Pandemic Inflation

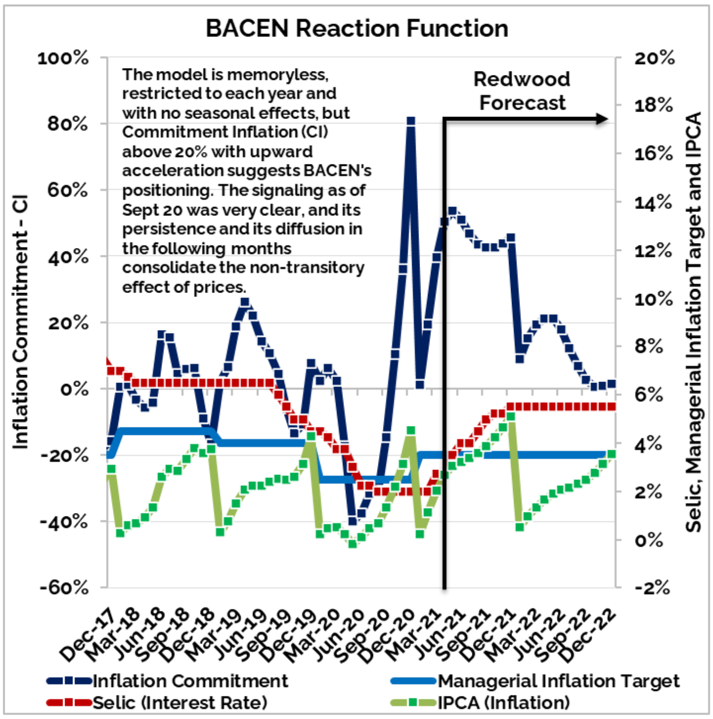
The most vicious of taxes and the greatest disorganizer of the economy

Mario Cezar Silva Serpa[1]

Inflation must be interpreted as constant and widespread price change. In this respect, for the simple reason that inflation is a monetary phenomenon, government ***is the one*** to be held accountable for it is the sole producer of money (currency and credit). Obviously, there is no shortage of versions of this thesis, let alone the causalities it entails. Supply and demand shocks are recurrent topics of study; they "explain and prove" theses, and are always invoked for a "better" understanding and correct choice of instruments to control inflation. Regulating the money supply, in its various forms, means expanding or contracting the means of payment, thus curbing inflation.

Such control, in much of the world and here in Brazil, is carried out by Central Banks (CBs) through its monetary policy apparatus. Among the "various" instruments that the monetary authority has in its toolbox, the basic interest rate of the economy - the Selic - is the preferred one. Once defined by COPOM, BACEN operates in the government bonds market so that the effective Selic rate converges to the target set by the Committee. Thus, the system's liquidity is increased or decreased, affecting all interest rates in the country, while influencing expectations. In this sense, it is a powerful mechanism, since in the long run the determinant for duration and persistence (pressure) of inflation are expectations (of inflation). BACEN, therefore, "rules the roost" for good or for bad.

What has been said above may simplify matters too much, but they are not out of touch with the problem. Externalities, non-creditworthiness and growing government deficit are recurrent factors that haunt us more and more. A vastly closed economy adds harm to foul, with a bad business environment and the so-called "Brazil cost" at blinding heights, among other aspects, all build the complete repertoire for unstable equilibrium. More developed and stable economies are, as a rule, less susceptible to greater inflationary outbreaks. We are not at this level, and the "inflationary memory" lives in us. How so? Our society's preferences reflexively incentivize government officials to spend far beyond our mean (level of productivity). The current debate on the budget is an example, namely: how many do think in a fiscally responsible way? Soon the issue of Tax Dominance will be raised again (*Fiscal Dominance or Dominance of the Absurd?*).



The Coronavirus pandemic has come to attack far beyond healthcare systems, compromising economic activity, employment and inflation in all continents. The world has become Keynesian (in the sense of bottomless spending), alternative theories like MMT (Modern Money Theory) are gaining ground, and much of the reflexes of these adopted policies, sometimes not in tune (although due to some extent by the pandemic situation), will have an impact on inflation. In the largest economy in the world, the US, no matter how "different" we say it is, it will also not be immune, as it was not in the 1970s, to serious inflationary problems. The point is: will the FED be willing to take appropriate action should the expectations of inflation rise? At the pace of

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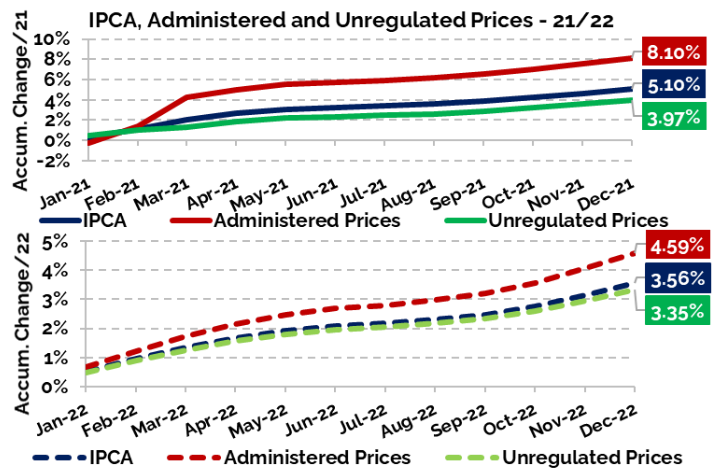
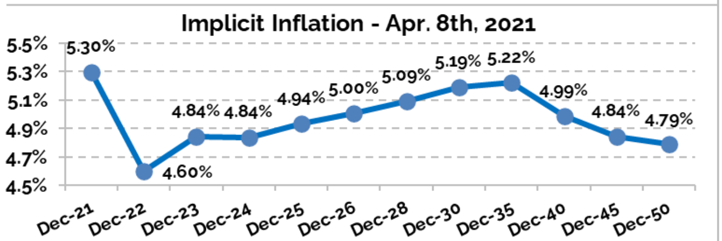
current stimulus through trillion-dollar packages and the (strong!) recovery of economic activity, above-target inflation levels in 2022 are not negligible. At any sign of this, odds are the Fed will start its monetary tightening sooner than late so as to influence expectations.

Here lies the danger for Brazil. If the FED (and the other CBs on the planet) starts lowering liquidity, our situation could become very complicated. Today we already have the "problem" of inflation as it stands. Expectations are already dispersed, either by the pandemic situation and its consequences, or by the increasingly deteriorated fiscal and the monetary policy falling behind the curve. Anchoring expectations back means facing these issues. On the BACEN side, we will see strong and successive increases in the Selic rate henceforth. The BACEN Reaction Function graph (proprietary model) clearly shows this trend. Failing at this task will bring huge costs when and if the world has higher interest rates; and with no guarantees of any good results.



Source: IBGE | Elaborated by Redwood (Redwood forecast from Apr/21)



Source: B3: BACEN | Elaborated by Redwood (Linear interpolation is used for NTNB's rates)

Our inflation forecasts for headline IPCA are not encouraging. The current projection for 2021 and 2022 is now 5.1% and 3.6%, respectively. For both administered and unregulated prices, the pressure continues throughout the year 2021, at 8.1% and 4.0%, with some relief in 2022; that is, if it is followed by the prospects for Selic increases in 2021, wherein we may face rates at 4.6% for administered and 3.4% for unregulated prices. The task of forecasting inflation is not a simple one, because it admits countless other exogenous variables without major impacts - a simplification that sometimes needs to be dynamically adjusted. This is why the relevant horizon for monetary policy is so important to be "respected". Monetary policy mechanisms take time to take full effect, so the proper interpretation of the scenarios is crucial for decision making. This assertiveness has multiple benefits, since the most affected, as a rule, are the lower income classes and, with a low inflation under control, investments flow with greater abundance.

The financial market helps us, in a way, in this assessment of inflationary expectations. The implicit inflation in the various inflation-indexed government bond maturities give us some guidance. In this sense, the stress seen all across the yield curve (pre-fixed interest rates) compared to the real interest paid in the past few weeks, speaks volumes of what investors expect from inflation in upcoming years. This trajectory of inflationary expectations by the market, when compared to economic studies, opens ample space for diverse bets and arbitraging. It also informs government analysts on the efficiency of their policies so they can calibrate accordingly.

In one way or another, models and tools for policy and control are in place. If we cannot get all the variables right, such as the externality associated with the timing of international monetary tightening, at least we have the "lead indicator" for action. Running behind the curve at this point is not an option for the BACEN. Its independence will soon be put to the test after it is made official - a good test.

One should have no doubts as to whom created this situation, let alone that the same person will face the obligation of fixing his wrongdoing.

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