International inflation and trade linkages in Brazil under inflationtargeting.

Guilherme Spinato Morlin*

We assess the connection between global and domestic inflation in Brazil during the period from 1999 to 2020. Input-output linkages have been shown to be an important cause of inflation synchronization of inflation for advanced and emerging economies. International cost shocks are less studiedin the case of Brazil. We therefore estimate a Structural VAR model with an index for producer prices (PPI) of Brazilian trade partners, in addition to the other relevant determinants of inflation. Estimates shows a positive effect of the Foreign PPI on Brazilian Consumer Price Index, constituting a relevant explanation for domestic inflation in Brazil during the period 1999-2020. Impulse Response functions show that the Exchange Rate is the main determinant of domestic CPI in Brazil. The results are in line with the literature's empirical findings showing the overall relevance of internationalvariables in the explanation of inflation. Overall, our results reveal the dominance of shocks related to the external sector (Exchange Rate, Foreign PPI, and Commodity Prices) over domestic shocks (GDP and Interest Rate) to explain inflation in Brazil. The importance of international shocks and of Foreign PPI in particular has important implications for monetary policy. International shocks are not affected by the policy rate pegged by the CentralBank of Brazil. However, the impact of these shocks on Brazilian prices also depend on the exchange rate. Therefore, our results seem to confirm that the inflation targeting regime relied mainly on the exchange rate effect of interestrate increases. Finally, this paper provides an additional variable explaining the effect of external shocks on domestic inflation in Brazil.

Key words: inflation, monetary policy, global inflation, exchange rate.
JEL codes: E31, E52, F41, O54.