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Separating Macroprudential Policy and Monetary Policy

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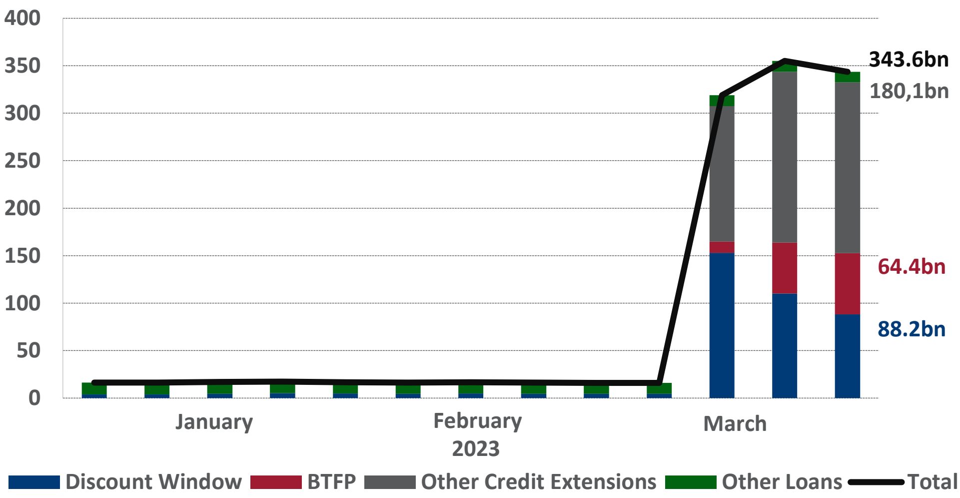
As monetary policy in the major economies advances farther into contractionary territory and approaches the end of the tightening cycle required to bring down lower inflation, episodes of financial instability have begun to appear, such as the events involving banks in the United States and Europe. The secondary effects of these events on the banking system and a possible deterioration in credit conditions beyond what was expected have raised concerns about the role of monetary policy in mitigating the risks associated with financial instability.

In the US, the collapse of Silicon Valley Bank (SVB) led regulators to act energetically to avert a systemic crisis, guaranteeing all of its deposits including those not covered by the FDIC and extending credit lines to financial institutions that faced or risked facing liquidity problems as a result. In addition to existing lines (such as the Discount Window), the Fed created a new facility (called the Bank Term Funding Program, or BTFP) with even better terms and conditions in order to bolster banks' liquidity and assure the provision of funds and credit at sufficient levels to keep the economy running more or less smoothly.

Figure 1: Fed Loans (USD Billions)



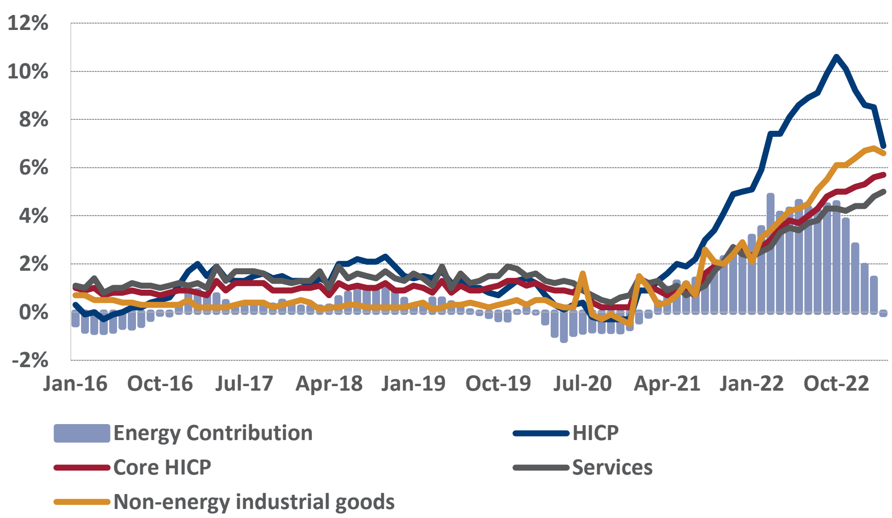
Source: Fed, BOCOM BBM

During the month, these liquidity programs added up to more than USD 300 billion (Figure 1), reinforcing the continuity of the monetary tightening cycle. At its last meeting, the FOMC raised the fed funds rate by 25 bps to 4.75%-5.0%. The terminal rate projected by its members is 5.0%-5.25%.

In Europe, the rapid takeover of Credit Suisse by UBS attenuated fears of financial contagion in the euro zone, but the episode emphasized the high level of inflation in the region and the need for monetary tightening to continue. The European Central Bank (ECB) raised its policy rate by 50 bps to 3.0% at its March meeting. The markets are pricing in a terminal rate of about 3.4%, and one or two more hikes are expected at forthcoming meetings. Euro zone inflation has been helped by falling energy prices (e.g. natural gas), but remains under pressure from food prices, inertia in services, and expected wage rises in response to the many strikes that are under way around Europe. Core inflation reached a new high of 5.7% (Figure 2), reinforcing the view that monetary policy should continue to pursue price stability, despite the careful attention to potential vulnerabilities in the European financial system.

Since the Great Financial Crisis of 2008, various instruments have been established to provide liquidity to the financial system and avert the risk of an acute systemic crisis due to bank failures. These mechanisms are all the more important in the current context, since inflation remains high in both the developed and emerging-market countries, while some cycles have not yet reached completion, and interest rates are set to stay at a restrictive level until the inflation convergence process is consolidated.

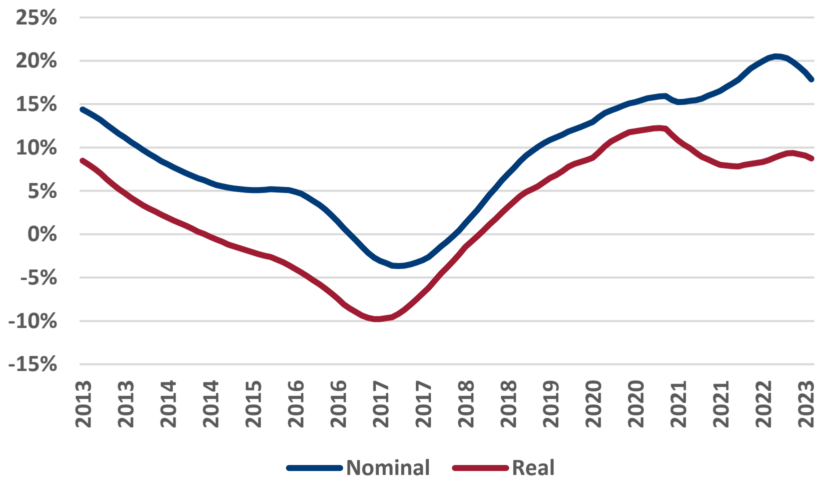
Figure 2: Euro Zone Inflation (% YoY, HICP)



Source: Eurostat, BOCOM BBM

The importance of separating the objectives and instruments of monetary policy from those of macroprudential policy has been emphasized by several central banks, including Brazil's, which kept its policy rate (Selic) on hold at 13.75% p.a. at its last meeting and noted that the additional tightening of credit conditions remained in line with expectations (Figure 3). Inflation projections rose for all horizons considered, and the post-meeting statement and minutes maintained the alternative scenario under which the Selic stays unchanged on 13.75% throughout the relevant period, reinforcing the view that there will be room for rate cuts only once the disinflation process is consolidated. The committee also noted that the de-anchoring of inflation expectations, as long-term expectations become sensitive to short-term negative inflation surprises, slows down the disinflation process and raises the cost of the disinflation needed to reach the target of monetary policy, but that it will remain vigilant for abrupt reductions in lending.

Figure 3: Non-Earmarked Credit Balance (12M Accum. Var.)



Source: BCB, BOCOM BBM

The government announced its proposal for a new fiscal framework at the end of the month, providing a little more information on how it plans to conduct fiscal policy and potentially contribute to disinflation. Judging by what has been disclosed so far, the framework will certainly be more expansionary, given that expenditure will be allowed to rise at least 0.6% in real terms (more than under the previous mechanism, known as the spending cap). Moreover, it will have cyclical components, with growth in government revenue from taxes and other sources acting as a potential trigger for increased spending. It includes a commitment to achieving a primary surplus within two years and would require revenue growth of BRL 100 billion-150 billion to assure a sustainable trajectory for the public debt. We have not yet adjusted our projections for this proposed increase in government revenue as the framework has yet to be debated by Congress, and we have left the year-end Selic on 13.75%. Our projections are shown below.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F	2024F
GDP Growth (%)	1.2%	-3.3%	5.0%	2.9%	1.5%	1.0%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	6.2%	4.0%
Unemployment Rate (eoy ,%)	11.1%	14.2%	11.1%	7.9%	8.5%	9.0%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.75%	13.75%	10.0%
External Accounts						
Trade Balance (US$ bn)	27	32	36	44	43	35
Current Account Balance (US$ bn)	-68	-28	-46	-56	-48	-52
Current Account Balance (% of GDP)	-3.6%	-1.9%	-2.8%	-2.9%	-2.4%	-2.5%
Fiscal Policy						
Central Government Primary Balance (% of GDP)	-1.3%	-9.8%	-0.4%	0.6%	-1.1%	-1.2%
Government Gross Debt (% of GDP)	74.3%	86.9%	78.8%	72.9%	76.8%	81.6%