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PRINCIPLES GUIDING
BRAZILIAN MONETARY POLICY

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A foreigner visiting Brazil cannot fail to be impressed by the
tremendous achievements of recent years. The signs of recent expansion,
growth and development are everywhere. Brazilians have become so
accustomed to these signs of expansion and change that they are often more
inclined to talk about the problems that inevitably come with change than
about the achievements that continue to run ahead of the problems and provide
the additional resources used to develop the country.

An outsider sees the achievements, and the problems, from a different
perspective. Rarely can he know the full range of reasons that bring a
country to choose and maintain policies that seem inappropriate or provide
less than the best solutions to problems. He suffers from this
disadvantage when interpreting events and decisions but can perhaps compensate,
at least in part, by bringing a point of view that is less influenced by
current concerns and more open to comparisons with countries facing similar
problems. It is in this spirit that I comment on Brazilian monetary policy.

Some General Principles

In every country there are two main sources of long term growth of money.
One is the government deficit. The central bank and government must issue
base money or bonds to finance the deficit and retire base money or bonds when
there is a surplus. The other main source is the balance of payments. With
fixed exchange rates, the central bank or monetary authority cannot maintain
control of the stock of international reserves; base money flows into the country when there is a surplus and out of the country when there is a deficit in the balance of payments.

Most inflation stems from the first source. Governments spend more than they receive in taxes and in one way or another print money to finance the deficits. A common device this century has been to engage in open market operations. The government sells bonds or debt instruments to the market and the central bank buys them back. The net result is an increase in base money. The deficit is financed by money creation.

These principles governing the basic source of money creation can be found at work in most countries. I was puzzled by their apparent absence when I first came to Brazil in 1976. The government budget was generally in surplus. International reserves had been rising, and provided for some growth of money, but the rise in international reserves was much too small to explain the very high growth rate of money.

I soon discovered that the principal source of monetary expansion in Brazil does not appear in official accounts. The federal budget does not show the spending and lending that is being financed by money creation. The accounts of the monetary authorities are consolidated, and they do not show the principal reason for the growth of the monetary base. To find the source of monetary expansion, one must separate the accounts of the monetary authorities and look at the balance sheets of the Banco Central and the Banco do Brasil. Here one finds the principal source of money growth. I refer, of course, to the Conta da Movimento.
The Conta da Movimento is nothing more than borrowing by the Banco do Brasil from the Banco Central. At the end of 1977 the Conta da Movimento was equal to 75% of the outstanding stock of base money.

As long as the Conta da Movimento exists in its present form, the central bank cannot have an effective monetary policy. To execute monetary policy, the monetary authority must be able to control the monetary base. The institutional arrangements in Brazil, represented by the Conta da Movimento, prevent the central bank from controlling the base.

Once I found the Conta da Movimento, I understood a great deal more than I had. The budget of the federal government is in surplus because most of the subsidies and expenditures that one might expect to find in the fiscal budget appear in the monetary budget. These subsidies take the form of credits to agriculture, to exports and to other sectors.

Central banks in most countries have responsibility for three main types of policy. Monetary policy has responsibility for the control of money. Credit policy is the establishment of rules and regulations about who borrows and the terms on which they borrow. International economic policy is concerned with the control of exchange rates or international reserves.

The three types of policies are inter-related in many countries, but in Brazil the ties are particularly close. Credit policy is used to promote exports as part of the strategy for development. Credit policy is closely linked to the policy of accumulating international reserves and servicing Brazil's international debt. Credit policy makes it difficult to control the money stock while maintaining the arrangements for producing credit.
In Brazil, consideration of monetary policy begins with a monetary budget. The monetary budget tells the amount of base money to be issued and therefore controls the amount of additional money to be produced. But the monetary budget is easily changed by forces outside the control of the monetary authorities, like weather. If it rains, or doesn't rain, if it is too hot or too cold, the monetary budget is affected. The Banco do Brasil lends to producers of soybeans, coffee, cocoa or wheat in amounts greater or less than the amounts foreseen at the time the monetary budget was drawn. The Banco do Brasil finances the loans to agriculture, as it finances most of its loans, by increasing the Conta da Movimento. Immediately, there are two effects. One, the monetary budget is exceeded if there is a substantial change in the amount of loans to one or another of the agricultural sectors. Two, the growth rates of the monetary base and money rise. Under current arrangements every substantial shock that affects agriculture has an effect on the growth rate of the money stock.

Suppose the arrangements are changed so the money stock is better controlled. Then, as now, each of these shocks affects real output and prices. A drought that destroys a part of the crop of soybeans causes a rise in the price of soybeans, and the price index rises. But if the growth rate of the money stock is controlled, the drought does not increase the growth rate of money. Once the drought ends, output returns to the expected level and prices fall. No long-term inflation results from the crop damage.

Raising the growth of money converts a temporary problem into a long-term problem. Higher money growth in response to a temporary decline in output means that you either face the problem of pulling the growth
rate of money down later or you let the rate of inflation rise. Lowering the growth rate of money often means that there will be a temporary decline in the growth rate of output; letting the money growth rate remain high means that inflation continues at a higher rate.

Early in this decade, the rate of inflation remained in the neighborhood of 15 to 20%. It is now nearly 40%. The credit policy of aiding agriculture and exports has pushed the money growth rate up. The financing of subsidies through the Conta da Movimento has provided much, not all but much, of the increase in the growth rate of money.

We have touched on a principal problem of Brazilian monetary policy. Let us look more deeply. Much of the credit in Brazil is subsidized. The press reports that Dr. Simonsen estimates that 82% of the credit is subsidized. That figure may be too high. Whatever the current figure is, however, there can be very little doubt about the effect. Credit subsidies introduce very large distortions into the Brazilian economy. Some of the credit is granted at a 4 or 5% nominal rate of interest. With 40% inflation, the effective rate paid by the borrower is minus 35%. Other credits limit the amount of monetary correction to a maximum of 20%. A loan that is made with a real interest rate of 5% and monetary correction of 20% has an effective rate of minus 15% under current conditions. It is not surprising that there is a very large demand for credits of this kind.

Credit subsidies have two main effects. First, markets do not allocate credit according to the efficiency with which resources are used. Instead, investors are encouraged to put resources to work at low and even negative rates of return. Second, the policy creates powerful groups in favor of higher inflation. Let me illustrate why.
Suppose you invest a million cruzeiros in an enterprise that expects to lose 5%. You are able to borrow 60% of the money for the enterprise, six hundred thousand cruzeiros, at a maximum interest rate of 20%. If the inflation rate is 25%, you gain at an annual rate of thirty thousand cruzeiros on the loan and lose fifty thousand cruzeiros on the investment. At an inflation rate of 30%, you gain sixty thousand cruzeiros a year by borrowing and lose fifty thousand cruzeiros on the investment, so you have a 2-1/2% return on the amount of your own funds, Cr. $400,000, that you invested. The higher the rate of inflation, the more you gain. At a 40% rate of inflation the gain is seventy thousand cruzeiros and the return on your investment is approximately 16%.

The credit policy encourages you to invest in projects that have low or even negative rates of return. The return on a project does not depend upon the way in which the resources are used; it depends on the rate of inflation. The borrower becomes an advocate of higher and higher inflation. Of course, he will not make speeches in favor of higher inflation. He will urge more subsidies to agriculture, to exports or to some other type of loan. The effect is the same. The rate of inflation is increased by the substantial expansion of credits of various kinds because the Conta da Movimento permits the Banco do Brasil to borrow from the Banco Central and increase the monetary base.

Controlling Brazilian Inflation

The most important single step that can be taken to control the rate of money growth and inflation is to separate the Banco Central and the Banco do Brasil.
The central bank could then control the stock of money and participate in the discussions of credit policy with the Banco do Brasil. The separation of monetary policy from credit policy would be accomplished by closing the Conta da Movimento. The account can be frozen at its current size. If this is done, the Banco do Brasil and the Banco Central are separate entities. It is no longer possible for the Banco do Brasil to increase loans, borrow permanently from the Banco Central, by increasing the Conta da Movimento and the money stock. Unless this step — or some similar step — is taken, there can be no effective monetary policy in Brazil.

Once the Conta da Movimento is closed, it is no longer true that weather — rain, cold, sun, wind — and other natural events will immediately be reflected in the monetary budget and in the money stock. The central bank will have much greater control over the money stock, and it will be possible to have an effective monetary policy.

Closing the Conta da Movimento is only a first step. What I have said about the effects of the Conta da Movimento on the monetary budget and the money stock is correct, but it is too simple and therefore incomplete. The Banco do Brasil does not print money to frustrate the government, to annoy the Minister of Finance or to increase the rate of inflation. The Banco do Brasil prints money as an agent of the government. It is carrying out the wishes or decisions of the government. If the Conta da Movimento is closed, the pressures leading to higher money growth will not go away. They will shift from the Banco do Brasil to the Banco Central.

Under the proposed arrangement, the problem will, most likely take this form. A crop failure will bring borrowers to the Banco do Brasil. As loans
increase, interest rates on the loans rise. Other borrowers will be pushed out of the market. The Banco do Brasil will come to the central bank and, since there is no possibility of increasing the Conta da Movimento, the Banco do Brasil will borrow at the discount window. If the Banco Central lends to the Banco do Brasil at a fixed discount rate, the growth rate of money will increase just as much as it does now. Very little will be gained.

There can be no increase in monetary control by separating the Banco Central and the Banco do Brasil unless the freedom to restrict money growth is used. As long as the Banco Central keeps the discount rate unchanged, the pressure from monetary growth currently financed through the Conta da Movimento will shift to the discount window of the central bank. The principal difference between the new arrangement and the old is that the Banco do Brasil will pay interest on its borrowings, so its profits will be reduced.

The example illustrates one of the general principles of monetary control. The central bank or the monetary authority cannot control interest rates and the growth rate of money. It must choose between them. Either it controls the growth rate of money by raising interest rates when the demand for credit increases, or it controls the rate of interest and allows the growth rate of money to expand at the wishes of borrowers. Controlling the money growth rate requires that (1) the rediscount rate must rise as the interest rate rises. This can be accomplished by tying the rediscount rate to the interest rate, (2) by changing a penalty rate for loans made at the central bank, and (3) by using the penalty rate for all borrowers including the Banco do Brasil.

A policy of this kind is more effective if, in addition, the monetary authorities eliminate negative effective rates of interest. Even better is a policy of removing subsidies to borrowing.
If these steps are taken, there would be much greater control of the growth rate of money and therefore greater control of the rate of inflation. Control would not be complete. To gain complete control of the growth rate of money, the cruzeiro must become a floating currency. But as long as the rate of inflation in Brazil is substantially above the world rate of inflation, there is much that Brazil can do to lower the rate of inflation, and the need to decide between fixed and floating exchange rates is not urgent.

Closing the Conta da Movimento and allowing the discount rate to adjust flexibly to changes in conditions on the credit market are important first steps in the control of inflation. Institutional changes do not guarantee that the rate of inflation will be reduced. Nothing does. All that institutional reforms can do is to put the government, or the monetary authorities, in a position to control the rate of inflation. If the central bank is under pressure to subsidize credits of various kinds by expanding the money stock, institutional reforms will not prevent inflation. However, the central bank will be forced to make an explicit decision to inflate instead of finding out what has happened to monetary growth after the event.

Let me summarize some of the main principles we have applied.

1. **Inflation cannot** be controlled without controlling the growth rate of the money stock.

2. To control the money stock, credit and monetary policy must be separated. This can be accomplished by closing the Conta da Movimento, separating the Banco Central and the Banco do Brasil and giving the Banco Central responsibility for control of money.
3. Credit subsidies can, if desired, continue to be granted by the Banco do Brasil or they can be replaced by direct subsidies from the national treasury. In either case, fiscal and monetary policy is separated.

4. The separation of credit and monetary policy will be successful only if it is accompanied by additional steps that prevent the pressures for inflation from shifting to the central bank.

Monetary Correction

In the late 1960's Brazil was able to reduce the rate of inflation from above 60% to less than 20% while expanding output dramatically. The new policies produced sustained average real growth rates above 10% for more than 5 years. International reserves were accumulated, living standards increased, and the interior of the country was developed. It was possible then to control money much better than it is today. Many of the credit subsidies, controls on imports, blocked accounts, import deposits and the like were removed in 1964. Substantial new distortions were not introduced until later.

Another important step in the 1960's was the development of one of Brazil's important contributions to the practice of monetary policy. I refer of course to the system of monetary correction that has, in one form or another, continued to the present.

The main purpose of monetary correction is to separate, as much as one can, real effects and inflationary effects on decisions. Business, labor, consumers and producers become free to make judgment based on real rates of return. Judgments about the anticipated future rate of inflation have a much smaller role in decisions to invest, save, work or produce.
The system of monetary correction worked. No system of indexation is perfect, but the surge of investment and saving that occurred after the system was established testifies to the lasting benefits achieved. Saving flowed into productive real capital used to develop the country.

The system of monetary correction no longer works in the way that it did earlier. We all know of cases in which individuals borrow subject to subsidy at low rates of interest and invest in real estate, apartments and buildings rather than in the asset that the subsidy is supposed to encourage them to accumulate. Then, as the rate of inflation rises, the borrower gains on the loan because of the subsidy and on the investment because the prices of land, real estate and apartments, on average, rise with the rate of inflation.

The system of subsidies erodes many of the benefits of monetary correction by making investment decision depend on the anticipated rate of inflation and not solely on the anticipated real return. The gains to the individual from higher rates of inflation depend on the type of subsidy. Subsidies which take the form of a 20% ceiling on the maximum amount of monetary correction encourage individuals to invest when they believe the anticipated rate of inflation is above 20%.

Here we have an example of the conflict between private and social benefits. The individual who borrows with a maximum monetary correction of 20% is encouraged to invest even if the real rate of return is low or negative provided he anticipates a high rate of inflation. From the standpoint of society, resources are wasted when they are directed to projects with returns lower than the rate of return available elsewhere. From the
standpoint of the individual, the projects are profitable. The individual sees a high positive net rate of return. Society often sees a low or negative rate of return.

The Long-Term

During recent years in which there have been very large subsidies -- fiscal and financial subsidies -- the growth rate of real output has fallen in Brazil, and inflation has increased. A country grows more slowly if a significant share of its resources are invested in projects with low rates of return. I believe that if fewer subsidies are given and if credit subsidies produce fewer distortions, the growth rate of real output can be raised as the rate of inflation falls.

It is easy to overlook the cumulative effect of small changes in the growth rate of real output. At a growth rate of 7 or 8% -- the average of the past few years -- real output per capita grows at only 5 or 6%. It takes 12 to 14 years to double per capita income, so a son joins the work force at a real income about 2-1/2 times the real income his father received when he joined the work force. Compare a growth rate of 10 or 12%. If Brazil can again grow at that rate, per capita income will rise at 8 or 9%. It then takes only 8 or 9 years to double real per capita income. A son entering the work force would receive nearly four times the real income that his father received when the father entered the work force.

Not in the next year but later in the century, and in the next century, the real benefits of a program of removing distortions and encouraging growth will be found in the large changes in real income that become possible. Shifting to a less distorted, less subsidized, less wasteful, less regulated
system has costs. The economic reforms after 1964 did not produce effects immediately. But the benefits outweighed the costs, and there are good reasons to believe that this will again be true if you can bring yourself to act boldly and to use your credit policy to encourage, rather than to discourage, efficiency while using your monetary policy to reduce inflation.

A well known principle of administration teaches us that to get desired long-run results, we must:

1. form clear objectives;
2. establish procedures capable of achieving those objectives;
3. monitor or audit the process to assure that the objectives are achieved.

The objectives for Brazil, I believe, should be sustained high growth of per capita income without inflation. The procedures to achieve these aims include control of the rate of money growth and the establishment of a credit policy that removes rather than increases distortions.

The suggestions that I have made are not easy to apply, and they are not applied uniformly anywhere. But the enormous economic achievement of Brazil when these principles were applied more fully, and the lesser achievements now that they have been violated, are persuasive evidence of their importance. What has been accomplished in the past can be accomplished in the future if the principles guiding monetary policy in the past are reaffirmed.