes-para-pagamento-de-precatorios-e-rpvs-do-inss

two-day meeting, behind closed doors. This decision involves, as it should be - given the uncertainty that economists have about the functioning of the economy and the imperfect control that monetary policy has over the future trajectory of inflation - "human judgment", which is subject to cognitive and interest biases, whether private or class. It follows that one cannot rule out the hypothesis that monetary policy is conducted based on the interests of those who have the power to conduct interest rate policy on behalf of the interests of society, instead of being so based on the general interests of that society. This is the problem of agency well known to economists who did their PhD´s from the 1980s onwards.

2 Why Policy Interest Rate is so High in Brazil?

The problem of interest rates in Brazil is an issue that I have come across in my research and reflections for more than 20 years. In fact, in 2002 I published my first scientific article on the subject in the prestigious Journal of Political Economy, edited by former minister Luiz Carlos Bresser-Pereira (OREIRO, 2002). Since then, I have frequently revisited this topic in my academic work, culminating in the publication of the book Macroeconomics of Brazilian Stagnation, co-authored with Luiz Fernando de Paula, in 2021 by Alta Books (OREIRO; DE PAULA, 2021).

By analysing the experience of the Brazilian economy between 2003 and 2016, we found in our book that the Selic interest rate measured in real terms, that is, discounting the inflation rate, had remained throughout this period systematically above its long-term equilibrium value[3], given by the sum between the real interest rate of the 5-year US T-notes and the country risk premium measured by EBMI + calculated by J.P. Morgan[4]. Our calculations pointed to an equilibrium real Selic of 3.68% p.a., while the real average value of the Selic rate in this period was 6.25% p.a.

An interest rate above its equilibrium value should produce disinflationary pressures that, sooner or later, should cause inflation to converge to the inflation target, allowing the Central Bank

[3] Here a small digression is necessary on the concept of equilibrium interest rate. The conventional literature on the subject defines the neutral or equilibrium interest rate as the value of the real interest rate for which the inflation rate is kept constant over time. In macroeconomic models for closed economies, the equilibrium real interest rate is that value for which the output gap is equal to zero, that is, the economy operates with a level of activity equal to the potential (BLINDER, 1998, p.32). For small economies with an open capital account, as is the case of the Brazilian economy, the relevant concept of equilibrium interest rate is not one for which the output gap is equal to zero; but the one that eliminates arbitrage gains between domestic bonds and foreign bonds. If the capital account is fully opened, then the equilibrium interest rate will be equal to the international interest rate. In the case where there are restrictions on capital mobility, as is the case in Brazil, then appropriate risk premiums should be added to the international interest rate (BARBOSA et al. 2016). More specifically, the sovereign risk premium and the exchange rate risk premium should be added.

[4] The reference international interest rate is the US interest rate, since the United States is the world's leading financial centre, and the dollar is the most important international reserve currency. But what interest rate should we use to calculate the equilibrium interest rate? In principle, the relevant interest rate for this purpose would be the fed funds rate, which is the rate set by the monetary policy committee (FOMC) of the Federal Reserve, the Central Bank of the United States. The problem is that in Brazil the Selic rate, set by the Central Bank of Brazil at COPOM meetings, is also the index of a significant part of the federal public debt securities, more specifically, the Treasury Financial Bills (LFT's). The existence of public debt securities indexed to the Selic rate generates a problem of contagion of monetary policy by public debt (BARBOSA, 2006), making the short-term interest rate, determined by the Central Bank to regulate the liquidity of the interbank reserves market and thus operationalize the monetary policy with a view to achieving the inflation target; has to be equal, as a result of arbitrage operations, the interest rate of federal public debt securities. Thus, the relevant international interest rate for determining the equilibrium interest rate of the Brazilian economy is not the fed funds rate, but the interest rate of U.S. public debt securities whose maturity is like the average maturity of the Brazilian public debt. As the Brazilian public debt has an average maturity of around 4 years, it follows that the most appropriate US interest rate for calculating the equilibrium interest rate is the interest rate of the 5-year maturity T-Note.

to reduce, albeit gradually, the interest rate to its equilibrium level. However, this was not the behaviour observed in the inflation rate. In fact, in the period between January 2003 and September 2017, i.e. a period of almost 14 years, the cumulative inflation in 12 months remained systematically above the centre of the inflation targeting regime, except for a brief period between May 2006 and January 2008. Inflation in Brazil is resistant to interest rates, in a remarkable similarity to people who suffer from type-2 diabetes, when high blood glucose levels originate from insulin resistance. The resistance of inflation to increase in the policy interest rate ends up requiring the Central Bank to set the interest rate at a higher level and for a longer period of time than would be necessary if the patient, in this case the Brazilian economy, did not present this symptom of resistance to the interest rate.

Where does the resistance of inflation to the interest rate come from? This is a question I was only able to present a technically satisfactory answer in 2023 when I published, together with Professor Julio Fernando Costa Santos from the Federal University of Uberlândia, a work entitled "The Unfinished Stabilization of the Real Plan" in a book organized by Professors Fernando Ferrari Filho (UFRGS) and Luiz Fernando de Paula (UFRJ) and published in the United Kingdom by Edward Elgar (OREIRO; COSTA SANTOS, 2023). In this work we show that the maintenance of the indexation mechanisms of long-term contracts (with a maturity of more than one year) after the Real Plan - in which only the short-term indexation was eliminated - makes the inflation rate in Brazil more dependent on past inflation than on future inflation expectations. In other words, in Brazil, inflationary inertia is still an important component to explain the behaviour of the inflation rate, presenting a value much higher than that verified, for example, in the United States economy.

This finding has important consequences for the conduct of monetary policy. First, the problem of the "de-anchoring of expectations", recently cited as the cause of the new cycle of interest rate increases, has little relevance to explain the behaviour of the inflation rate. Past inflation and exchange rate behaviour are much more relevant to explain present inflation than inflation expectations. The relationship between the exchange rate and inflation, in turn, suggests that the mechanism by which inflation ends up yielding to the cycles of increase in the Selic rate is through the appreciation of the exchange rate, which has a harmful effect on the competitiveness of Brazilian industry, something largely showed in the debate on the problem of Brazilian premature deindustrialization (OREIRO; MANARIN; GALA, 2020).

That said, in order to be able to definitively solve the problem of high interest rates in Brazil, it is necessary to complete the unfinished stabilization of the Real Plan, that is, to eliminate all the mechanisms of indexation of contracts existing in the Brazilian economy through a Monetary Reform, thus reestablishing the role of the legal tender of the Brazilian economy as the only unit of account in all contracts in force in the national territory. This includes, of course, public debt securities, notably those that are indexed to the Selic rate, that is, the Treasury Financial Bills (LFT), designed to allow the operation of monetary policy in the period of high inflation, but which lost all their functionality after the stabilization achieved with the Real Plan. The existence of public debt securities indexed to the Selic rate reduces the power of monetary policy by obstructing one of the channels through which the interest rate can affect the level of economic activity and the inflation rate, that is, the wealth effect (OREIRO; DE PAULA, 2021).

In addition to the problem of inflation resistance to interest rates, the institutionality of the Inflation Targeting Regime in Brazil also contributes to the problem of high interest rates. Recently, a group of renowned Brazilian economists published an open letter to the National Monetary Council

in which they advocate a revision of the inflation target currently in force from 3% p.a. to 4% p.y[5]. I have no doubt that an inflation target of 3% p.a. is an unrealistic target for Brazil, given that the average inflation since the inflation targeting regime was implemented in Brazil in mid-1999 is about 6% p.a., that is, twice the target set by the National Monetary Council. What is the practical sense of setting a target of 3% when the long-term history (25 years) of the inflation targeting regime clearly points out that it is an unattainable objective, except for very short periods of time (as in 2006) and because of a strong exchange rate overvaluation that deepens the deindustrialization of the Brazilian economy? In addition, the ongoing climate change on Planet Earth due to the emission of greenhouse gases (GHG) will have adverse effects on agricultural productivity in Brazil, negatively impacting the dynamics of food inflation. As powerful as COPOM members may believe themselves to be, changes in the policy interest rate are not capable of reversing the impact that climate change will have - and apparently already being having - on food inflation and, through it, on inflation measured by the IPCA. In this context, common sense and pragmatism indicate an increase in the inflation target, not least because the credibility of the monetary authority is not achieved through the definition of unattainable targets, but through the strict compliance with the established targets.

However, the problems of institutional arrangements of the inflation targeting regime are not limited to the numerical value of the Centre of the target. First, it should be noted that the use of the full IPCA, instead of the core inflation, produces an upward bias for the interest rate, since a distinction is not made, at least at the level of the public debate, between those components of inflation that are sensitive to the variation of the policy interest rate and those that depend on the supply conditions, which are influenced by factors such as rainfall, natural disasters and geopolitical instability (which manifests itself in the appreciation of the dollar against the currencies of developing countries), and are insensitive to the Selic rate. As an example, while the IPCA-15 cumulative in 12 months rose from 4.12% in September 2024 to 4.47% in October 2024, driven mainly by the increase in electricity (5.29%) due to the increase in the tariff flag to red II, and food at home (0.95%), making actual full inflation dangerously close to the limit of the inflation target for 2024, which is 4.5%; The average of core inflation in the cumulative index in 12 months is 3.81%, which is comfortably below the upper limit of the inflation targeting regime for 2024.

In addition to the problem of using full inflation instead of core inflation, the inflation targeting regime has become less flexible in recent times. In fact, on June 26, 2024, President Lula signed the Decree 12,079 that "establishes a new inflation target system as a guideline for setting the monetary policy regime"[6]. According to the new system, the inflation targeting regime in Brazil is (sic) continuous, that is, the Central Bank of Brazil is now obliged to maintain the accumulated inflation in 12 months within the tolerance interval of the inflation targeting regime every month of the year! Prior to the decree, the Central Bank committed to delivering inflation within the tolerance range at the end of the calendar year, which gave some flexibility to accommodate the normal seasonality of inflation throughout the year. Now, the decree that President Lula signed obliges the Central Bank to keep inflation within the tolerance range throughout the calendar year, considering non-compliance with the inflation target the case in which the accumulated inflation in 12 months is above the ceiling of the targeting regime for six consecutive months. This decree transformed something that was already bad - an inflexible inflation targeting regime (ROCHA; OREIRO, 2008)

[5] https://www1.folha.uol.com.br/opiniao/2024/10/carta-aberta-ao-conselho-monetario-nacional.shtml.
[6] https://www.in.gov.br/web/dou/-/decreto-n-12.079-de-26-de-junho-de-2024-568020148.

- into something even worse. I have no doubt that this decree law should add some doses of pressure to raise the Selic rate in the coming months.

3. Inflation and Unemployment in Brazil

Finally, why should the sole objective of monetary policy be to control the inflation rate? In the United States, the Federal Reserve has in its statutes that its mission is to ensure price stability while keeping the level of employment as close as possible to "full employment". Something similar should be thought of for the Brazilian case. The practical problem is to define exactly what full employment means. Conventional economic theory defines full employment as the unemployment rate that is compatible with the medium-run stability of the inflation rate. This definition is as precise as it is useless, as it is clearly a variable that we can only observe a posteriori: if inflation does not show a clear upward trend in the medium term, the economy will not have reached full employment. This seems to be the current case of the Brazilian economy: despite the consistent drop in the unemployment rate in the last 18 months (See Figure 1), there is no clear trend of increase in the inflation rate in the medium term. The Brazilian economy apparently does not behave as expected by the theory accepted by neoclassical economists.

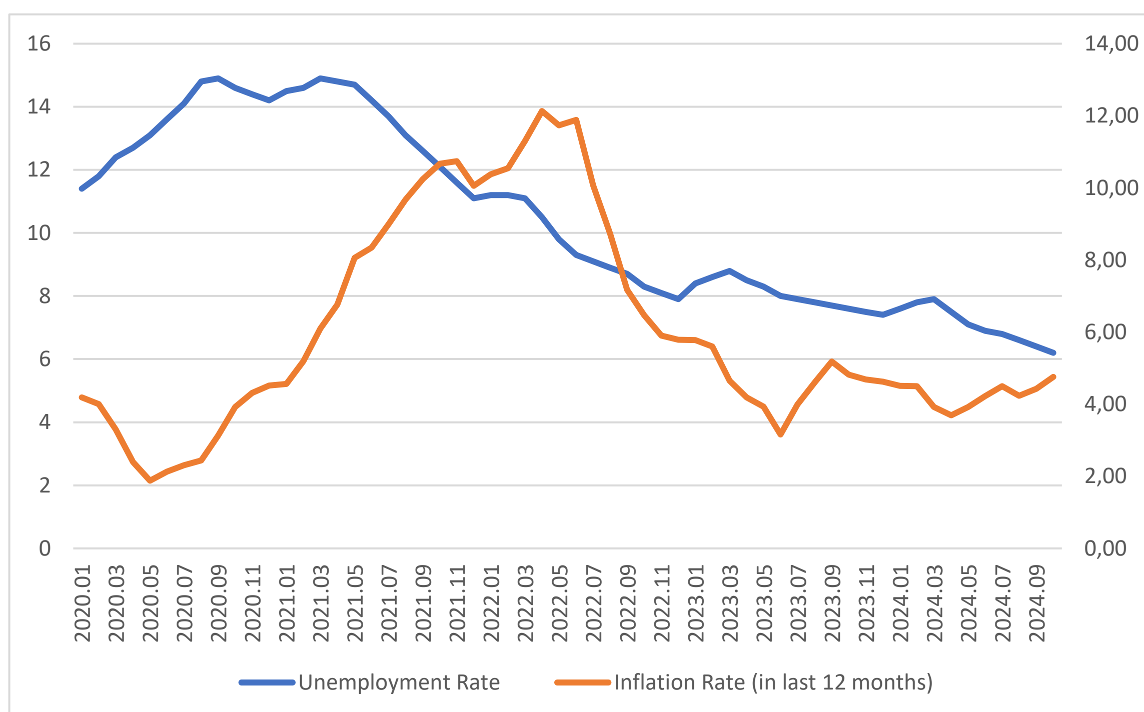

Figure 1 : Evolution of Unemployment Rate and Inflation Rate in Brazil (2020.01-2024.10)
Source: IPEADATA. Author´s own elaboration.

The reason for this divergence between what economists expects and what is observed in practice stems from the fact that the accepted theory is simply not applicable to the Brazilian case. Here I ask the reader to allow a brief theoretical digression. The concept of equilibrium unemployment rate assumes a mature economy, i.e., an economy in which the entire labour force has been transferred to the modern or capitalist sector of the economy, so that there are no significant productivity differentials between sectors of economic activity. Now, a simple inspection of the structure of the Brazilian labour market is enough to verify that this condition does not apply to

Brazil. Less than 50% of the workforce has a formal employment relationship, the rest are unemployed or have an informal job or are self-employed.

Nowadays there is a glamorization of the self-employed worker, who is portrayed as an "entrepreneur" equivalent in status to a Bill Gates or Elon Musk. Nothing could be further from reality. Most of our entrepreneurs do not own the means of production but have only their own labour power. They, in fact, are running a "side hustle" to be able to pay the bills at the end of the month and support themselves and their families. This means that in Brazil there is enormous, disguised unemployment, made up of workers who could be performing more productive tasks if they were formally employed in the modern or capitalist sector of the economy (SALVIANO, 2024). This has practical implications in terms of monetary policy: if the Central Bank does not interrupt a cycle of growth in the level of income and employment through an early increase in the interest rate, workers may be transferred from low-productivity activities in the informal or "entrepreneurial" sector of the economy to medium- or high-productivity activities in the modern or capitalist sector. The result will be an increase in the average productivity of labour due to the change in the sectoral composition of employment. This increase in productivity may act as a powerful disinflationary force that cancels out any inflationary pressures arising from growth at more robust rates. For this to occur, however, the Central Bank needs to have a medium-term inflationary control policy, in which the objective is to keep inflation within the tolerance range over a longer time horizon (18 or 24 months). In other words, it is necessary to move towards greater flexibility in the conduct of the Inflation Targeting Regime, exactly the opposite of the decree signed in June this year by President Lula.

4. Final Remarks.

I end this article by explaining to the reader the reason for the title. The title is inspired by Hernest Hemingway's classic novel "For Whom Do the Bell Toll?" published in 1940, which depicts the horrors of the Spanish Civil War. In the adaptation of the book to the cinema in 1943, the phrase that would become known worldwide is uttered: "(...) Don't ask for whom the bell tolls, they toll for you." This phrase refers to the idea that the death of any person is a tragedy for all humanity. Well, the maintenance of the policy interest rate at high levels is a tragedy for all the almost 210 million Brazilians. It is past time to confront and solve this problem, before it is too late.

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