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IMPLICATIONS OF PUBLIC DEBT INDEXATION FOR MONETARY POLICY TRANSMISSION

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The goal of this paper is to provide a better understanding of monetary policy effectiveness in the case of indexed bonds. When public debt management deals with bonds indexed to the interest rate set by the monetary policy, there is no wealth effect and, as a consequence, monetary policy has a weak transmission channel reducing its effectiveness. This can help to explain why monetary policy in Brazil has been so tight and interest rates so high during the Real Plan.

JEL classification codes: E32, E43
Key words: wealth effect, monetary policy, indexation, public debt management

I. Introduction

Since the implementation of Brazil's Real Plan in 1994 and the beginning of a period of stable inflation, the monetary policy of the Brazilian Central Bank has been qualified as very tight. Not only are interest rates very high, so is their response to inflation shocks (Minella, Freitas, Goldfajn and Muinhos 2003). This result casts doubt on monetary policy's effectiveness to stabilize the inflation rate in Brazil.

Some economists argue that public debt management in Brazil may be responsible for this weakness and, as a consequence, for the tightness of the monetary policy. Actually, they argue that the existence of public debt indexed

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to short run Selic interest rate does not permit that the wealth effect channel of monetary policy fully operates.[1]

This paper makes an attempt to quantify the monetary policy transmission through the wealth effect. The wealth effect is related to how wealth variations induced by monetary policy affects aggregate demand. The seminal contribution came from Pigou (1943) who argued that deflation would increase wealth leading to the expansion of aggregate demand. Modigliani (1943 and 1963) and Ando and Modigliani (1963) extensively studied how the wealth effect could stabilize labor, goods and monetary markets delivering its contemporaneous interpretation of the wealth effect.

In the applied field, the macro econometric models in the 1960's and 1970's predicted significant impacts caused by the wealth channel. Ludvigson, Steindel and Lettau (2002) conducted an experiment to investigate the role of the wealth effect in the Data Resources, Incorporated (DRI) model, the Washington University Macroeconomic Model (WUMM) and the Federal Reserve Bank (FRB) model and reported large impacts.

Although those macro econometric models pointed out some important effects of the wealth channel, there is a trend in the recent models to abandon it. This trend may be explained by the recent research on monetary policy transmission that has concluded it has a secondary role compared to direct interest rate effects (Boivin, Kiley and Mishkin 2010).

Fair (2004) also provides evidence of small wealth effects, concluding, however, that the large capital gains during 1995-2000 were responsible for the great performance of the U. S economy. In other words, despite the small estimated coefficients, the wealth effect may have large macroeconomics consequences. Because of this controversy, the interest in this theme has been renewed in order to understand the changes that might have occurred during the recent period.[2]

Other than that, public debt management offers an efficient way for consumption smoothing over time. On the positive side, public debt can help overcome imperfections in financial market intermediation (Woodford 1990). Public debt provides liquid assets in private wealth, thereby increasing the flexibility of the

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[1] The wealth effect channel measures how asset variations induced by monetary policy affects consumption. For a model with a wealth effect, see Bénassy (2007) who constructs an IS-LM model in a non-Ricardian world.

[2] Boivin and Giannoni (2006), for example, provide strong support to the idea that the conduction of monetary policy has been responsible for the lower volatility after the 1980's.

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