Independent Central Bank: Objectives and Functions

What to Expect from Conducting Monetary Policy

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The autonomy of a Central Bank (BACEN) has been a long-standing reason for heated debates, both in academia and in politics, and in various parts of the world. In Brazil it is no different, and with the rise of a more liberal economic team under the aegis of the Bolsonaro government, the subject gained yet more relevance. Recently, a board member of the Central Bank of Brazil (BCB) Tiago Berriel lectured[2] on this issue, with a clear approach to the distinction between autonomy and independence of BACEN, with an evaluation of the reasons on the basis of empirical studies, notably regarding its main mission: inflation control.

Thus, it seems important to keep in mind that there will be opportunities for eventual reassessment and redefinition of objectives and functions - in particular as regards the focus of being exclusively the "guardian of currency stability" and/or, in addition, a combination of full employment and economic activity. In any case, the limitations of the objectives and functions, as well as the proper identification of its goals and guidelines cannot, under any circumstance, compromise its very existence in itself, that is, of dynamically keeping inflation under control.

That being said, and under the current Brazilian economic landscape, the challenges are even more daunting. In fact, Brazil is not yet broken, but the problems that surround us today place us in a binary situation. Solving the Social Security problem or not has the power to position us either before the beginning of a new "Brazilian economic miracle" or downright bankruptcy, both in the medium run. Yes, with more than 13 million unemployed and an enduring economic stagnation in 2019, which is about to repeat the last two years (around 1.5%), reflects the absolute lack of definition of clear-cut scenarios and, therefore, zero-appetite by investors until the country finds the solution to this problem.

In that regard, the truly independent BACEN will guarantee, at least, its impartiality (by some understood as insensitivity), either with respect to the executive branch or in relation to the market. Monetary policy may, under the definition of its objectives and functions, exercise the possible balance of the economy with price stability (whatever the outcome of the social security reform). Despite some "bumps" in recent years, BACEN's "operational autonomy" has enabled it to implement its policy with reasonable success.

The understanding that should prevail, with no doubt, should be that of "pursuing" the natural (neutral) interest rate (NIT)[3], initially tackled by Henry Thornton and furthered by Knut Wicksell. This rate, which nobody can calculate accurately, is the one that balances Savings and Investments, which is consistent with stable prices and a balanced economy. Thus, apart from economic instability, the neutral interest rate would be that practiced in the market, matching aggregate supply and demand to each other.

Thus, given the current situation, and given that the results of monetary policy take months to come to full effect, assessing future scenarios become pivotal. However, what we have today is very low savings and uneasy investors (especially the foreign ones). Sky high levels of unemployment, weak activity and projected inflation falling short of target all point to basic interest rates falling even further, but the question remains as to how to finance our debt at lower interest rates?

Is monetary policy tight or loose then? As the

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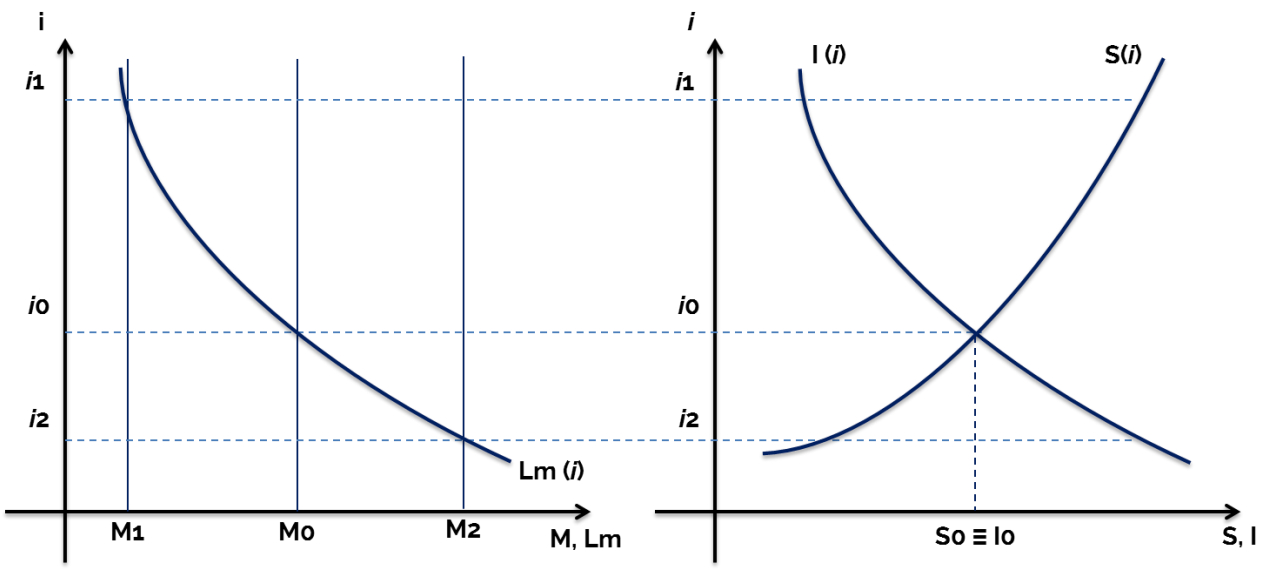
neutral rate cannot be observed, under Wicksell's concept, how can we know if the market interest rate is above or below the neutral rate? We should focus on the overall price level. If inflation is rising, higher interest rates are needed and, under opposite circumstances, interest rates should be reduced. The stability factor, therefore, will occur when there is no difference between these two rates. However abstract this idea may seem, BACEN's focus will always lie on this, while at the same time interfering with the money supply.

On the other hand, in a less intuitive and much more pragmatic way, there is the Taylor Rule[4]. It is a mechanism where BACEN can change interest rates in accordance with economic conditions. Thus, through the methodology proposed by John Taylor, it is possible to adjust short-term interest rates to stabilize the economy, while ensuring GDP growth. In general, the basis of this concept is based on the fact that the neutral rate is the short-term interest rate that prevails when the difference between the actual rate of inflation and target rate of inflation and difference between expected GDP growth rate and long-term growth rate in GDP are both zero. But, after all, what is this nominal rate? We would still need to assume a real equilibrium interest rate...

Obviously, BACEN technicians have plenty information, studies, and much more at their disposal. The independence of BACEN, together with its strict mission (with objectives and functions), will provide guidance and, enjoying absolute autonomy, will exercise even more power over the economy. Following its mandate, with responsibility, governance and external control, the credibility of BACEN (certainly its main asset) will be guaranteed.

In this sense, what should we expect from Bacen when it comes to monetary policy for this year? The baseline scenario is on the record: controlled and anchored inflation, high unemployment with no signs of major improvements, and still with low savings and public finances (including and especially states) in shambles - the latter being an exogenous variable for BACEN. Additionally, an increasingly challenging external environment with worldwide sluggish growth – apart from the balance of domestic and foreign rate parities, influenced by the likely hikes in US interest rates. In the face of all this complexity the answer is most trivial: for now, nothing much. *Coeteris Paribus*, BACEN finds itself in the same predicament as we all



Where Lm = demand for cash; M = stock of money; S= Savings; I = Investments; *i* = interest rate

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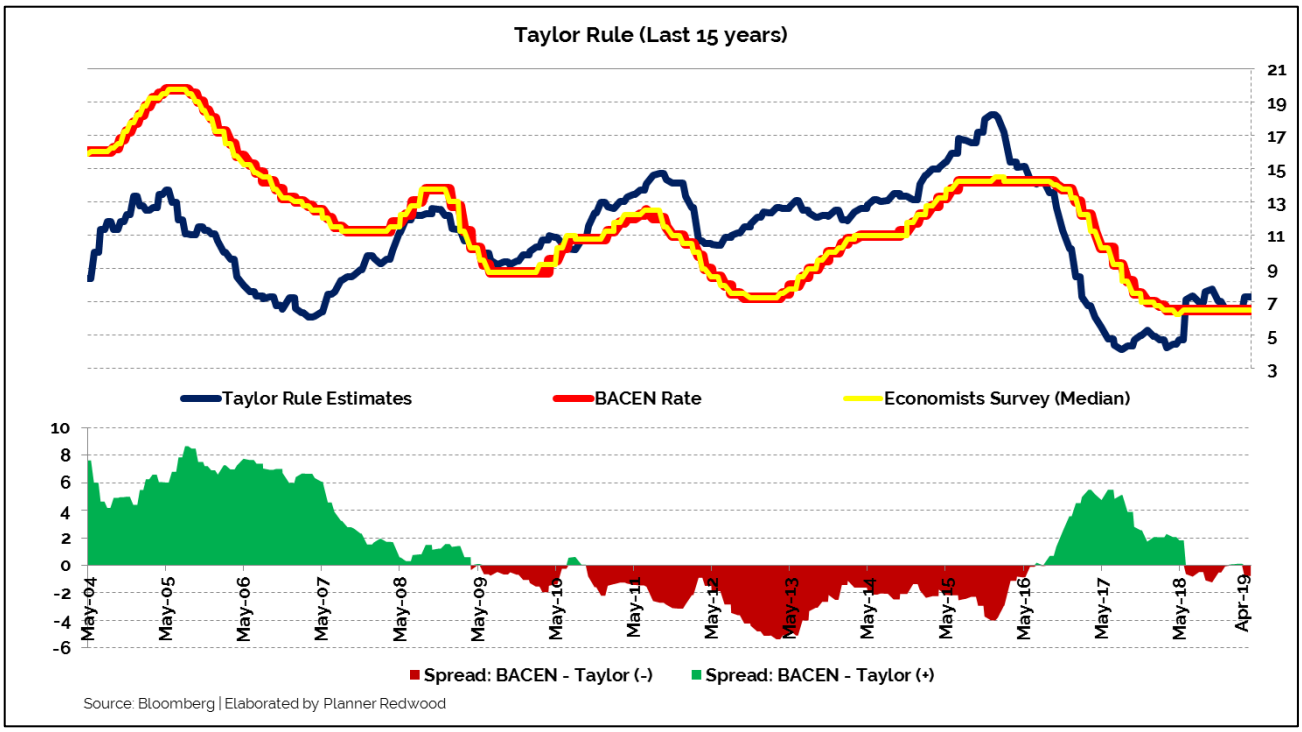
do, simple as that. Waiting for the solution of the Social Security stalemate and the pursuit of other liberal adjustments proposed. In fact, the models presented here do not factor in all aspects; hence other variables are also part of a broader analysis that, albeit indirectly, may affect the conduct of monetary policy. The fact is that non-autonomous BACENs are, as a rule, "behind the curve", while the truly independent ones are, especially in the short and very short run, "ahead of the curve" (anticipating and influencing market movements). However, with positive changes in the terms of the social security reform, we can embark on a virtuous cycle; otherwise the scenario will be discouraging. Thus, there is quite a large asymmetry, because should this reform pass the neutral rate may drop some ticks on the scale, and conversely, we will experience a significant increase of the entire Term Structure of the Interest Rates - ETTJ.

This possible adverse scenario has the potential to broadly and sharply disorganize the economy, leaving out the responsibility for the macroeconomic equilibrium, once again, for monetary policy to bear. At any rate, once BACEN is independent, in one way or another, it will deliver the best possible outcome to the Brazilian economy.



In fact, we are all Wicksellians now and forever!!!

[2] https://www.bcb.gov.br/conteudo/home-ptbr/TextosApresentacoes/Apresentacacao_Diretor_Tiago_%20Autonomia_BCB_24042019.pdf

[3] https://mises.org/wire/neutral-interest-rate-feds-impossible-goal

[4] Target Rate (Selic) = NIT + 0.5 × (GDPe – GDPt) + 0.5 × (Ie – It), or: Taylor = NIT Real + Inflation +[α x (Inflation – Target)] + [β x Factor x (NAIRU – Unemployment)]

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