



BANCO CENTRAL DO BRASIL

**Síntese das Mensagens do Presidente Ilan Goldfajn nas Reuniões do
Encontro Anual do FMI.**

Washington, DC, 6 a 8 de outubro de 2016.

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Washington, DC – 6 a 8/10/2016

It is a pleasure to have the opportunity to share my views about the impact of the global economy on Emerging Market Economies (EMEs), and the current policy framework and latest developments in Brazil.

The global economy is now undergoing a transition to a new steady state. The current context has been characterized by abundant liquidity and slow growth recovery among major economies. From the perspective of EMEs, I have called this period as a “benign period”.

Benign because abundant global liquidity has enabled cheaper funding, favoring especially EMEs, which are traditional external savings importers. This configuration holds because neither the pace of global growth is strong enough to trigger the removal of monetary stimulus in Advanced Economies (AEs), nor is too weak to reduce aggregate demand or to stimulate capital outflows from riskier markets. In addition, the fear of a new global recession has abated.

This benign scenario is transitory. It is not likely that this environment will last for long.

In the US, in particular, good signs from the labor market confirm that the economy is recovering robustly. Hence, one cannot disregard the perspective of a reduction of the monetary stimulus sooner than expected.

EMEs should seize this opportunity to reform and adjust their economies. EMEs need to address their problems and now is the time to do it. The normalization of monetary conditions in advanced economies should end the capital “flight from zero interest rates” to EMEs. Thus, needed reforms will become more costly and we should not ignore bouts of volatility ahead.

However, the normalization of global monetary condition should not be interpreted as bad news in the medium and long term. After all, the world economy will be recovering.

Domestically, Brazil has experienced the most severe recession of its history. In the last year and a half, GDP fell 7%. The labor market has slowed down sharply and the unemployment rate has reached 12% after achieving 6% in 2013. At the same time, inflation reached 11% by the end of 2015 and it is now expected to end 2016 slightly above 7%. These developments were equivalent to a supply shock, and the effects of the global deceleration were magnified by the adoption of distorted domestic policies.

The Brazilian economy suffered a confidence crisis generated by fiscal problems. Along the road, the fiscal primary surplus declined from 3-4% of GDP to -2.5% and the gross debt reached 70% of GDP. The deterioration of fiscal accounts raised questions about the debt dynamics and led expectations of gross debt to GDP ratio to achieve 80-90%. In addition, political and non-economic events aggravated the lack of confidence.

More recently, political uncertainty has diminished and the new government has advanced a comprehensive economic policy agenda.

Our policy strategy is clear. We are strengthening the policy framework that has already proven to be successful in the past. It is based on fiscal responsibility, inflation targeting and flexible exchange rate regime.

On the fiscal side, the new administration has shown strong commitment in pursuing structural reforms to ensure a sustainable debt dynamics over time. A constitutional amendment establishing a spending cap for all levels of government is currently being appreciated by Congress, while a proposal for social security reform will be sent to Congress soon.

Actions devoted to reinforce the pillar of fiscal responsibility and put public finance in order are arduous and require continuous work. Nevertheless, I believe they are rewarding actions in terms of restoring confidence of economic agents. Measures that rationalize the expenditures enable investors to expect stabilization and the following decline of the debt to GDP ratio in the upcoming years with immediate impact on their confidence.

Beyond the fiscal policy, the new administration will advance on a broad agenda of structural reforms to boost productivity and long-term economic growth. The agenda includes initiatives to foster investment in infrastructure, privatization and labor reform. In this regard, the government has recently launched a plan for infrastructure concessions and privatizations. We all know that these investments have a multiplier effect as they

reduce the costs and risks of productive activities and, consequently, increase the expected returns on other investments in the economy. More attractive projects bolster investment and raise the potential output.

All these initiatives are important to recover sustainable growth and deliver low and stable inflation.

In fact, the policy strategy put in place has already produced some results. Firstly, the reduction of uncertainties and risks in the Brazilian economy has been reflected in financial variables, for instance, the decline in risk premium on Credit Default Swaps (CDS). Also, expected and implicit inflation have fallen.

The Monetary Policy Committee's (Copom) baseline scenario envisages economic stabilization in the short run and a gradual recovery in economic activity over the next quarters, in a context of a high level of economic slack. The evolution of prices indicates an ongoing disinflationary process, but the speed of disinflation is still uncertain.

The economy displays early signs of stabilization after contracting for six straight quarters until April-June 2016 and confidence in recovery ahead has increased. The industry interrupted five quarters in a row of negative growth whereas investment grew after declining for ten consecutive quarters. The indicators of consumers and entrepreneurs confidence have risen since the second quarter.

The contribution of external sector to GDP remains positive, albeit less vigorous than it was in 2015.

Therefore, we have seen clear progresses in some areas, but there are still economic challenges to face.

Although the pace of labor market deterioration is moderating, unemployment is rising and wages falling. We need to create conditions for the economic recovery in the present so that we can have sustainable job creation in the near future, as the labor market respond with lags to GDP growth.

In this regard, the main challenge is to put debt dynamics in order. It is critical to approve and implement a reform agenda to reduce uncertainties and strengthen fundamentals. This is a necessary condition to regain confidence and to foster a virtuous cycle between confidence and growth. Sustainable growth and low and stable inflation will follow.

The Central Bank of Brazil (BCB) is contributing to restore confidence and to stimulate growth by increasing its credibility and by controlling inflation. Low and stable inflation is required to reinforce confidence because it preserves the purchasing power of individuals and firms. It allows the lengthening of planning horizons and reduces the uncertainty about investment projects returns. Confidence, in turn, leads consumers and investors to take risks, fostering consumption and investment.

Thus, I highlight that by pursuing its mandate of keeping inflation low and stable, the BCB enables the economic recovery.

The BCB is committed to control inflation across the entire relevant horizon of monetary policy. It considers the calendar-years with targets defined by the National Monetary Council (CMN) and includes 2017, for which the Copom pursues the convergence to the 4.5% target.

It should be noted that the relevant horizon is not static. It moves continuously throughout time. According to this strategy, as the months go by, the monetary policy actions attach gradually more importance to periods that are equally ahead.

The easing of monetary conditions will depend on factors that allow the Copom members to have greater confidence in meeting the inflation targets. The Copom will evaluate the evolution of all these factors as a whole, as none of them is, by itself, sufficient for monetary policy decisions.

Among the elements that may increase confidence in meeting the inflation targets, the Committee emphasizes the following domestic factors: (i) limited persistence of the impacts of the food price shock on inflation; (ii) the IPCA components that are most sensitive to monetary policy and economic slack show disinflation at an appropriate pace; and (iii) lower uncertainty regarding the approval and implementation of the necessary economic adjustments, including the composition of fiscal measures, and their effects on inflation.

Regarding the first factor, recent evidence indicates that the fall in wholesale food prices is being transmitted to the retail sector. In addition, projections for food-price sub items seem to provide increased confidence in the reversal of the price shock in this sector. In fact, part

of the recent resilience of current inflation seems to have been driven by temporary shocks to food prices. The Copom will remain alert to signs indicating that this resilience may also arise from inertial mechanisms.

With respect to the second factor, the signs about the pace of disinflation towards the target are still inconclusive. The Copom will evaluate (i) the disinflationary trend of a number of measures of services inflation; and (ii) the secondary effects that disinflation in this group may have on other IPCA components.

Turning to the third factor, there are positive signs regarding the proposal and consideration of fiscal reforms. However, uncertainty regarding the approval and implementation of the necessary adjustments still remains. These reforms are relevant for the BCB inasmuch as they affect the balance of risks and the inflation trajectory with respect to meeting the targets.

We have conducted monetary policy as cautiously as required by the moment. By acting prudently, we have already obtained some results. Inflation expectations converged to 4.5%, from 2018 on. For 2017, the median of expectations declined since June, from 5.5% to 5.1%.

It is important to clarify that the Brazilian Central Bank is not committed to any established timeframe for easing monetary policy. Any decision will be driven by evidence after a careful assessment by Monetary Policy Committee Members (MPC's members), looking at the evolution of those three main domestic factors mentioned in the Inflation Report and the behavior of inflation expectations and forecasts. In sum, it is the evolution for these domestic factors that can bring comfort to our MPC that inflation is converging to the target at appropriate speed.

The BCB will also contribute to the economic recovery by respecting the floating exchange rate regime, which has already proven its value as a stabilizer when economy is hit by large shocks.

However, the floating exchange rate regime does not preclude the BCB from using its tools predictably and parsimoniously. These tools will only be deployed when appropriate conditions are present.

An example of the use of these instruments has been the gradual reduction of our position in currency swaps, which has mitigated the exchange rate volatility without changing the FX market trend. I believe, however, that under current conditions, the scope for those interventions has been diminished considering the proximity of the normalization of monetary conditions in the US.

The fight against inflation and the flexibility of exchange rate are not the only contributions of the BCB to the economic recovery. When confidence of investors and consumers enables the resumption of economic activity, the financial system will have to be ready to facilitate business. Therefore, a sound financial system will also act as a driver for economic recovery.

The BCB's regulation and supervision goals are to maintain the Brazilian financial system liquid and provisioned throughout the crisis. Institutions are supervised in a standardized manner, whether public or private-owned institutions. In addition, we continuously monitor markets and individual institutions in order to identify promptly potential risks and vulnerabilities. By doing so, we can act preemptively, avoiding potential threats to the system.

Despite the hurdles posed by the crisis, our financial system remains liquid, capitalized, provisioned and inclusive.

Liquidity, in particular, is a remarkable feature of our system. Banks have increased their ability to absorb liquidity shocks in the short term. In the long run, they are not expected to face liquidity shortages, as their long-term assets remain fully supported by stable funding.

The solvency of the Brazilian banking system also remained solid. Capital stood at a high level in the first quarter of 2016. Moreover, the system continues to operate with capital ratios above the regulatory requirements.

Similarly, the leverage ratio above the requirement level suggested in Basel III discussions reinforces the soundness of the system's solvency.

Rigorous capital stress tests, periodically carried out by the BCB, have shown that the banking system holds adequate capacity to withstand shocks stemming from adverse macroeconomic scenarios. These scenarios take into account abrupt changes in interest

and exchange rates, increase of non-performing loans and intense falls of housing prices. These tests confirm the resilience of our financial system. With all these simulations considered, I believe that the system is prepared to face the ongoing crisis.

The BCB is also working to boost the efficiency of the Brazilian financial system. Studies and initiatives to reduce the cost of credit are under way. We are also designing an agenda to tackle existing distortions and inefficiencies in the system.

I emphasize that these actions will strengthen our ability to accomplish the institutional mission of ensuring a sound financial system.

Apart from the strength and the efficiency of the financial system, the BCB has given special attention to new financial services customers. Financial inclusion process has enormously advanced in Brazil. Individuals have almost universal access to financial services across the country. However, there is still much room for development of other fundamental aspects of financial citizenship, especially those related to financial education and protection of the newly included population.

I have recently expressed my opinion that the BCB is structuring an agenda, which comprises a wide-range set of actions. The main pillars of this agenda are: (i) reducing the cost of credit, (ii) increasing the efficiency of the financial system, (iii) strengthening financial inclusion, and (iv) revising the legal framework of the BCB.

I believe EMEs should seize the opportunity created by the benign period in the global scenario to implement the necessary adjustments.

For Brazil, it is imperative to approve reforms to restore confidence and create the conditions for the economic recovery, with low and stable inflation.

As I have stressed, the BCB is committed to bringing inflation back to target and keep it stable. This will help the economy to regain confidence and recover growth.