Monetary Policy Transparency and Decision Making in Brazil: The Monetary Policy Committee

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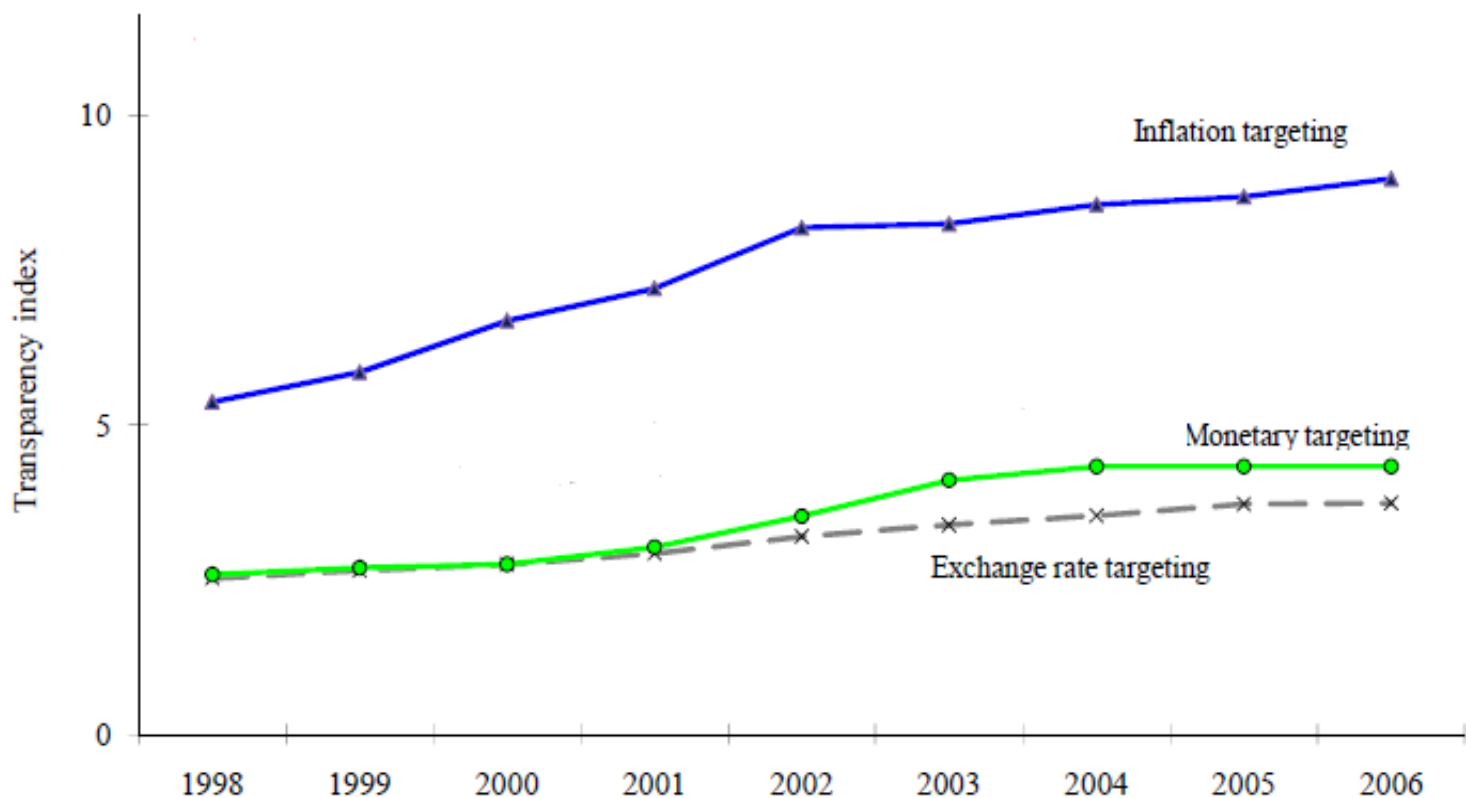
Outline

1. Monetary Policy Transparency

2. Monetary Policy Decision Process

3. Effectiveness

Transparency: International Trend

➢ Central banks have become more transparent at least since the 90s (Geraats, 2009).

Transparency: International Trend

➢ The rationale was

  (i) to coordinate expectations more effectively;

  (ii) to increase accountability, legitimizing more autonomy.

➢ Expectations influence price setting, asset prices and the term structure. It is a key channel of transmission (Woodford, 2005).

➢ Autonomy reduces the risk of political pressure, and accountability insures public support for autonomy

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Transparency: International Trend

"The most important distinguishing characteristic of inflation target regimes is the emphasis they place on transparency and accountability."
(Mervyn King, 1997)

Transparency: International Trend

➢ After inflation targeting adoption, forecast errors of consensus forecasters tend to decrease (Crowe, 2010)
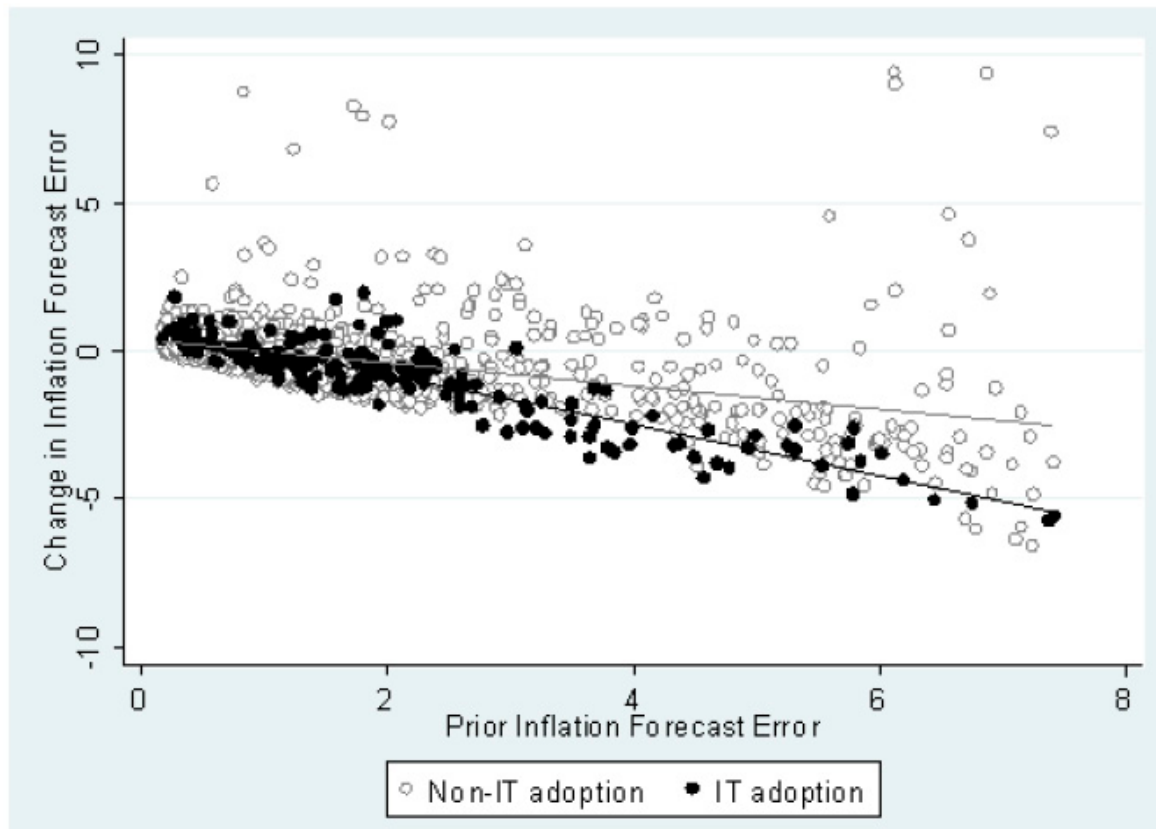
Transparency in Brazil

➢ In Brazil, the trend towards transparency begun in 1994 with the Real stabilization plan.

    ➢ Nominal exchange rate target

    ➢ Monetary Policy Committee (COPOM) created in 1996

➢ It gained impulse with inflation targeting in 1999, since more flexibility requires more transparency (Blinder, 2001)

    ➢ Inflation target (forecasts)

    ➢ COPOM becomes more transparent and accountable in 1999

    ➢ Meeting Notes, Inflation Reports, Open Letters, Congress Hearings, Forecasting model disclosure, etc.

Transparency in Brazil

"*The process of disinflation has been, and still is, a process of taming inflation expectations*" (Bevilaqua, Mesquita and Minella, 2006)

Decision Process: Transparency

➢ National Monetary Council (CMN) sets inflation target two years in advance; BCB Governor one vote in three.

➢ The COPOM meets 8 times per year, at known dates

➢ Immediate Communiqué, with <u>votes and identity</u>

  ➢ Federal Information Access Law (12.527, Nov 2011)

➢ Detailed Meeting Note <u>one week</u> after decision

  ➢ Informs only if BCB forecast are higher or lower than the target

➢ Inflation Report every quarter, with <u>press conference</u>

  ➢ Point forecasts and fan-charts for *baseline* and *market* scenario

Decision Process: Accountability

➢ **Official Representatives**

  ➢ Senate hearing at the Economics Commission occur every quarter and complement Inflation Report

  ➢ Congress hearing where the Bank reports its financial statements

  ➢ Open Letter to the Ministry of Finance in case inflation exceeds the target upper limit

➢ **General Public**

  ➢ All press releases, notes and reports available on the internet

  ➢ State of the art site, including social media features

  ➢ Communications department under the Deputy Governor for Institutional Relations and Citizenship

Decision Process: Forecasting

➢ The COPOM is informed by forecasting models

  ➢ Small semi structural model (benchmark)

  ➢ Vector auto regressions

  ➢ Dynamic Stochastic General Equilibrium model

➢ The models are disclosed in special sections of the Inflation Report (possibly complemented by other technical publications)

➢ The COPOM also considers forecasts of economic variables based on detailed assessment of the economic outlook, but mostly for the short run.

Decision Process: Information Aggregation

➢ The COPOM is also informed by expectations and other qualitative information provided by market participants

➢ Official meeting with market participants and consultants before Inflation Reports

  ➢ One way communication from market to Central Bank

  ➢ Not open to the press to encourage active participation

➢ Weekly research of market expectations

  ➢ Used for the market scenario in inflation projections

  ➢ State of the art design, with a list of top performers

➢ Surveys by trading desks with market participants

Effectiveness

"*To the extent that **central bank talk** provides useful guidance to markets (…), policy makers will exert greater influence over the longer-term interest rates*." (Bernanke, 1997)

Effectiveness

➢ Inflation targeting regime is credible, since surprises (relative to market consensus) lead to responses in the term structure in the right direction (Wu, 2009)

Figure 1: Impact of a 1 Standard Deviation Surprise on IPCA and Industrial Production on Different Maturities of the Term Structure of Interest Rates (in Basis Points)
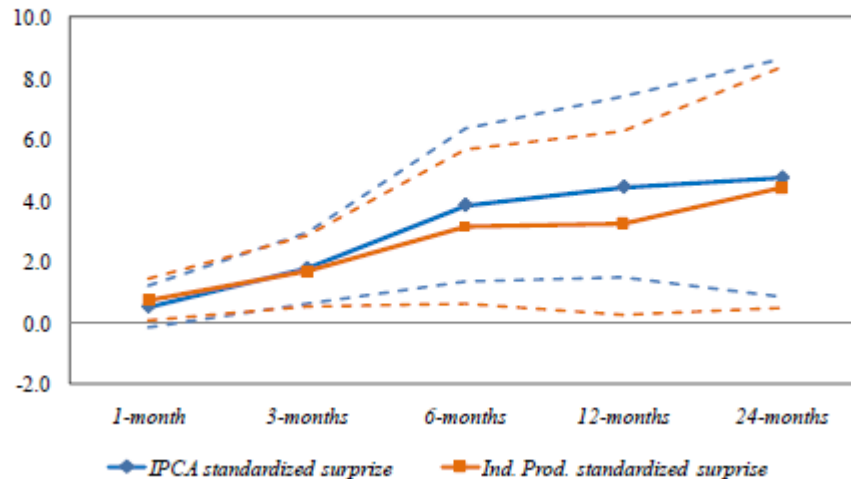
Effectiveness

➢ Communication strategy matters

➢ Specific features of the *Meeting Notes*, such as forecast relative to the target and how divided was the vote move medium term rates (Mendonça and Simão, 2011)

Effectiveness: Other Ingredients

➢ Inflation targeting effectiveness presumed responsible fiscal and financial frameworks.

➢ How to manage expectations within an unsustainable fiscal environment? How to tame expectations with extreme bank events around every corner?

➢ The great success story of inflation targeting in emerging markets involved addressing exactly these issues.

➢ Somewhat ironically, advanced economies are facing similar questions today.

Effectiveness: Other Ingredients

➢ In Brazil: inflation targeting + fiscal responsibility + floating exchange rate + international reserves + strong regulation

  ➢ Fiscal responsibility law (2000): safeguards and punishments for non-compliance at all levels of the federation.

  ➢ Banking crisis of the 90s led to conservative regulation and supervision; more recently, financial stability committee.

  ➢ Large depreciations, during early ears of IT, required large and costly interest rate increases. Response: (i) extinguishing public bonds linked to the exchange rate and (ii) accumulating international reserves.

➢ Checks and balances: it is hard to support, say, competitive depreciation or fiscal expansion when the inflation costs start to become evident to the public.

Final Remarks

➢ The COPOM decision process, by international standards, is very transparent

➢ The decision process is credible according to reactions of market expectations to innovations

➢ The communication strategy is effective in guiding market expectations

➢ As hinted by Bernanke, refining "forward guidance" to affect the long side of the curve is the next frontier.

➢ Brazil and other emerging markets have one lesson or two to give when it comes to complementary ingredients to inflation targeting

Thank you!

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