BANCO CENTRAL DO BRASIL

Inflation Targeting: Performance and Challenges

= The Brazilian Case =

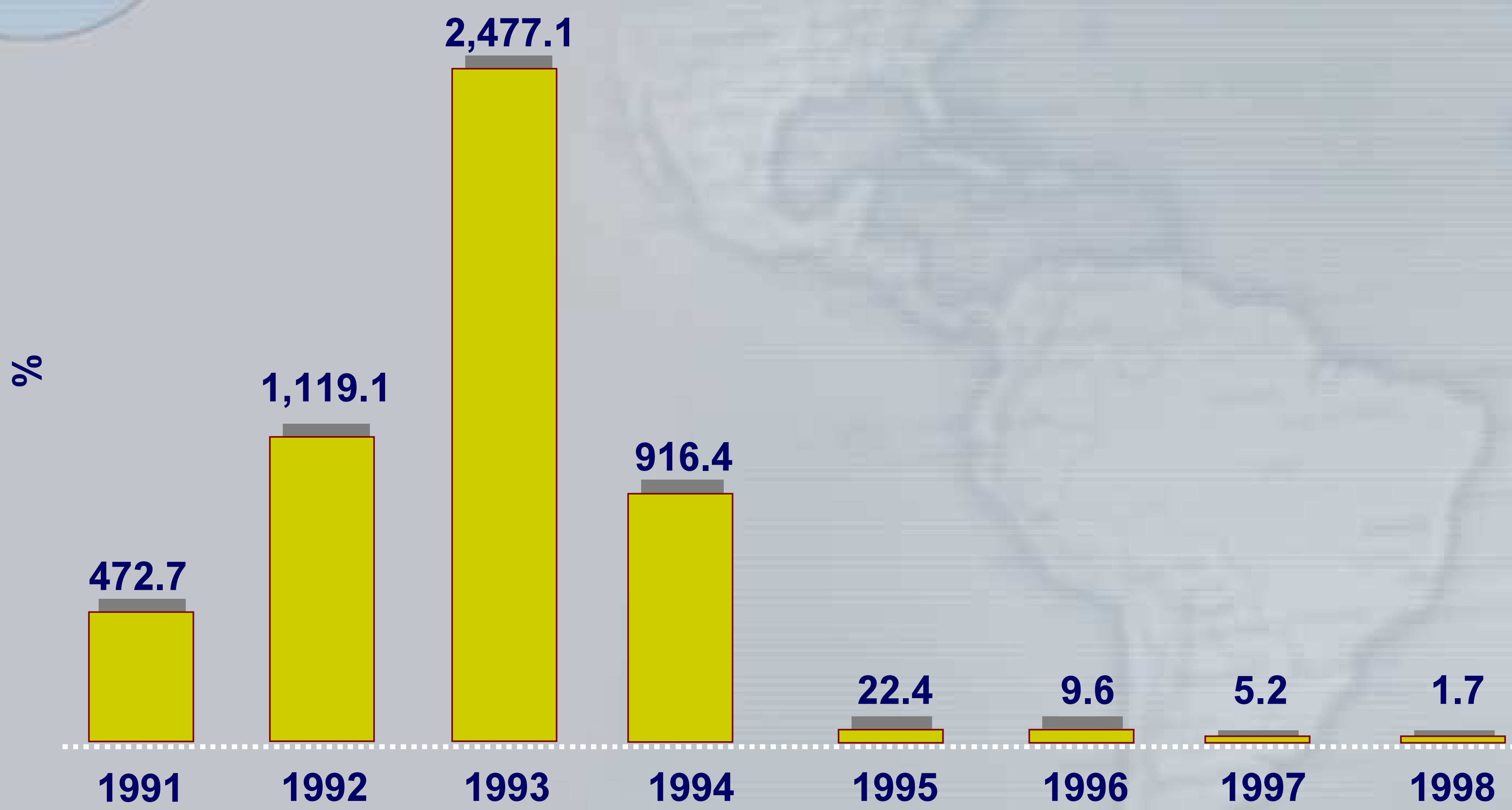
Pedro Fachada
Istanbul
January 2006

I. Background

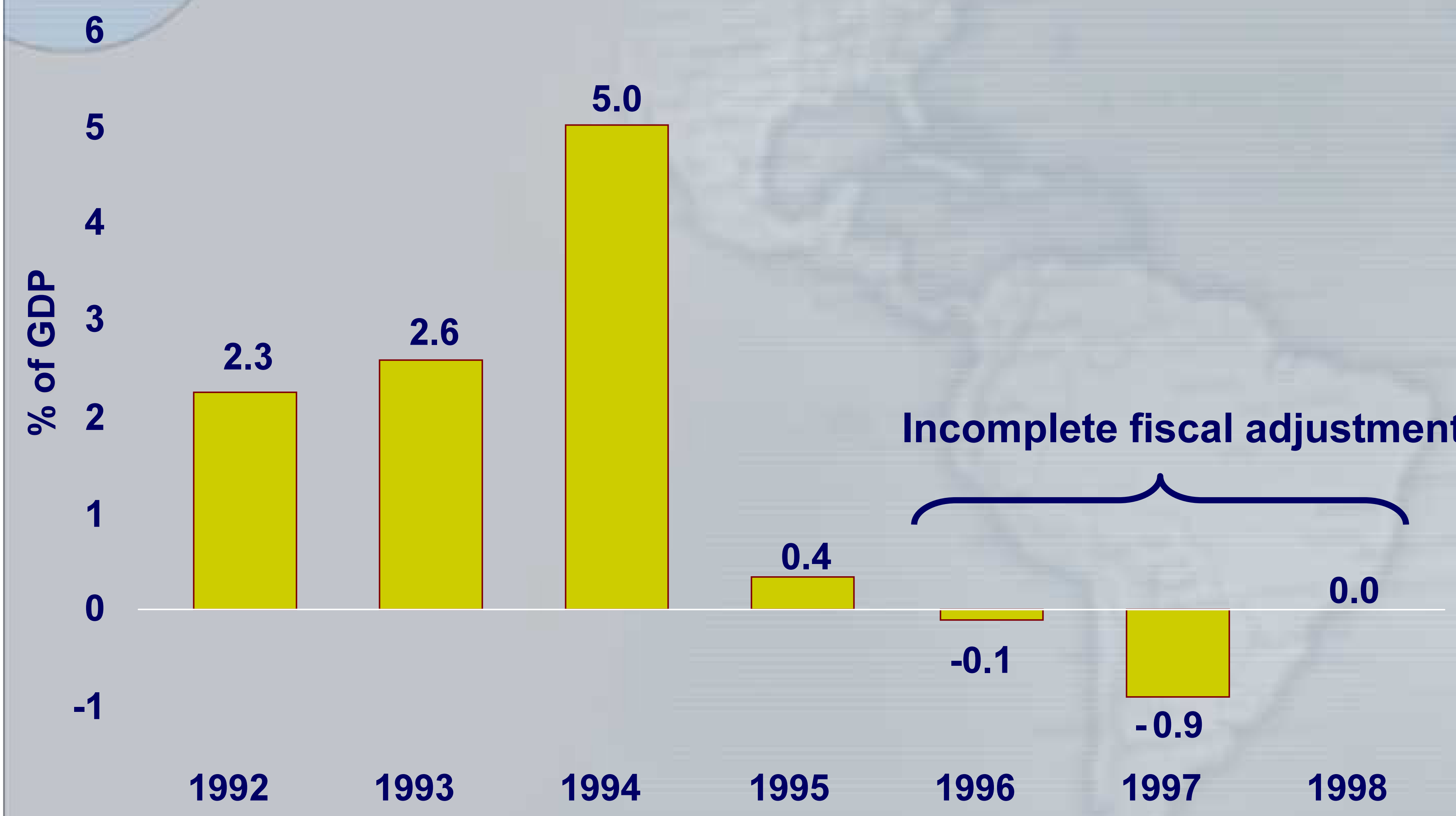
Background

- In 1994, successful monetary reform reduced annual inflation from nearly 2,500% to single-digit rate;
- Monetary reform was accompanied by incomplete fiscal adjustment;
- Deepening external disequilibrium due to overvalued exchange rate;
- External crises in the late-90s (Southeast Asia , Russia) gradually increased vulnerability of the Brazilian economy, with significant losses of international reserves to sustain the peg.

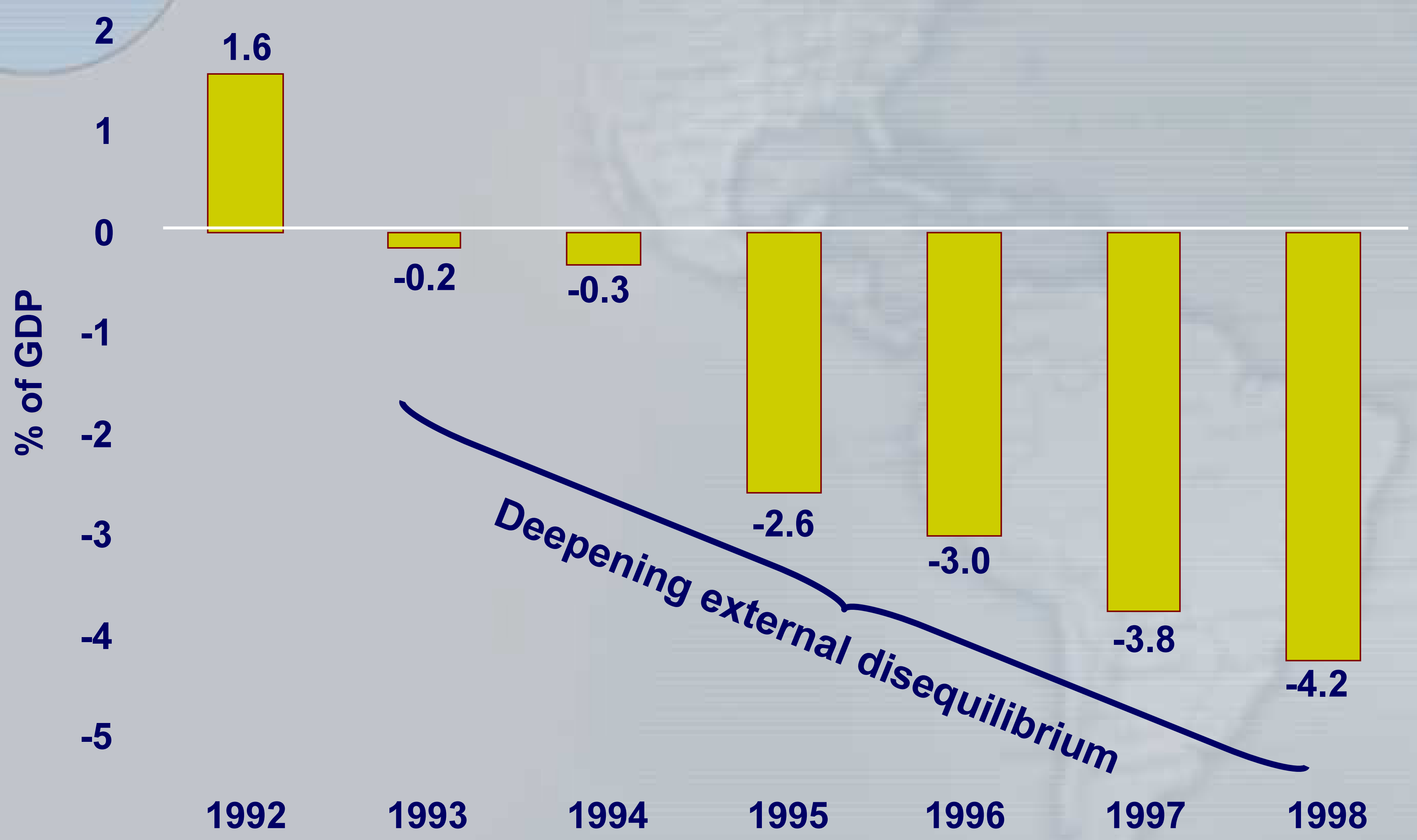
Consumer Inflation Rate: 1992-1998



Consolidated Public Sector Primary Surplus: 1992-1998

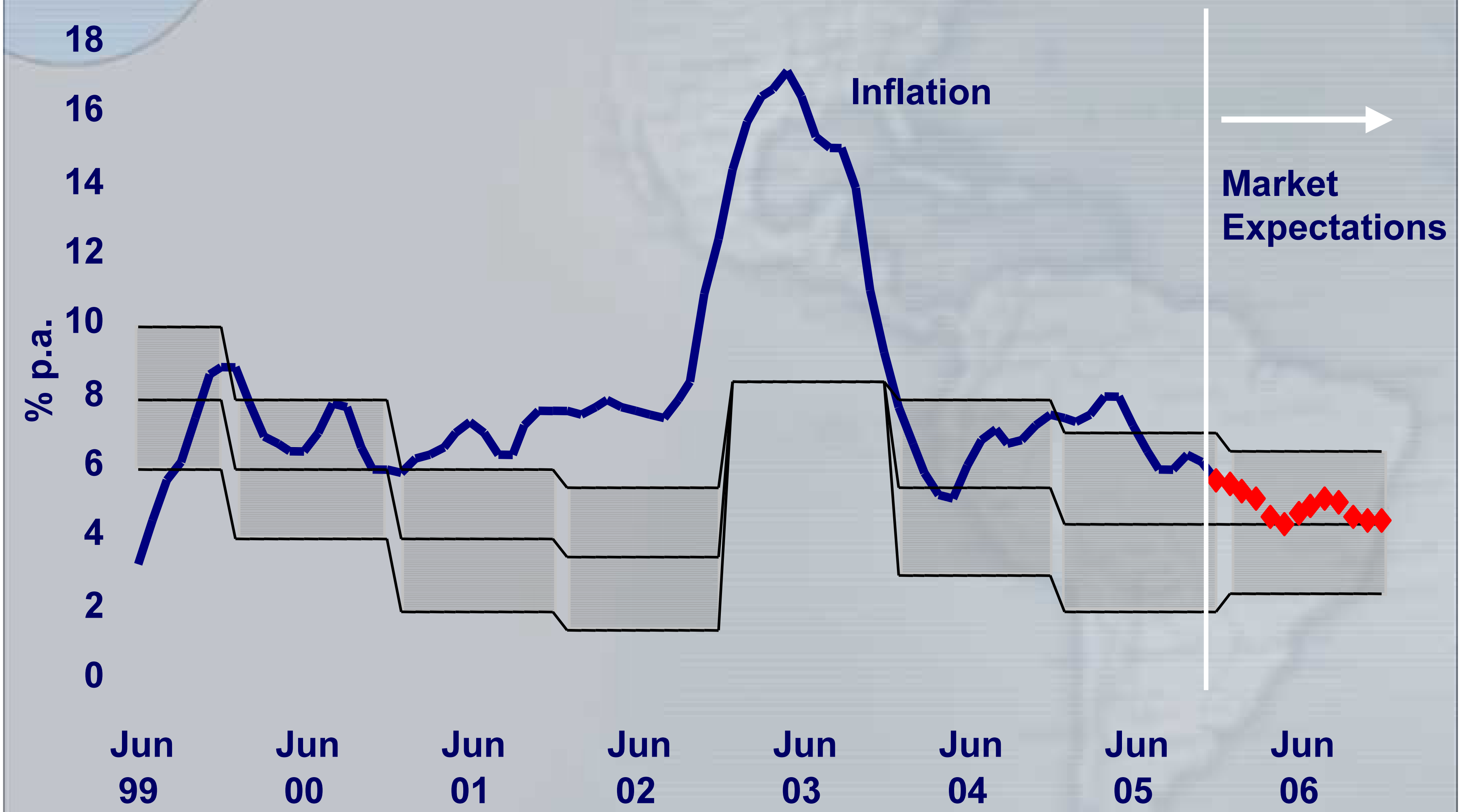


Current Account Surplus: 1992-1998



II. Overview: Targets vs. Inflation

Targets vs. Consumer Inflation



III. 1999-2000: The Initial Years

The Initial Years: 1999-2000

- January 1999: Floating exchange rate regime → search for a new nominal anchor
- June 1999: implementation of inflation targets, complementing the transition from a fixed to a floating exchange rate regime
  - Targets set up by the CMN (National Monetary Council) for calendar years
  - Targets set up two years and a half in advance
  - Reference index: Broad National Consumer Price Index (IPCA)
  - Targets defined with tolerance interval, without escape clauses.

The Initial Years: 1999-2000

- Initial targets envisaged a fast disinflation strategy (multi-year declining inflation targets):
  - Targets set in 1999:

    1999 → 8% +/- 2%

    2000 → 6% +/- 2%

    2001 → 4% +/- 2%
  - Targets set in 2000:

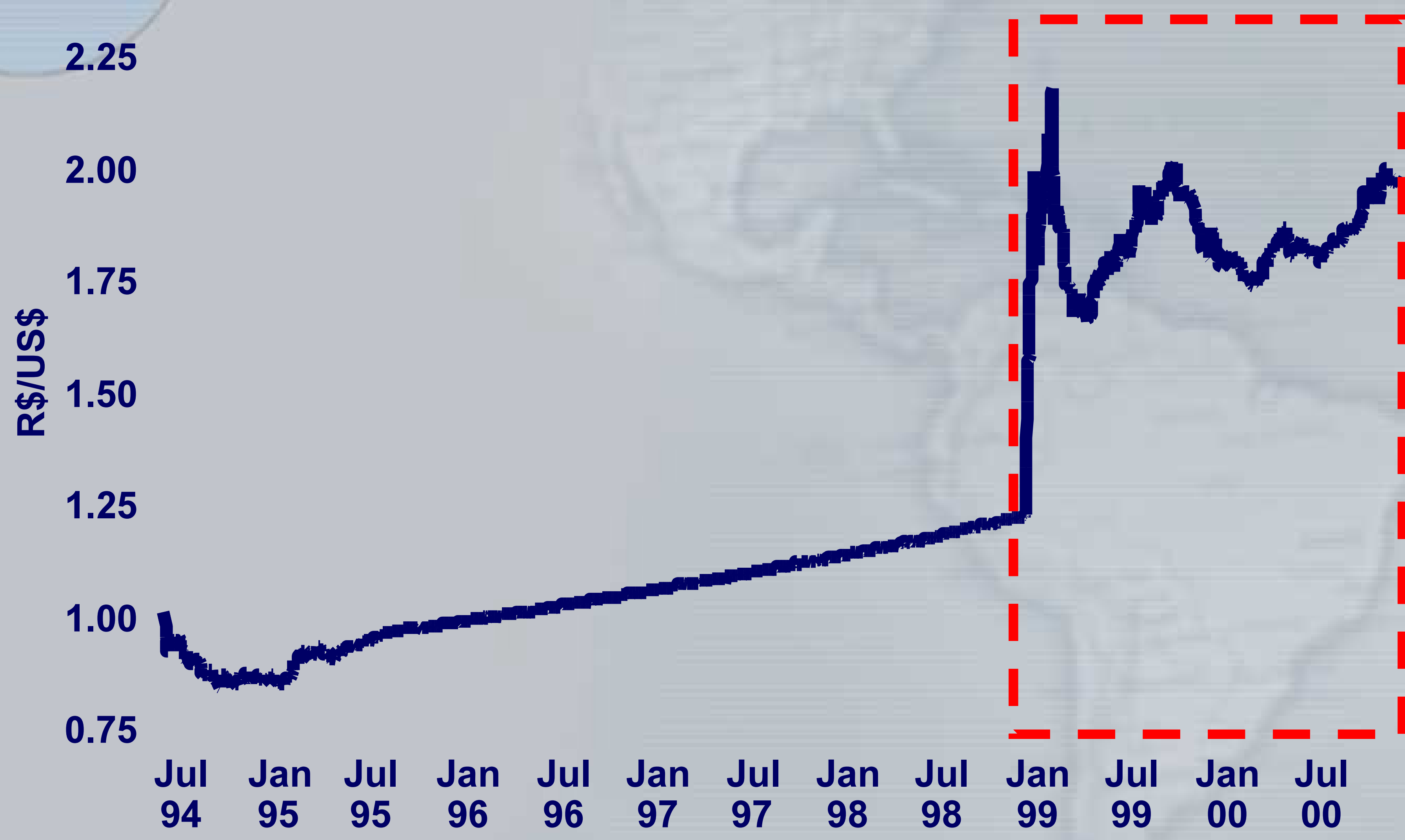
    2002 → 3.5% +/- 2%
  - Target set in 2001:

    2003 → 3.25% +/- 2%

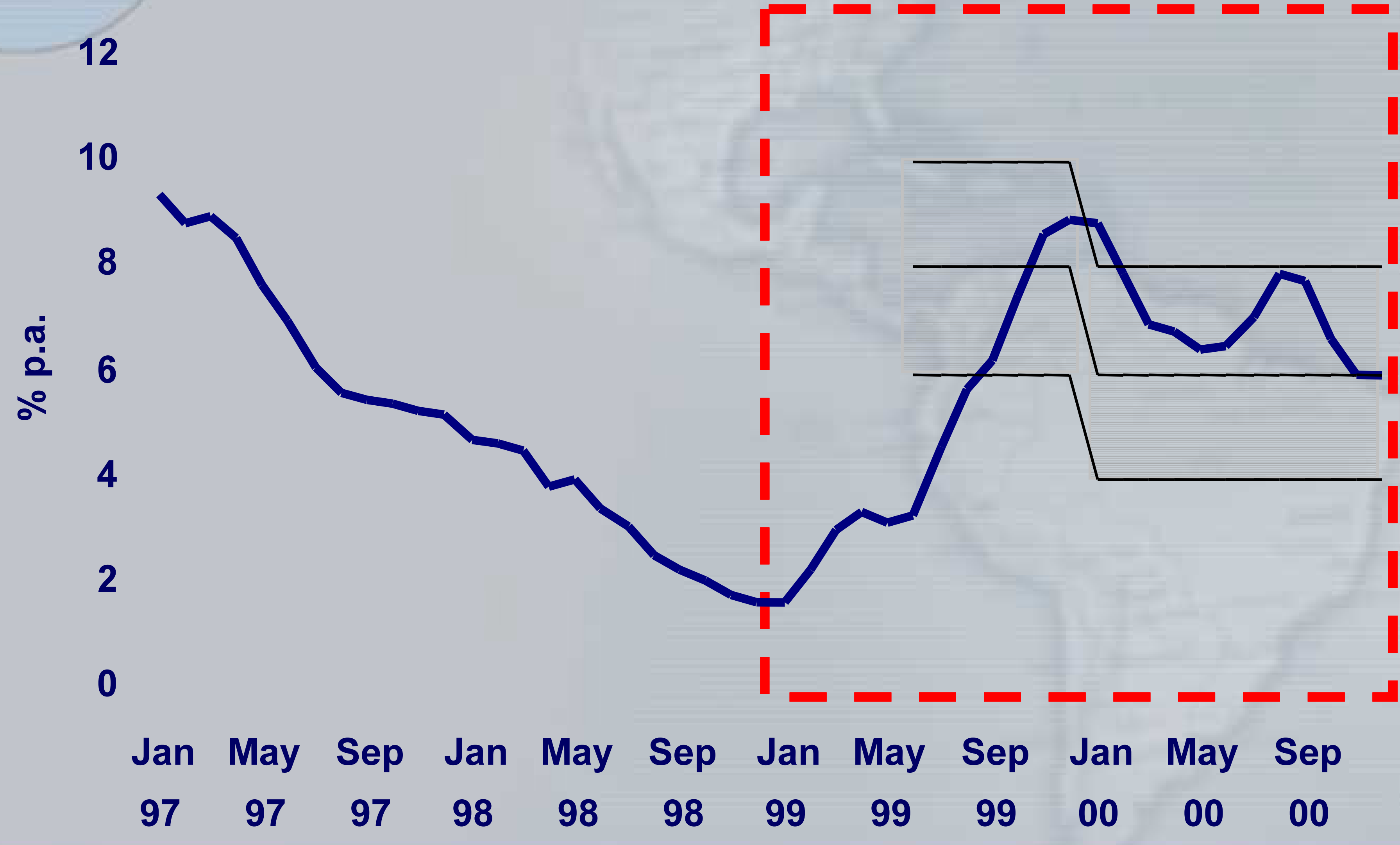
The Initial Years: 1999-2000

- Inflation rate stood at 8.9% in 1999 and 6.0% in 2000, within target range.
- However, fulfilment was not an easy task due to:
  - Initial inflation expectations well above target;
  - Sharp exchange rate depreciation in 1999;
  - Pressure from backward-looking regulated prices (utilities representing about 30% of consumption basket, with rises of 20.9% in 1999, and of 12.9% in 2000).

Nominal Exchange Rate: 1999-2000



Consumer Inflation Rate: 1999-2000



The Initial Years: 1999-2000

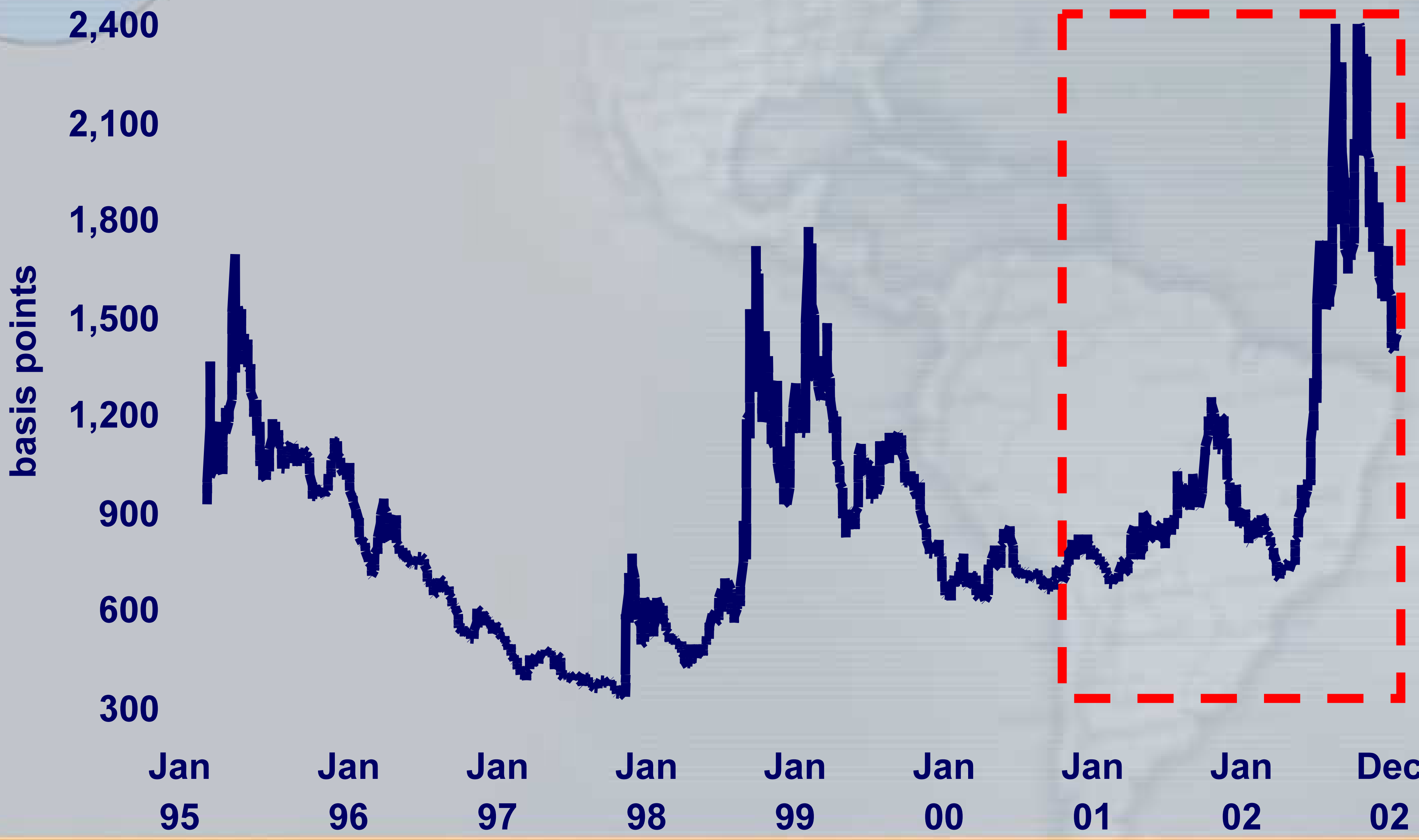
- **Causes for initial success:**
  - **Consistent fiscal policy;**
  - **Strong commitment of Central Bank with targets, with adequate calibration of monetary policy to targets path;**
  - **No currencies mismatch in the aftermath of the devaluation, due to provision of hedge by Government → main cost of devaluation was the increase of public sector´s debt/GDP ratio;**
  - **Low initial inflation level;**
  - **Widespread anticipation of devaluation (currency clearly overvalued before floating);**

IV. 2001-2002: Target Miss

External Shocks: 2001-2002

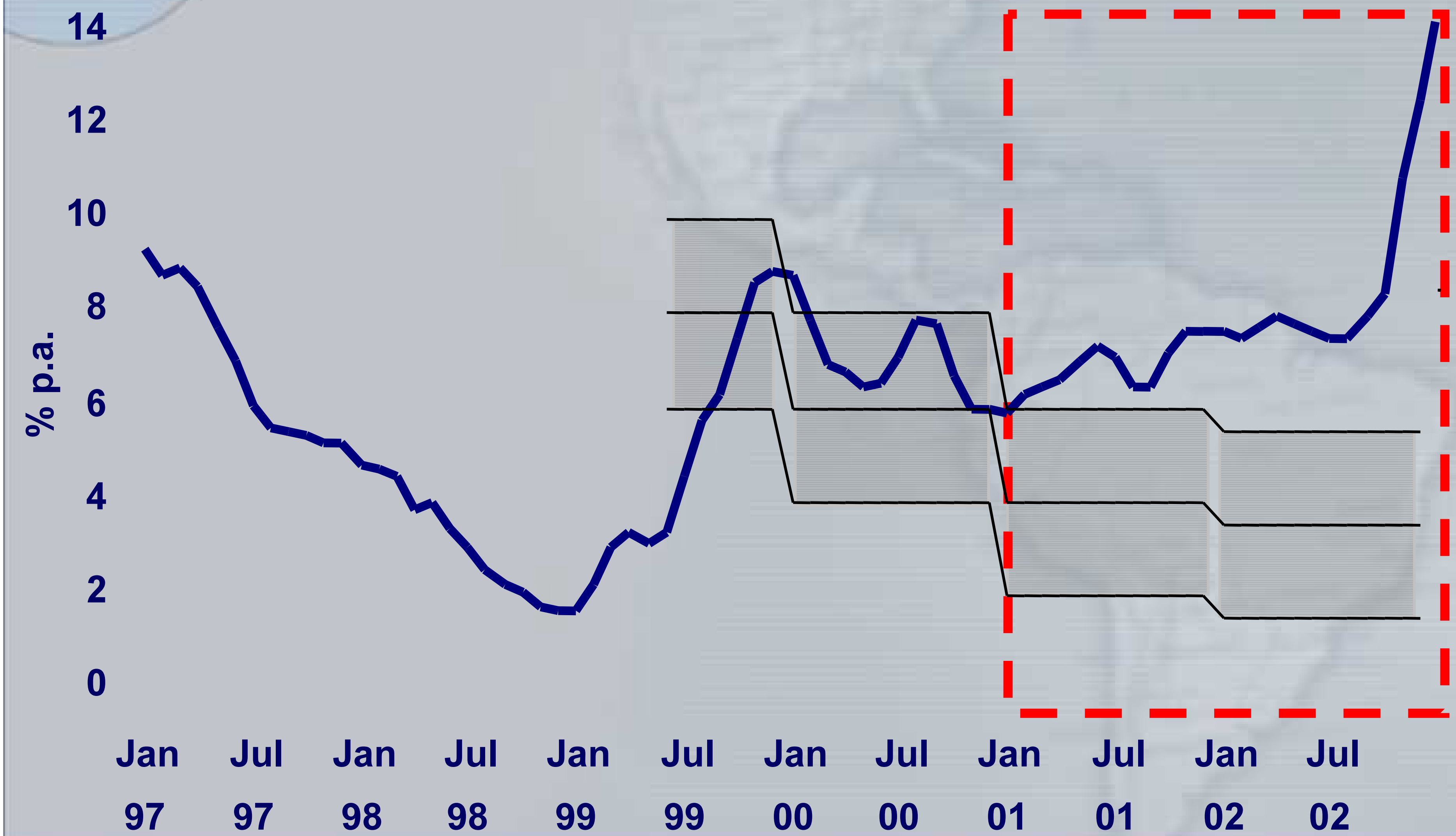
- 2001 and 2002 marked by adverse external developments, aggravated by a domestic confidence crisis triggered by uncertainties regarding new government policies;
- Sudden stop in capital flows and aversion to claims denominated in Brazilian “reais” (increase in country risk);
- Sharp exchange rate depreciation, jeopardizing the achievement of articulated inflation targets;
- Like in previous years, inflation also pressured by backward-looking regulated prices;
- Inflation at 7.7% in 2001 and 12.5% in 2002, missing the target ranges (4% + 2% in 2001 and 3.5% + 2% in 2002).

Sovereign Country Risk: 2001-2002



Nominal Exchange Rate: 2001-2002

Consumer Inflation Rate: 2001-2002



V. 2003-2005: Disinflation Strategy

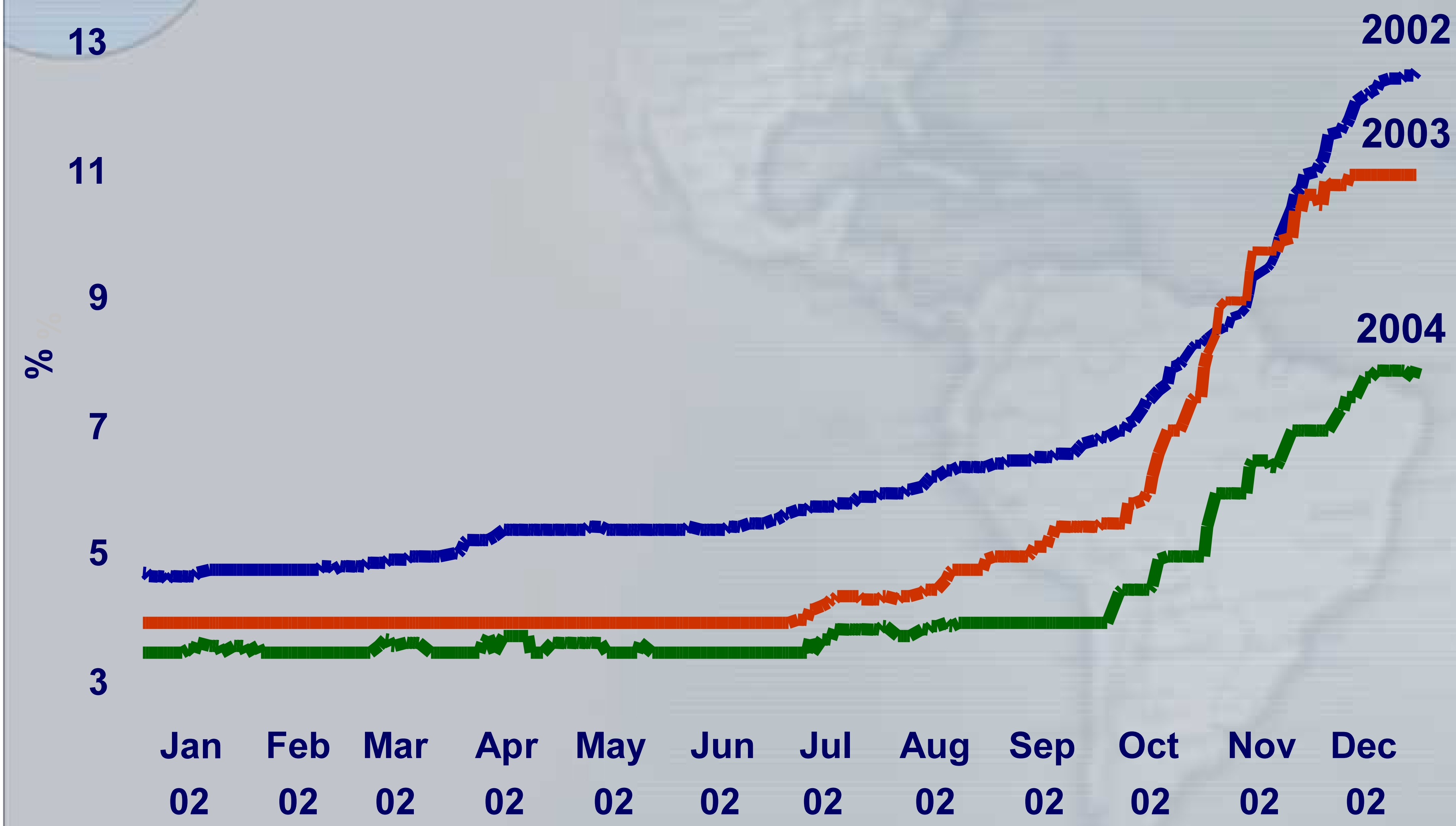
Rebuilding Confidence: 2003-2005

- Since the 2002 inflation target was missed by a very large margin, original disinflation trajectory lost credibility;
- Long-term inflation expectations severely increased;
- Hence, Central Bank proposed in early-2003 an adjusted target trajectory → objective was to regain control over inflation, while smoothing out the economic cost of disinflation:
  - Adjusted targets trajectory proposed in 2003:

    2003 → 8.5%

    2004 → 5.5%

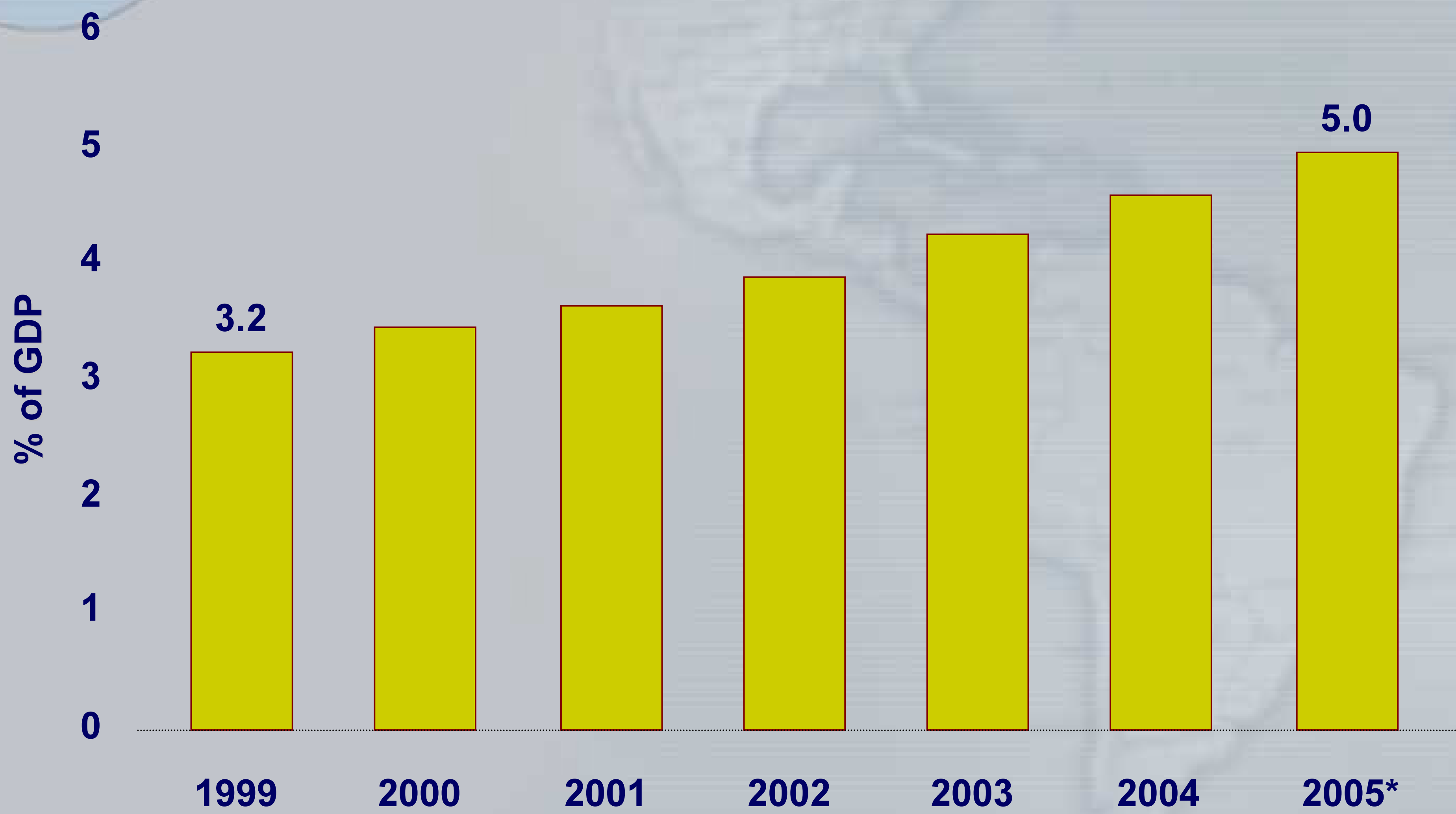
Inflation Expectations: 2002



Rebuilding Confidence: 2003-2005

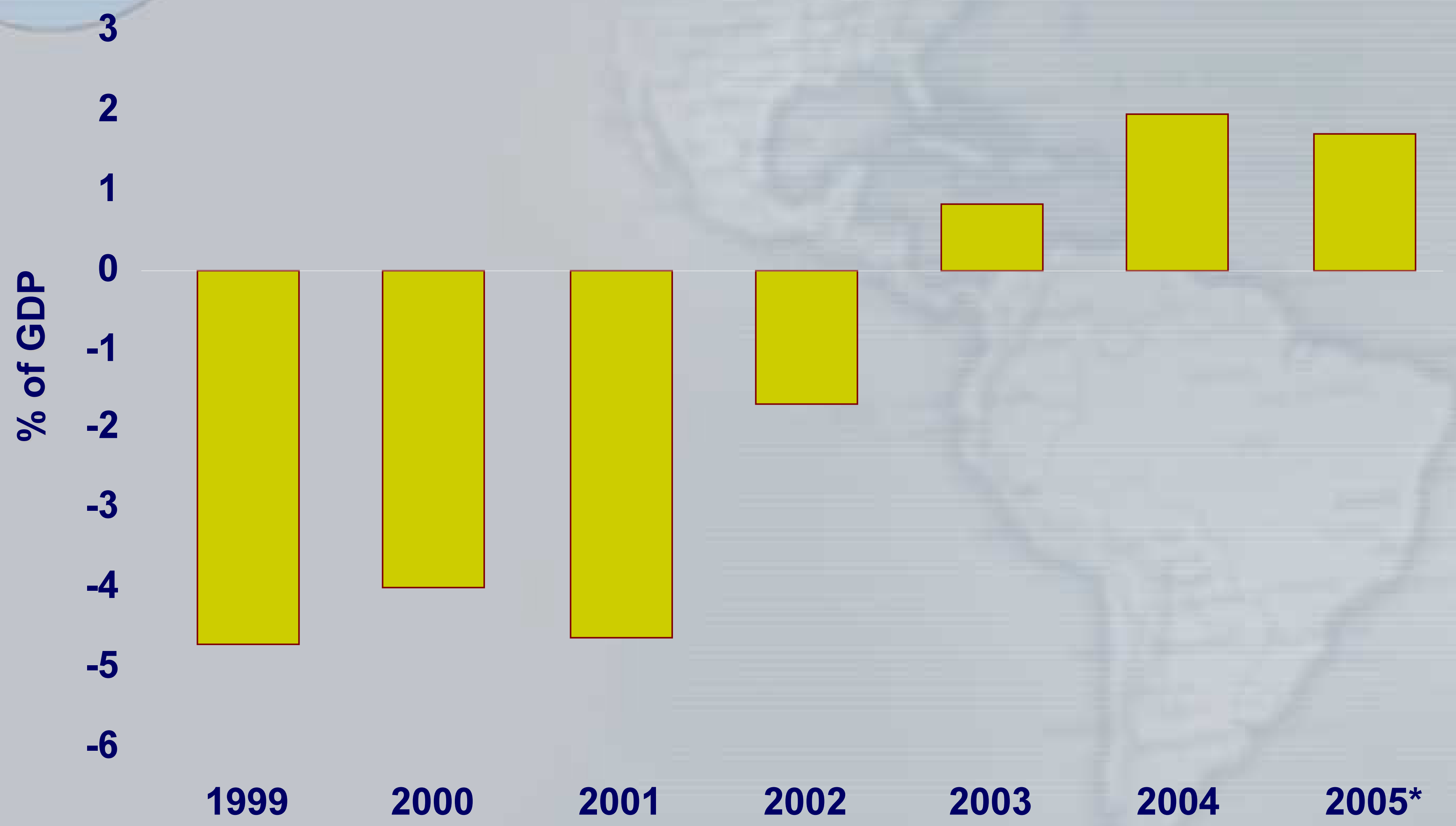
- On the fiscal front, government reaffirmed commitment with fiscal responsibility → consolidated primary surplus rose and consistently outperformed stated annual targets (4.25% of GDP in 2003, 4.5% in 2004 and 4.25% in 2005);
- On the external front, continued FX depreciation from 1999 to 2002 produced a sharp external adjustment, mainly achieved through a significant increase in exports.
- Benign external scenario contributed to exports surge and exchange rate appreciation.

Consolidated Public Sector Primary Surplus: 1999-2005



*preliminary

Current Account Surplus: 1999-2005



*preliminary

Nominal Exchange Rate: 2003-2005

Rebuilding Confidence: 2003-2005

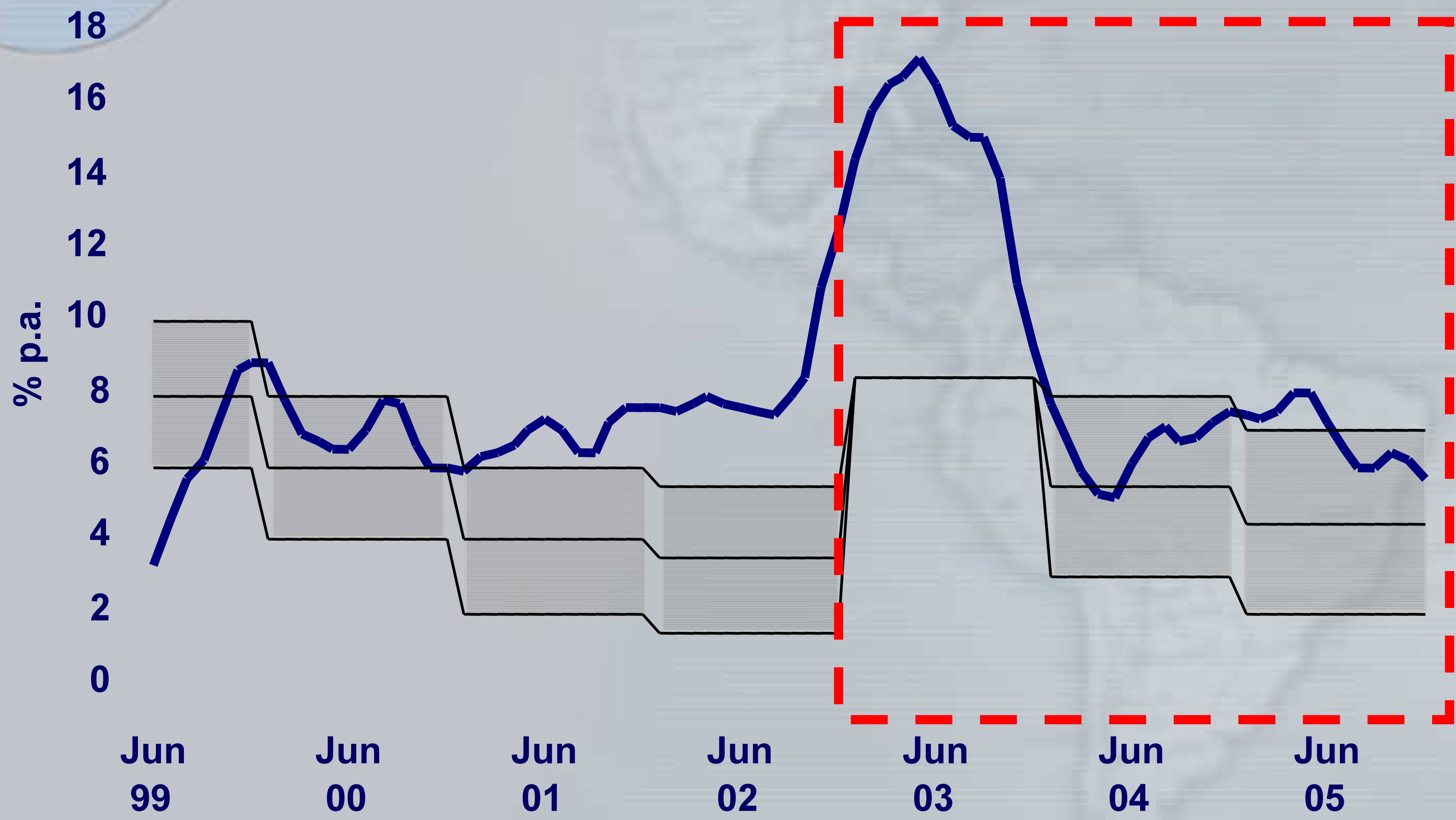
- Inflation fell to 9.3% in 2003, from 12.5% in 2002;
- Successful disinflation enabled the CMN to adopt the Central Bank adjusted target for 2004 as the new CMN target, and to return in 2005-2007 to the original targets strategy:
  - Target set in 2003:

    2005 → 4.5% +/- 2.5%
  - Target set in 2004:

    2006 → 4.5% +/- 2%
  - Target set in 2005:

    2007 → 4.5% +/- 2%

Consumer Inflation Rate: 2003-2005



Inflation Expectations: 2003-2005

VI. What Have We Learned?

What Have We Learned?

- Importance of fiscal consistency;
- Disinflation requires continuous effort;
- A high degree of transparency and a good communication strategy are paramount to maintain credibility, even in situations of large adverse shocks.

BANCO CENTRAL DO BRASIL

Inflation Targeting: Performance and Challenges

= The Brazilian Case =

Pedro Fachada

Istanbul

January 2006