RESEARCH INSIGHTS

IDB

How Well Does Fiscal Policy Explain Brazil's Inflation History from 1960 to 2016?

- **Inflation rates are closely related to the expansion of the monetary base in Brazil in 1960-2016. Persistent fiscal deficits resulted in constraints on debt financing and pushed the government to resort to monetary financing, permitted by a weak institutional framework surrounding the monetary authority.**

- **Official statistics often did not represent the country's true fiscal situation, as they did not include deficits of public entities such as public banks and state-owned enterprises.**

- **Improving fiscal balances was among the measures needed to end inflationary episodes, and the implementation of those measures was followed by periods of faster economic growth.**

CONTEXT

Latin American and Caribbean countries often face macroeconomic instability. Prior to 1990 this instability was reflected in high inflation rates in most countries, and Brazil was no exception. In the 1990s, however, many stabilization plans successfully controlled inflation in Brazil as well as other countries. Since then, the vast majority of countries in the region have experienced low inflation rates. The goal of this project is to learn the sources of these high inflation episodes in Brazil and what measures were needed to control them, focusing on the interaction between fiscal and monetary policies.

PROJECT

This project collected historical data on fiscal and monetary statistics as well as records on macroeconomic policies adopted in Brazil between 1960 and 2016. The data were analyzed through a theoretical framework consisting of a consolidated government budget constraint comprising both monetary and fiscal authorities. A particular effort was made to account for "hidden" deficits such as those of public banks and state-owned enterprises. These government deficits were then matched to the revenues that resulted from the expansion of the monetary base by the monetary authority (seigniorage revenues) during the high inflation episodes.

RESULTS

The history of inflation in Brazil from 1960 to 2016 is largely explained by the country's fiscal policies. The high-inflation period from 1960 to 1994 was characterized by a combination of fiscal deficits, passive monetary policy, and constraints on debt financing by the government. In contrast, the transition to the low-inflation period (1995-2016) was associated with improvements in government fiscal balances and higher de facto independence of the monetary authority, as well as much greater access to debt financing.

In addition, periods of high inflation were closely related to higher rates of monetary expansion by the central bank and higher seigniorage revenues captured by the government. A poor institutional framework, in which other public entities besides the monetary authority had indirect control over money issuance, contributed to this problem. While periods of higher inflation (1980-1994) were characterized by poor growth rates of GDP per capita, the transition to low inflation rates in 1994-2016 led to only moderate improvements in economic growth.

It is nonetheless worth noting that the country's successful stabilization plans, which improved fiscal balances, did not lead to economic contractions. In fact, higher growth rates in GDP per capita are observed in the years following their implementation. Small changes in the institutional framework, such as granting more independence to the central bank, can generate large improvements in economic outcomes.

Key Concept

MONETARY FINANCING

Occurs when the source of financing is the issuance of money by the monetary authority.

POLICY IMPLICATIONS

High inflation rates are very unpopular, suggesting that they impose significant welfare costs to citizens. This project shows that in order to achieve price stability (low inflation rates), governments should seek fiscal balance as well as an institutional framework in which the monetary authority has autonomy in conducting monetary policy—what is often referred to as central bank independence.

In the case of Brazil, the fiscal austerity measures undertaken to stop the high inflation episodes were not contractionary, as may have been feared. In fact, the Brazilian experience suggests that governments that choose to pursue similar measures are likely to enjoy faster economic growth in the following years.

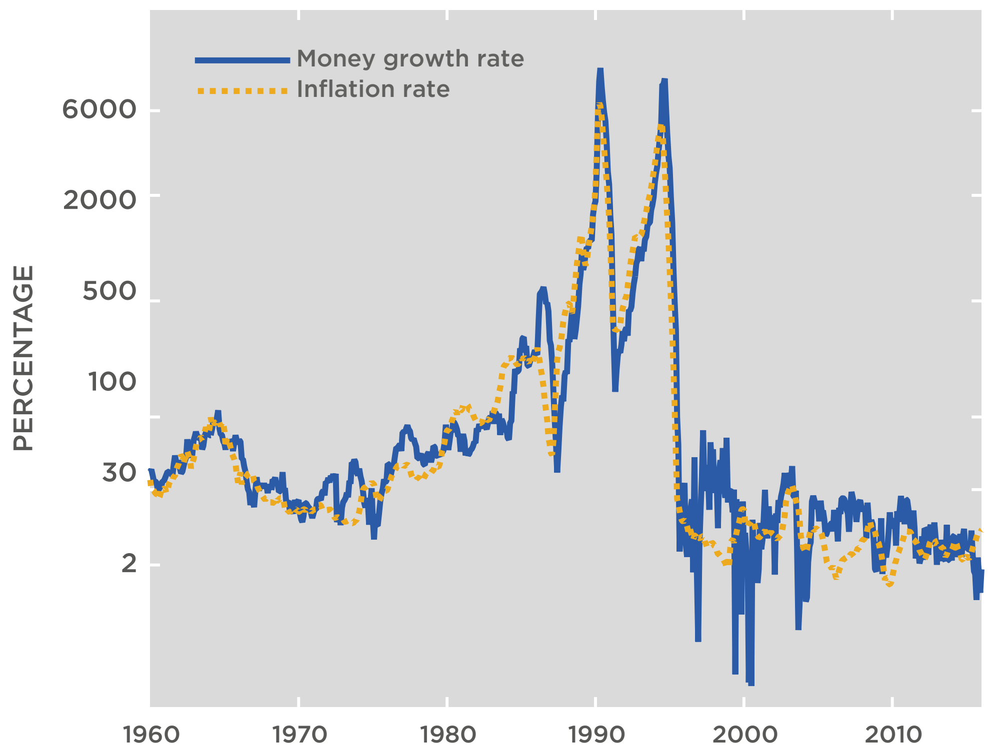
Moreover, governments can achieve significant improvements in economic outcomes by pursuing relatively simple changes in their institutional framework. Such changes in Brazil included reforms granting greater autonomy to the monetary authority and the adoption of fiscal rules that allowed the government to have better control over its finances.

Key Concept

INFLATION RATE

The rate at which the prices of products and services increase in units of the local currency.

Figure 1. Monetary Growth Rate and Inflation



FULL STUDY

[Ayres, Joao, Marcio Garcia, Diogo Guillen, and Patrick Kehoe. 2019. "The Monetary and Fiscal History of Brazil, 1960-2016." Washington, DC: Inter-American Development Bank.]

This study was also published as a chapter in the book *A Monetary History of Latin America, 1960-2017.*

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.

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