Monday, April 14, 2014- Harvard Club

35 West 44th Street · New York City

Brazil Economic Outlook & Challenges When Normalization Begins

Remarks: Luiz Awazu Pereira da Silva[1]

(Central Bank of Brazil)

My remarks will briefly touch upon: my view of the Global Economy now that normalization of policies has begun in the US; how it affects and relates to recent development in Emerging Market Economies (EMEs); then speaking about Brazil I will look at our Policy Reaction in this transition; finally, I will give my views about Inflation, Growth and our Challenges.

The Global economy is a bit better (e.g., the US recovery is holding, there are somehow less tail risks/false positive in the EuroZone and China is working its soft-landing towards a different sustainable growth model);

Normalization of Unconventional Monetary Policy (UMP) in the US has begun, there is now much better coordination, clearer FED's communication on UMP exit (e.g., explaining the separation between its phases, acknowledging spillovers into other jurisdictions and willingness to proceed with caution); in that context, the repricing of EMEs assets is underway naturally, as expected, with some volatility.

So the Global Economy is doing slightly better but my view of the recovery is that it's still complex, why? One reason is that UMP was an unprecedented policy experiment; it succeeded and indeed saved the World but exiting from it is perhaps more complicated than we thought. Despite the FED's much improved guidance there are still in Advanced Economies (AEs), especially the US, fundamental macro questions being debated whose result affect how policy should react and/or will be expected to react.

For example, on labor market conditions, there are different studies/estimates for the NAIRU, the flattening of Phillips Curve, how different "measures" of unemployment[2] (short-term, by skills?) influence most wage inflation in the US; there are also different studies trying to ascertain the neutral interest rate in AEs, whose level after Great Moderation and Global Financial Crisis (GFC)

[1] Deputy-Governor, Financial Regulation and International Affairs, these remarks are personal and do not necessarily reflect the opinion of the Central Bank of Brazil
[2] See for example: Krueger, Alan B. Cramer, Judd, and Cho. Are the Long-Term Unemployed on the Margins of the Labor Market?, Brookings Panel on Economic Activity, March 20–21, 2014, Princeton University & NBER

might have changed[3]. You might add phenomenon like nominal wage "rigidity" in the 2008-09 downturn that might now compensate and moderate or delay "upward" wage adjustment in the present 2014 upturn. So life has become more complicated for all of us, macroeconomists, under a possible "New Normal". And our anxiety could be summarized in the following question: would there be the capacity to sail through the ups and downs of forthcoming data while managing to handle expectations over the slope of yield curve, the timing of future changes in monetary conditions?

Why is this so important for us in Brazil and other EMEs? Naturally because of possible anticipations bringing more volatility. Now being pragmatic, even with heated debates/uncertainties in the US about the NAIRU, the neutral rate, labor market conditions and wage transmission into inflation, I maintain ***my view that UMP exit is a net positive for everyone, the US and the rest of the World***. I also believe that the FED communication is working, its forward guidance is conveying clearer messages of separation between the phases of its exit strategy, a cautious approach, mindful of spillovers, etc. And, for Brazil, therefore and for the moment, despite these debates, I stick to the Baseline I just described as the most likely scenario.

What about Emerging Market Economies (EMEs)? Until the last couple of weeks, it was Chronicle of a Death Foretold. What was the story?

It went like the tale of the "The Ant and the Grasshopper" or the story of the guy who is trying to sober up and diet and is invited to a "free liquor & all you can eat" party. The presumption was that EMEs benefitted from "easy money" and allowed excessive relaxation of policy stances; their local political economy favored counter-cyclical policy (especially the expansionary bit); fundamentals deteriorated (e.g., asset-credit bubbles, higher current account deficits, inflationary pressure, fiscal stance-debt-to-GDP ratios, external financing for both corporates and sovereigns, etc.). There were no structural reforms undertaken in good times: hence we would get lower growth prospects in the future. And therefore, EMEs were heading to the perfect storm: higher vulnerability to "sudden stops" and the usual financial-current crisis, "This Time Is (No) Diferent".

Now with hindsight, there is nothing really new in the challenges faced by EMEs during the Global Financial Crisis (GFC)[4]. Our monetary policy frameworks (Inflation Targeting (IT) or not) always had to cope with flows and address challenges posing significant risks to our monetary independence

---

[3] See for example: Bayoumi T. and alii, "Monetary Policy In the New Normal", SDN 14/3, IMF Staff Discussion Note April 2014

[4] To begin with, excessive exuberance is not only an EME problem (e.g., see the Eurozone periphery, the Baltics, the UK, the US). Debt-financial-currency crises are a perennial (and now, given what happened to Advanced Economies, an equal opportunity menace). And it seems to –contrary to some cultural explanation about the propensity to save/spend/borrow, crisis seems to affect Confucean/Protestant jurisdictions of "savers" as much as Latino/Catholic jurisdictions of "consumers". For debt to rise, public, private or both, there is always the following combination: (1) someone saying "This time is different" (I agree with Ken Rogoff & Reinhard); (2) some excessive irrational exuberance in lending and borrowing (it takes two to tango and I agree with Robert Shiller); (3) some mispricing of risk (the financial World is not Gaussian nor linear, as Benoit Mandelbrot reminded us and even if it was normally-distributed you need to pay attention to fat tails as Nassim Taleb); (4) some lax regulation, lack of supervision, explicit or implicit guarantee that compounds (2) & (3) (I agree with Alan Blinder); and (5) some political economy institutional set-up that favors pushing the bill to your children, the next government, or both.

and/or financial stability (e.g., typical "boom" & "feel good" moments, followed by "sudden stop", reversals). We have been used to manage pragmatically the Impossible Trinity to keep the independence of our monetary policy (e.g., paying attention to the transmission of capital flows into inflation, asset prices, exchange rate, credit market, etc.). And having gone through so many crises in our history, EMEs got more experienced, more prepared because we are always riding some global financial cycle (local MP in AE have global effects). We are always into some kind of "beauty contest", especially deficit-savings countries. This time, the major difference might have been the unprecedented speed, intensity and simultaneity of UMP (combining the Zero Lower Bound (ZLB), massive asset purchase programs by CBs or Quantitative Easing (QE) and Forward Guidance (FG) simultaneously in the three major monetary areas.

But nevertheless, so this overly pessimistic story went out and became popular, with new fancy "acronyms", e.g., "The Fragile Five", the "crash of the BRICS", etc. Most of the analytics behind these narratives were based on simple cross-section static comparisons between nominal exchange rate depreciation and any variable showing an (unsustainable) external financing need. And its subsequent dynamics was the well-known Dornbusch-Edwards spiral of macro-populism: uncontrolled depreciation passing-through actual inflation, rising expectations, growth-income reduction, further fiscal stimulus, more deficits & debt, more monetary financing, higher inflation, and so on and so for. The "proof of this pudding" mixed actual socio-political unrests in countries far apart, scheduled elections in several countries, and pre-tapering risk aversion. For most if not all EMEs it was already an inescapable conclusion: after excessive complacency and exuberance, life after "easy money" and the commodity super-cycle was going to be gloomy and dark. Good bye "decoupling" and hello "middle-income growth traps" and "mid-life crisis"!

Let's recognize upfront that fears about old or modern versions of macroeconomic populism[5] are legitimate, and that there is one question markets were quite rightly so asking: how, after the "party", local political economy conditions in EMEs would allow the necessary and timely adjustments. But after Chairman Bernanke's May 22 famous speech, shorting EMEs across any class of risk was probably a relatively straightforward strategy, there was little need to differentiate and to be analytically more perceptive. ***Things nevertheless are changing, including because of differences in fundamentals, initial conditions and policy responses by each EME: during the Spring Meetings that ended yesterday and that I just attended in Washington DC, I have heard a number of investors actually much more bullish on EMEs, very capable of differentiating within that class of risk, and putting their money where their mouth is. Brazil is a case in point, let's turn to it now.***

Brazil kept Strong Fundamentals, has been Increasing its Differentiation, and was capable of a Preemptive Policy Reaction before the "tapering". We never got over-excited about market excessive exuberance and we knew that a reversal of market sentiment would eventually come, that this movement of euphoria would at some point end. Our response has been designed and

[5] The classical illustration of Dornbusch-Edwards macro-populism pictured Latin-American regimes with high inflation resulting from monetary financing of large fiscal deficits to subsidize popular consumption and (unsustainable) social transfers under a fixed exchange rate regime with low reserves. However, the model can probably get modern interesting extensions with Asian financial repression to finance large infrastructure investments under fixed, under-valued exchange rates and even AEs' implicit or explicit public guarantees to engineer private sector unsustainable housing booms compounded by very high, loosely supervised financial leverage and opaque, unregulated investment vehicles.

conducted in a cool-headed manner. We knew that we would need to have strong fundamentals, (especially reserves as buffers) and policies ready.

So we kept strong fundamentals and prepared ourselves: we accumulated sizeable reserves in good times to be used as buffers[6] during reversals. We always had a strong Financial Sector that has proven resilience, strong capital, provisions and liquidity indicators. Our Ratios of external financing (stocks and flows) are strong and sustainable; we were always cautious and restricted any reliance on external sources of funding.

In terms of policies, we took preventive measures during the upswing (e.g., we used macro-prudential instruments (MaPs) for controlling excessive credit growth). We kept our floating exchange rate regime as a first line of defense, allowing it to appreciate during the upswing but knowing that the repricing of our assets and some depreciation in the downturn was part of the solution and is not "vulnerability". We also took early and sizeable action on Monetary Policy, complemented by Fiscal Policy. Finally, last but not the least, we also implemented a large program offering FX-Hedge to our private sector in order to contribute to reduce FX volatility, including after "perfect storm" events (e.g., the real beginning of the "tapering", the EME January sell-off and Brazil's downgrading). Our real sector private firms with liabilities in dollars and those who just wanted clearer direction on the exchange rate were able to plan accordingly. This has been working very well.

Brazil's textbook response in this transition is working well: a flexible exchange rate, aggregate demand management (using both monetary and fiscal policies, MP and FP) with a sizeable buffer of self-insurance (reserves); our MaPs worked well for financial stability and complemented monetary policy in upswing; our FX buffer is important to reduce volatility during "tapering" and help financial stability (FS). We are not behind the curve; we are not reacting to a phenomenon that we did not anticipate. We acted preventively.

But of course Brazil's challenges remain: a high and persistent inflation, with sticky expectations, a current supply shock food prices, a conundrum about growth-investment and confidence.

Inflation headline was hit by a temporary supply shock early this year; naturally, headline inflation impacts expectations, the issue of persistence is well-known and documented. Inflation has been high and resistant; reflecting services inflation inertia and the realignment of administered prices. The BCB has acted to secure the convergence of inflation to the target starting very early at the beginning of 2013. In that respect, we must remember that monetary policy effects on inflation are cumulative and take place with lags. There should be no doubt that the policy is effective. In this sense, a significant part of prices response to the tightening cycle has yet to materialize. At this moment, there are renewed external and domestic food price pressures, but they are operating in a much tighter monetary conditions environment.

Brazil's growth will remain moderate. Part of the explanation is that the Brazilian economy faces a transition period pursuing new engines of growth: productivity gains and investment expansion and less reliance on household consumption. In 2014, economic activity should be somewhat lower than in 2013. In Industry – there is recovery, but not very strong signs of support. In Services – we will see

[6] An alternative strategy is to accumulate less reserves and have more faith and reliance on multilateral IMF-FCL lines of support

lower growth rates than previous years. And in Agribusiness – we'll have another record harvest year after year, despite bad weather in 2014.

We know that a better growth performance requires improvement in confidence and the pursuit of the present supply policies. Precisely, Brazil is implementing a set of textbook supply-side structural reforms. They will boost our (total factor) productivity (TFP). They go in three broad directions: (1) infrastructure, a key to Asian success, a must for us to reduce cost and create positive externalities; the ample concessions program, includes the transfer of airports, roads, railroads and port management to private sector. (2) human capital, a key to absorb/create technological change and broaden/increase our competitiveness beyond commodities; and (3) reduction of production factor costs through inter alia improvements in the business climate.

Brazil is not falling into a "middle-income growth trap". This is an old and interesting story but it doesn't fit our current story. For three reasons:

(1) our built-in existing productivity is well-established and growing in commodities and the pre-salt oil;

(2) our productivity potential is also growing not decreasing; our demographic bonus plus the on-going supply-side reforms on infrastructure, education and factor cost reduction will generate significant networking positive externalities; **there is a lot of "low hanging fruits" and growth potential; t**here are a number of low cost-high return infrastructure projects that are already identified; investment started to grow again in 2013 (~6% more than the ~2% for private consumption) – strengthening this trend will depend on confidence and tends to gain traction led by infrastructure projects and oil fields exploration;

(3) our institutional framework and our fundamentals are strong and tested; checks and balances everywhere, low debt, high reserves, entrenched stabilization culture, resilient federative government structure with clear rules, social and political stability, crisis-weathered financial sector, etc. you name it.

Brazil has indeed many challenges. We are continuing to ensure macro-financial stability; we will weather well through the normalization of policies in the US and AEs; we are beginning to feel the differentiation by markets, based on our fundamentals, our resilience and our policy readiness; we are now beginning to see a shift in many financial variables (e.g., exchange rate, risk premium, capital flows, etc.). Therefore, in a context where our macro-financial environment provides us with a better horizon, we will continue implementing our reform agenda toward a more efficient allocation of production factors for our economy and for future productivity gains. We know what our weaknesses are, but also what our potential is. We do react on time, and we know where we are going. There is no complacency and there is no denial about the challenges we need to address– just a period of transition. The current moment for the global economy, as I said at the beginning is still complex and that why in Brazil we are awake, on alert, 25 hours a day, eight days a week. No one is sleeping at the wheel. There's no rest since we want to provide sustainable growth, social inclusion and the best investment opportunities to our society and partners.