

**BANCO CENTRAL DO BRASIL**

**Brazil:  
Recent Macroeconomic and Market  
Developments**

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May 2006

# Recent Macroeconomic Developments

## Contents:

- 1. Monetary Policy and Inflation**
- 2. Fiscal Policy**
- 3. External Sector**
- 4. Economic Activity**

# Recent Macroeconomic Developments

## 1. Monetary Policy and Inflation

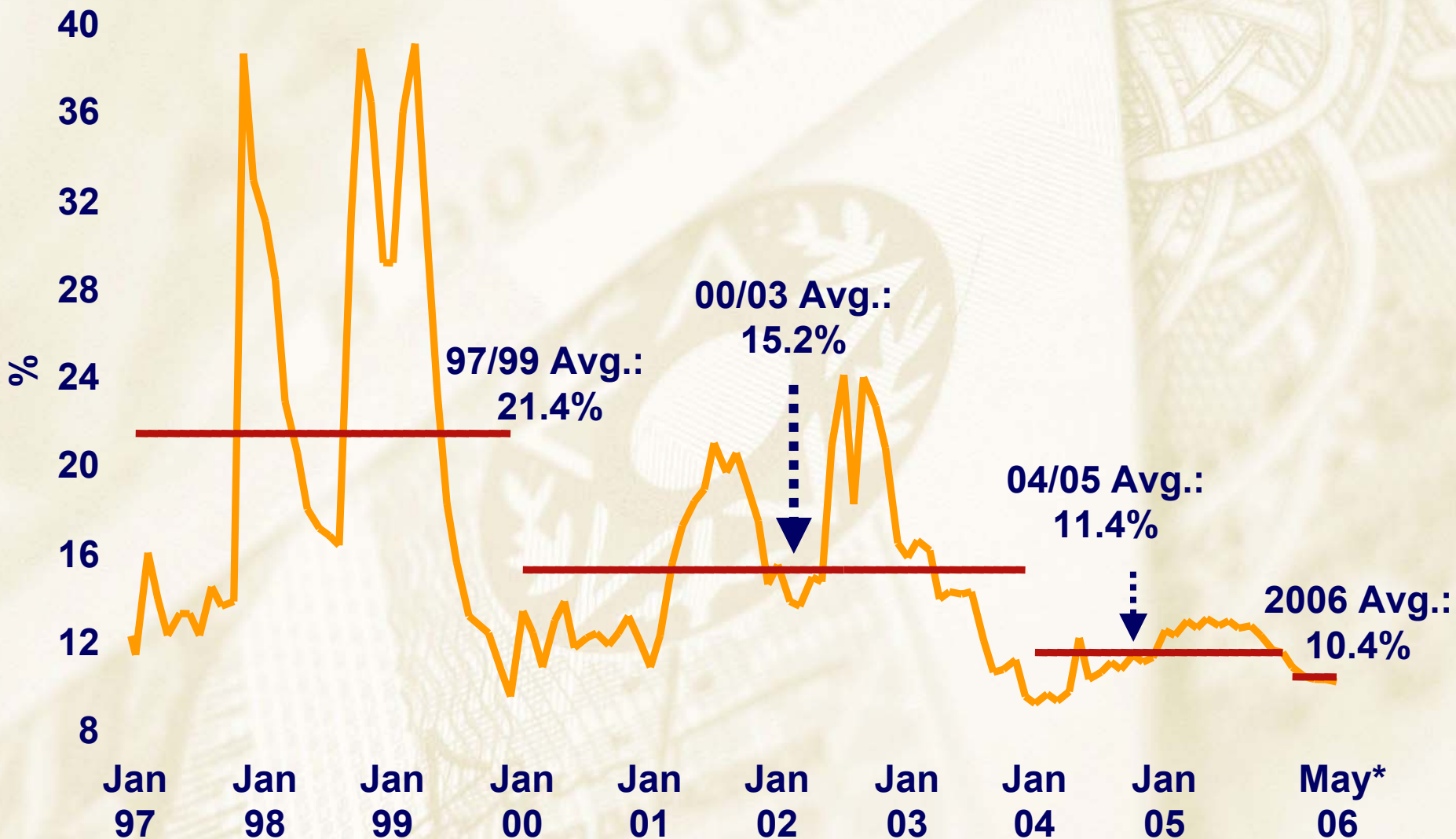
# Monetary Policy and Inflation

- **Consistent reduction of current and expected inflation.**
- **Monetary policy has both contained short-term inflationary pressures and consolidated a more favorable long-term macroeconomic environment.**
- **Scope for a reduction in real interest rates in the future will naturally follow.**

# Selic Interest Rate



# Real Interest Rate (360-day Swap)



# Real Interest Rate: *Ex-ante* vs. *ex-post*

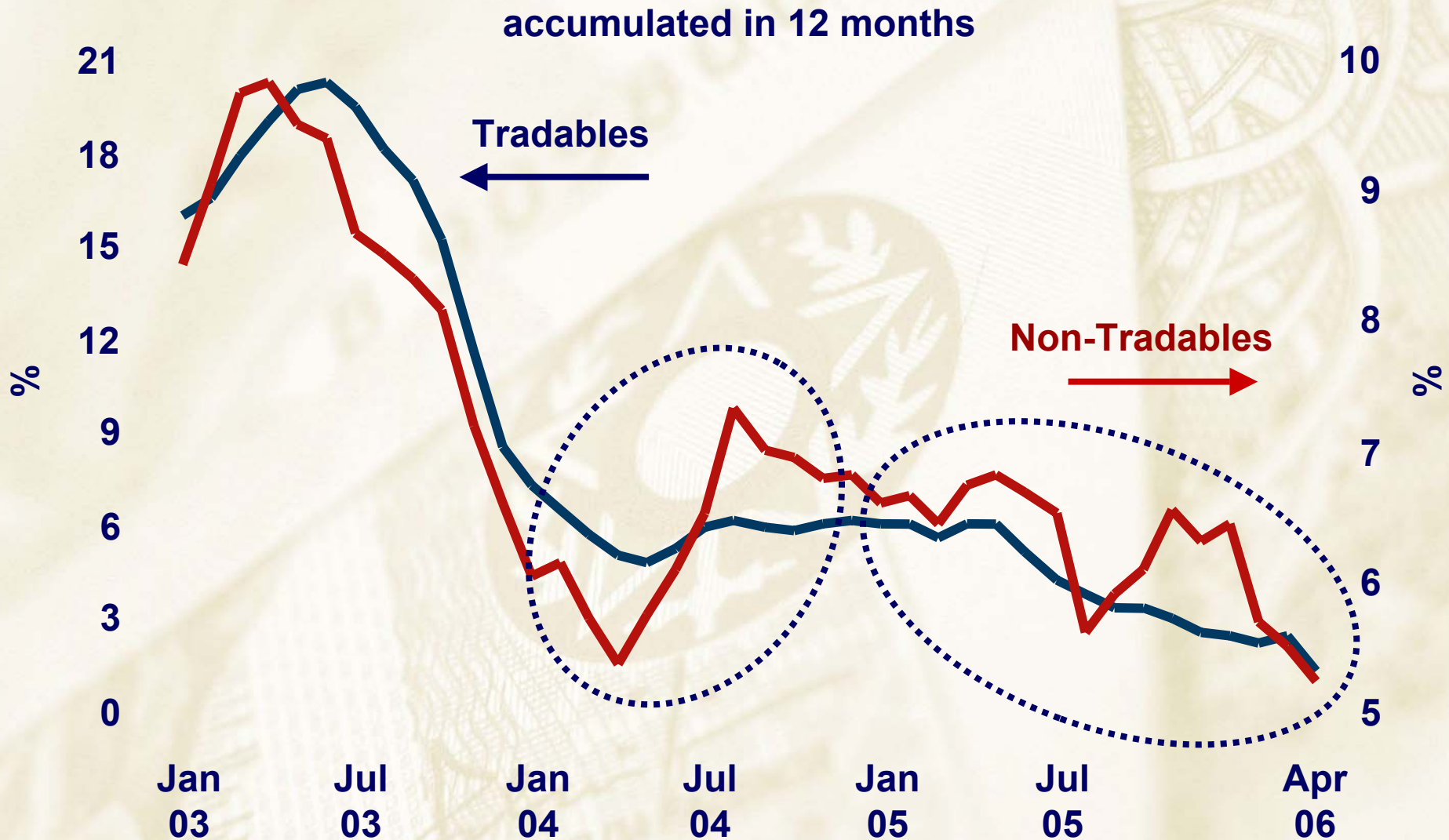


# IPCA Inflation

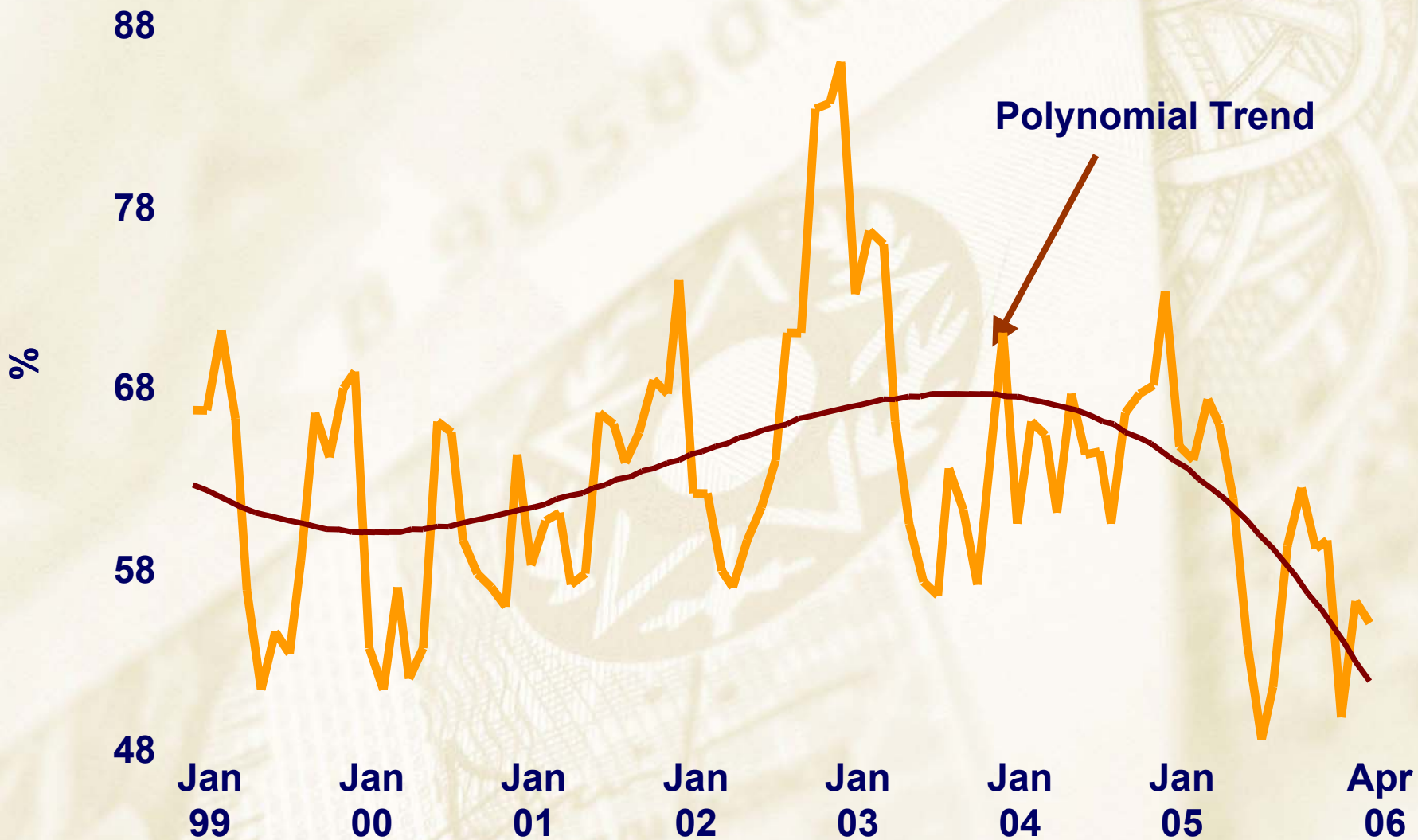




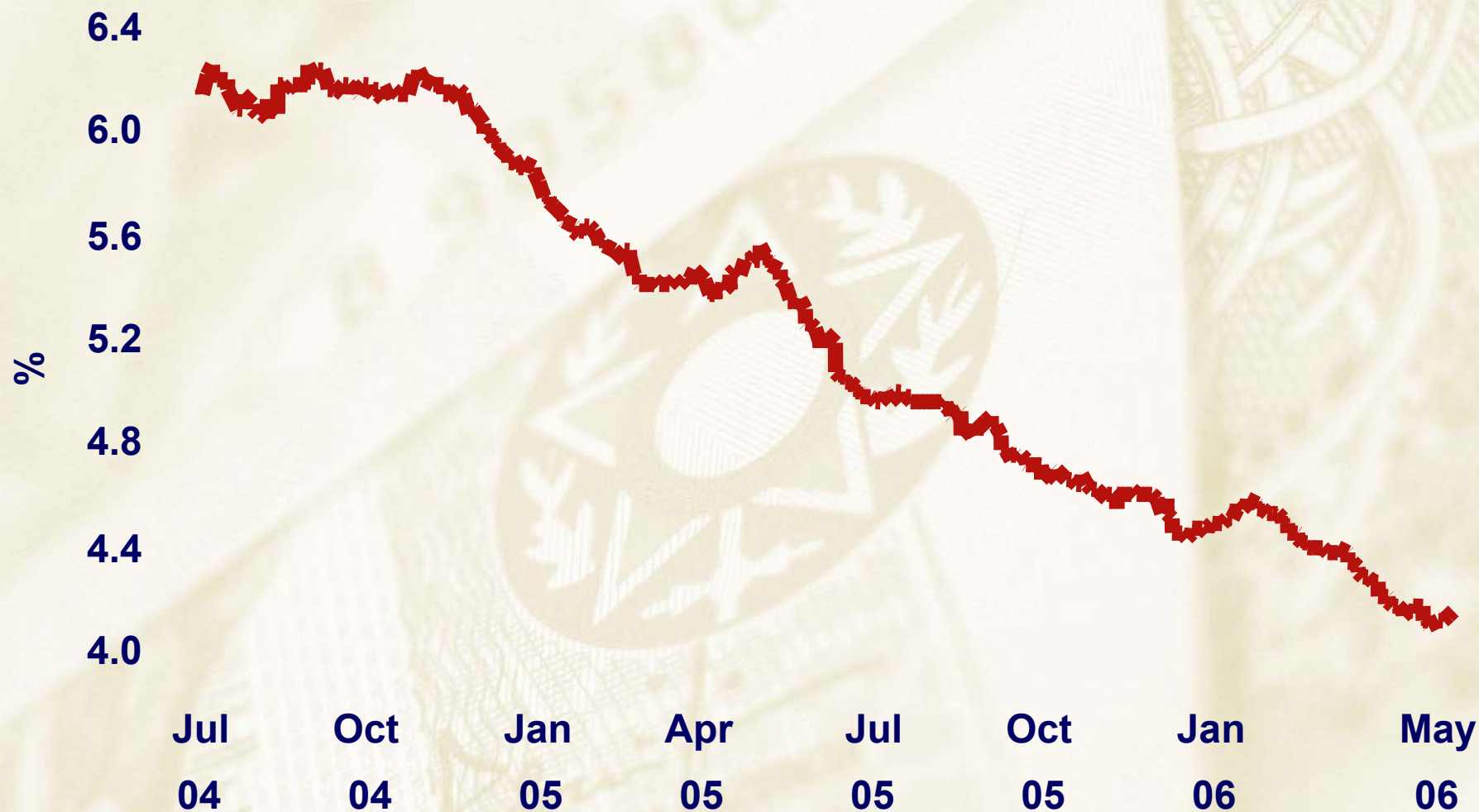
# Tradables x Non-tradables Inflation



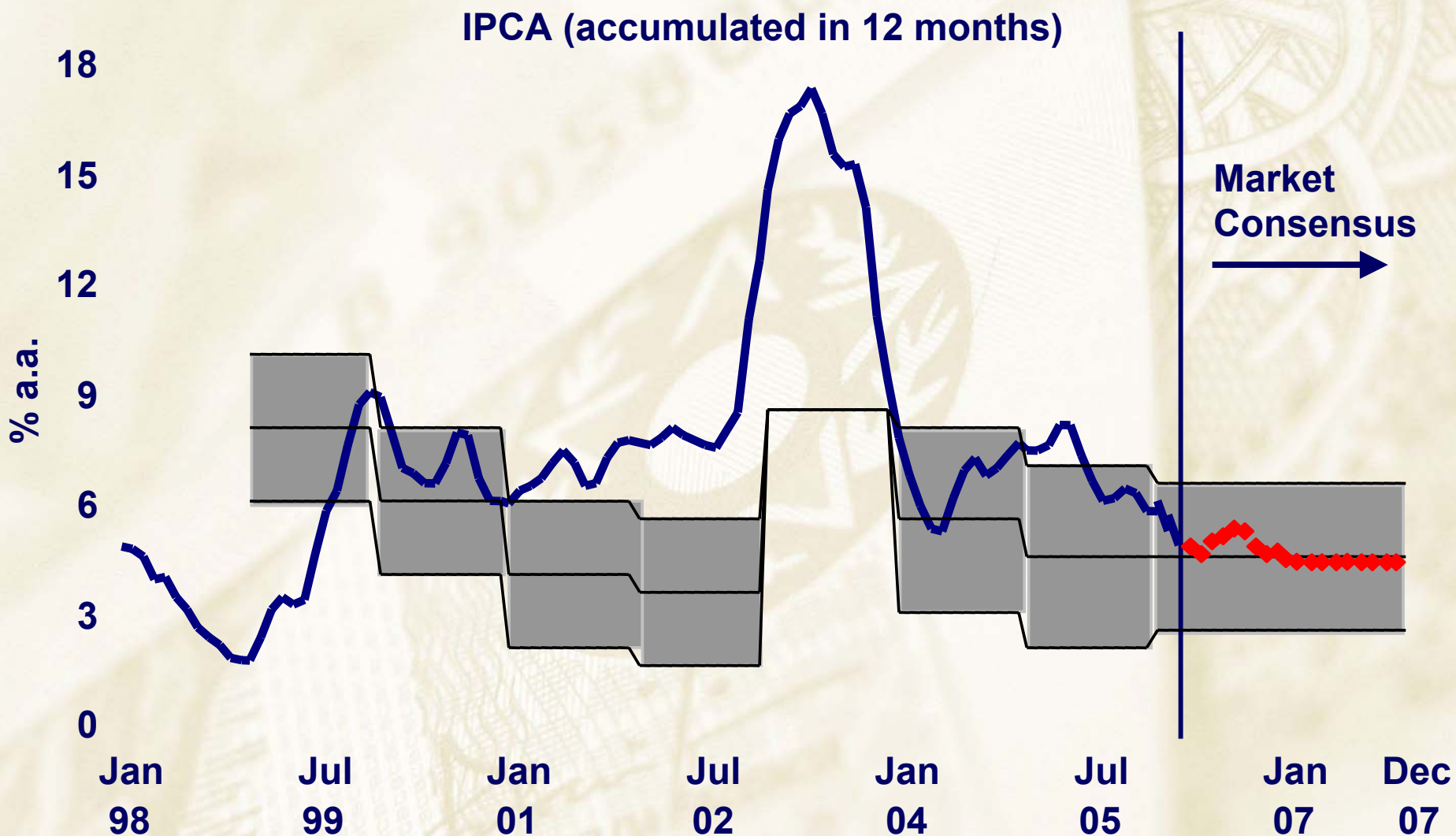
# IPCA: % of Items with Price Increases



# Market Expectations for the IPCA in 12 Months



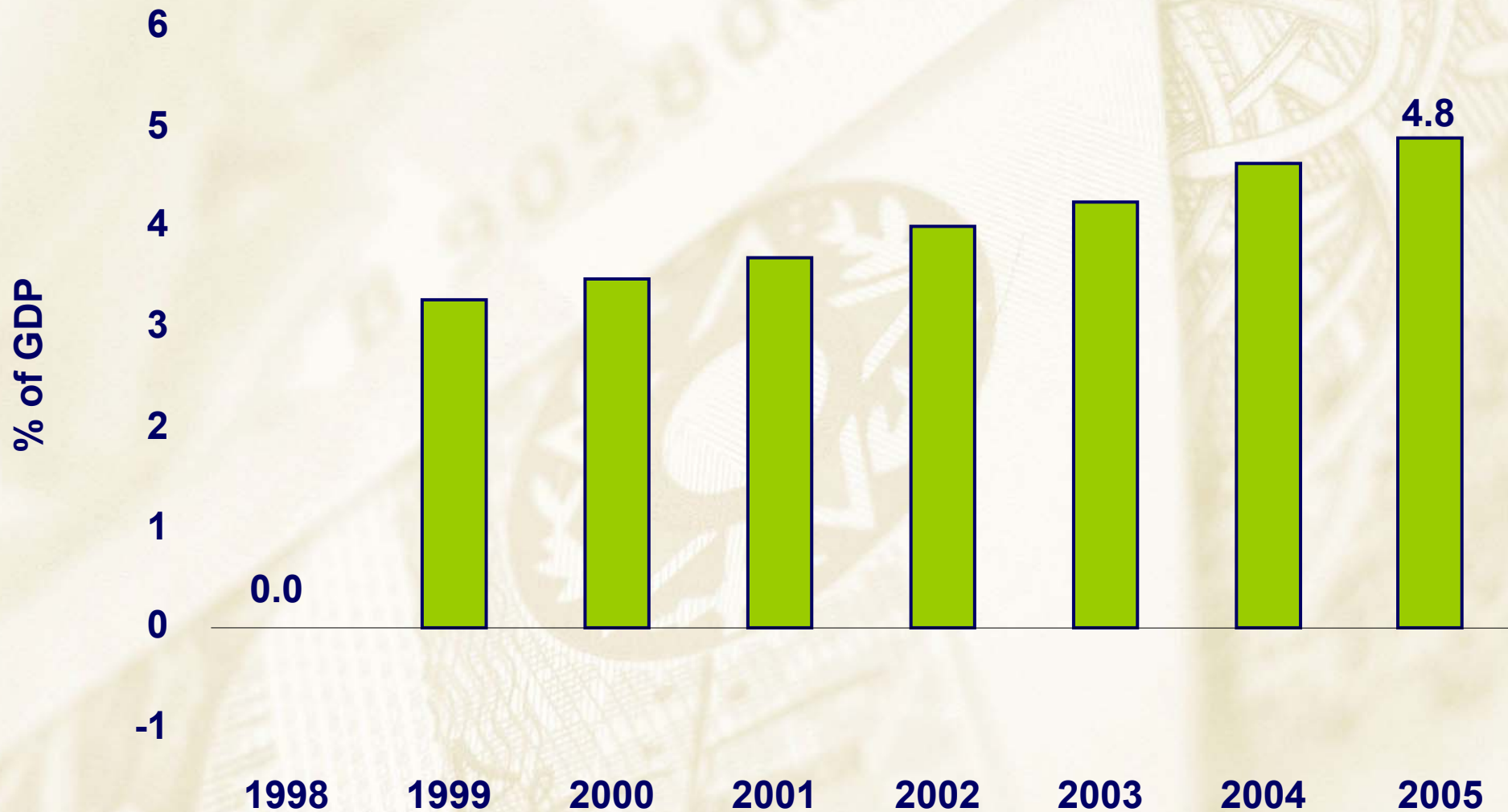
# IPCA Inflation vs. Targets



## 2. Fiscal Policy

- **Fiscal policy aimed at generating adequate consolidated public sector's primary surpluses, that ultimately ensures a gradual reduction in debt-to-GDP ratio;**

# Consolidated Public Sector Primary Surplus



# Debt-to-GDP Ratio





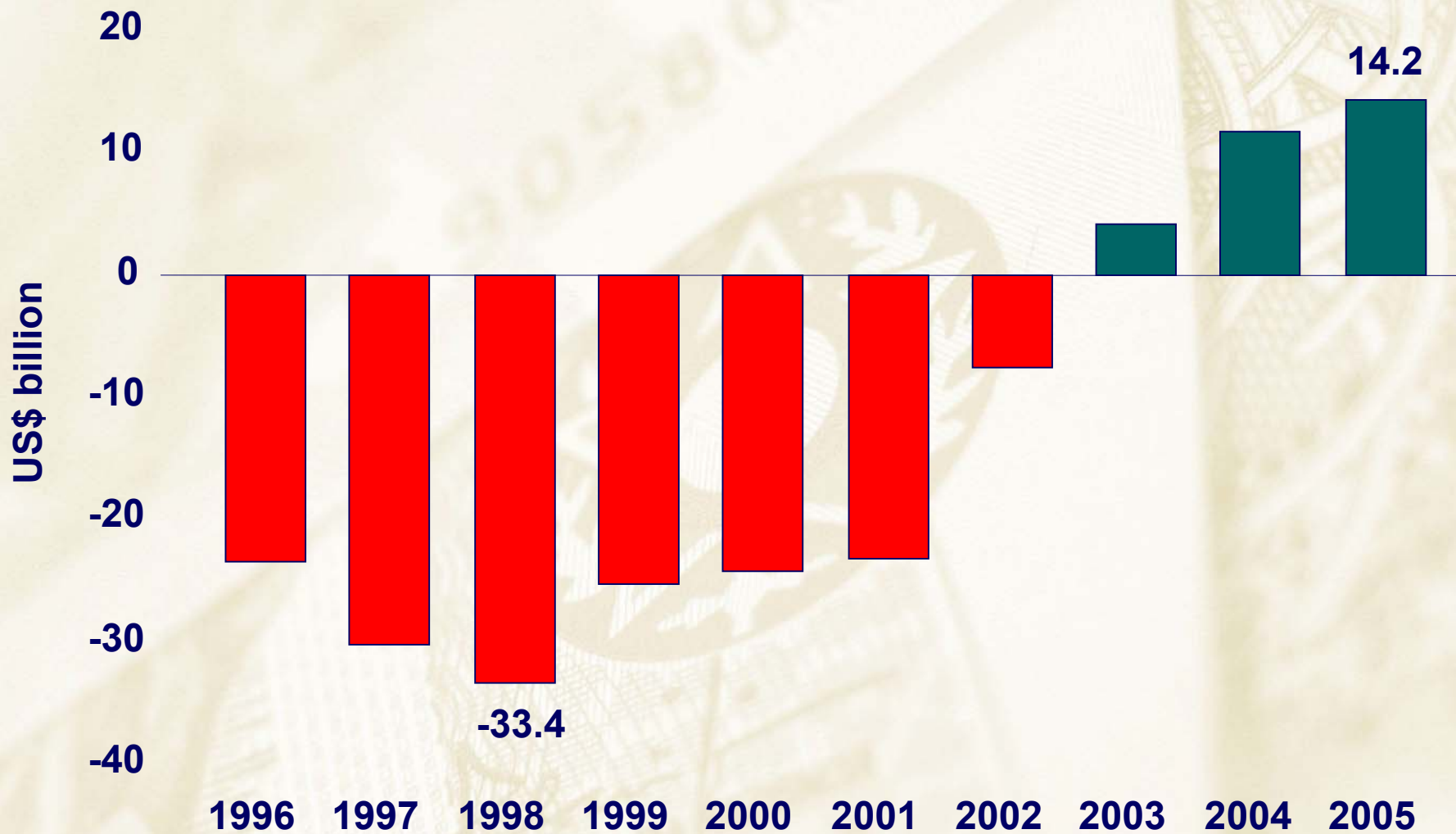
# Debt-to-GDP Ratio Trend



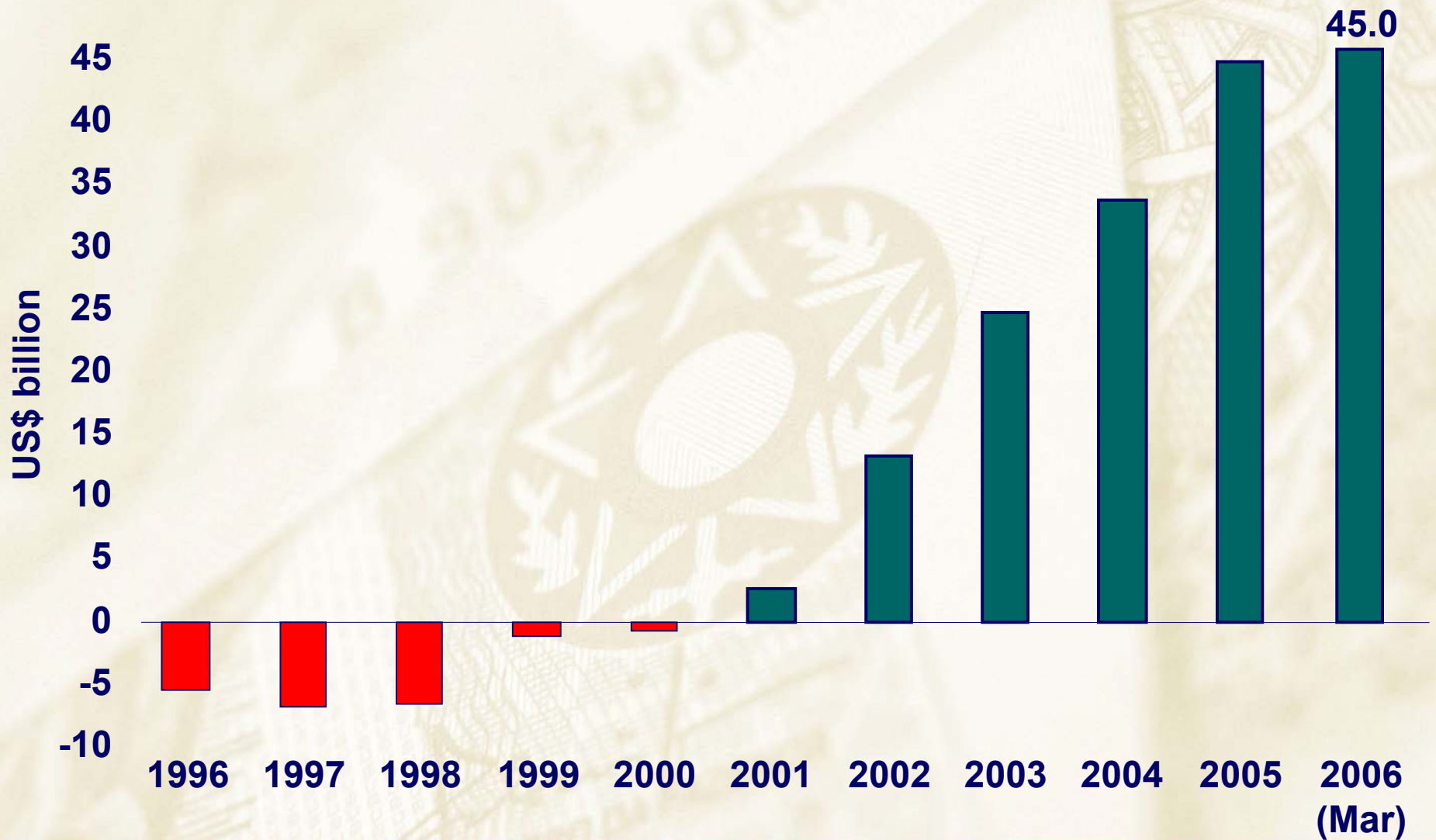
## 3. External Sector

- **Since 1998, the Brazilian current account surplus increased by more than 6% of GDP, driven by a dramatic improvement in the trade balance.**

# Current Account

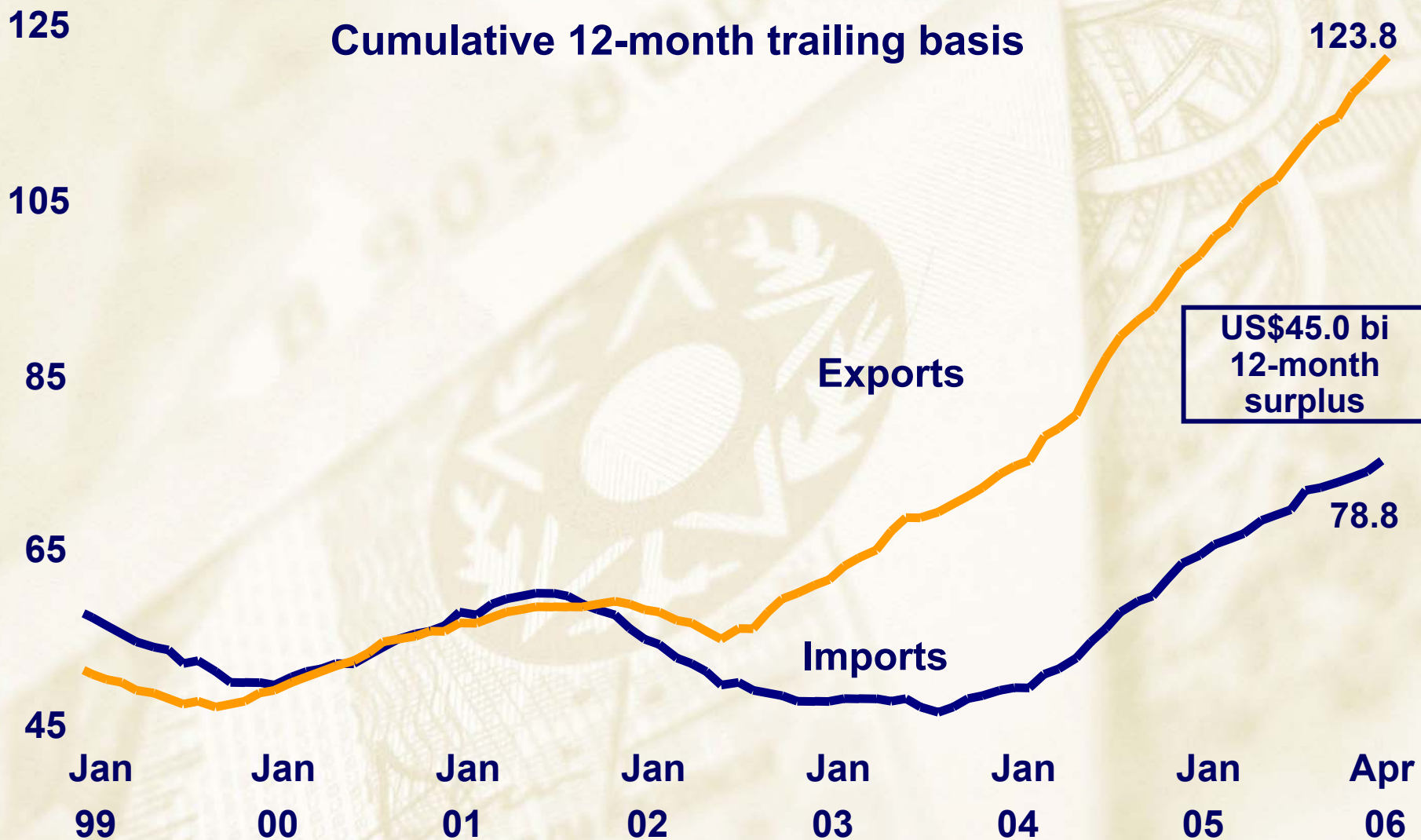


# Trade Balance

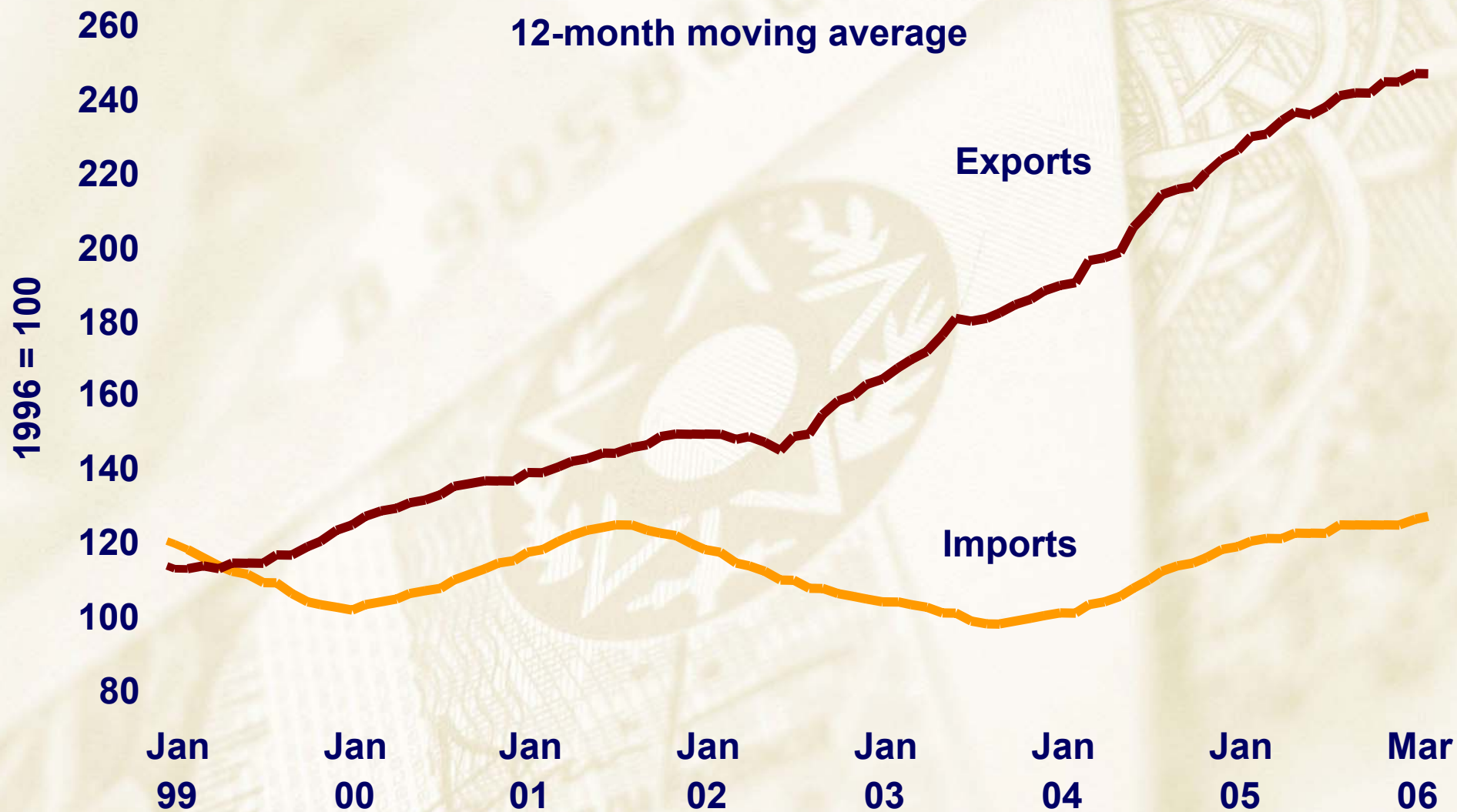


- **Brazilian exports grew an average 25.1% p.a. in the last three years.**
- **Exports through April (12-month cumulative) above US\$ 120 billion, and still rising, despite currency appreciation.**
- **Market share of Brazilian exports has increased significantly since 2002.**

# Trade Balance



# Exports and Imports Volume





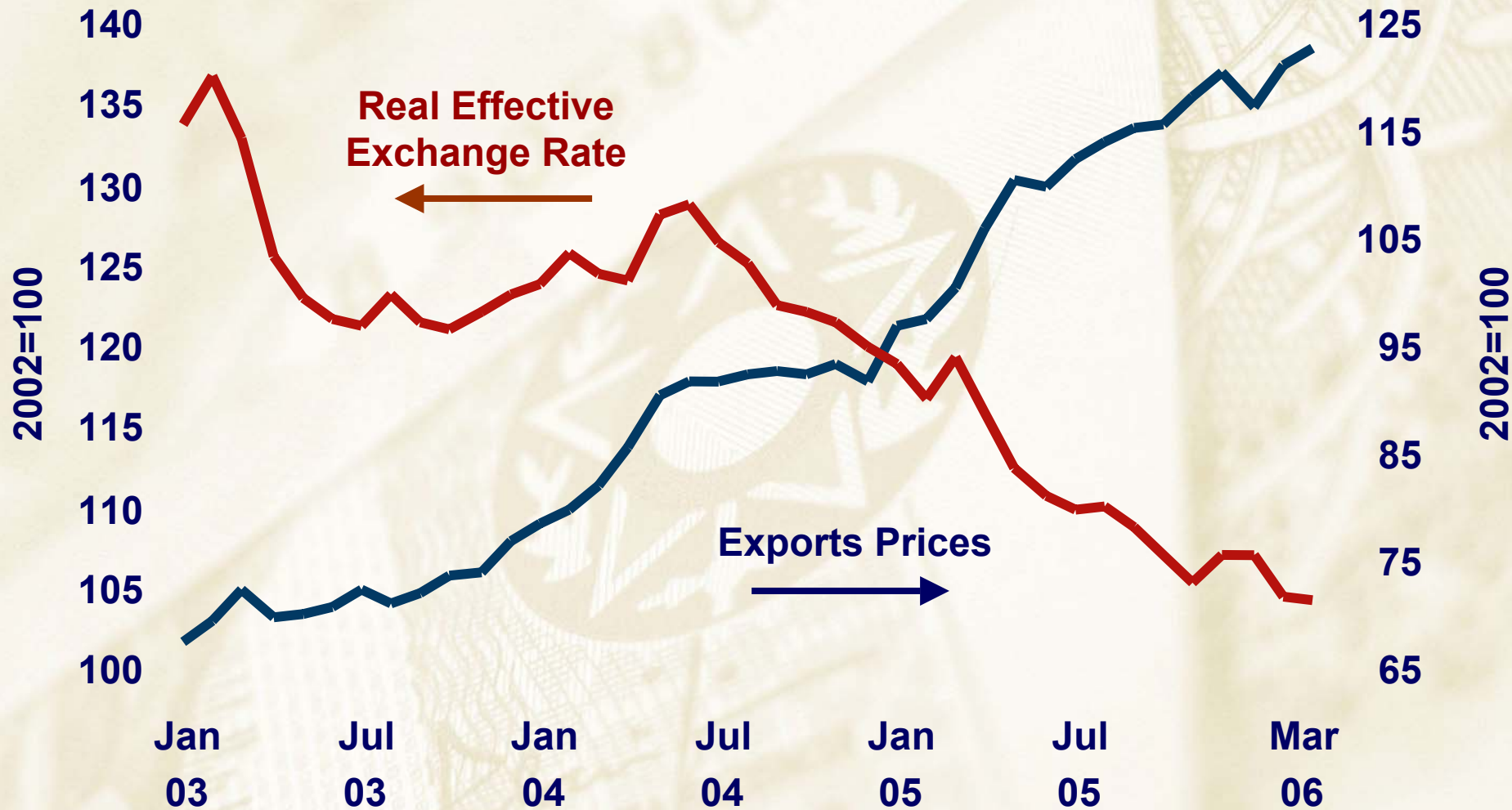
# Market Share of Brazil in World Exports



# Nominal Exchange Rate

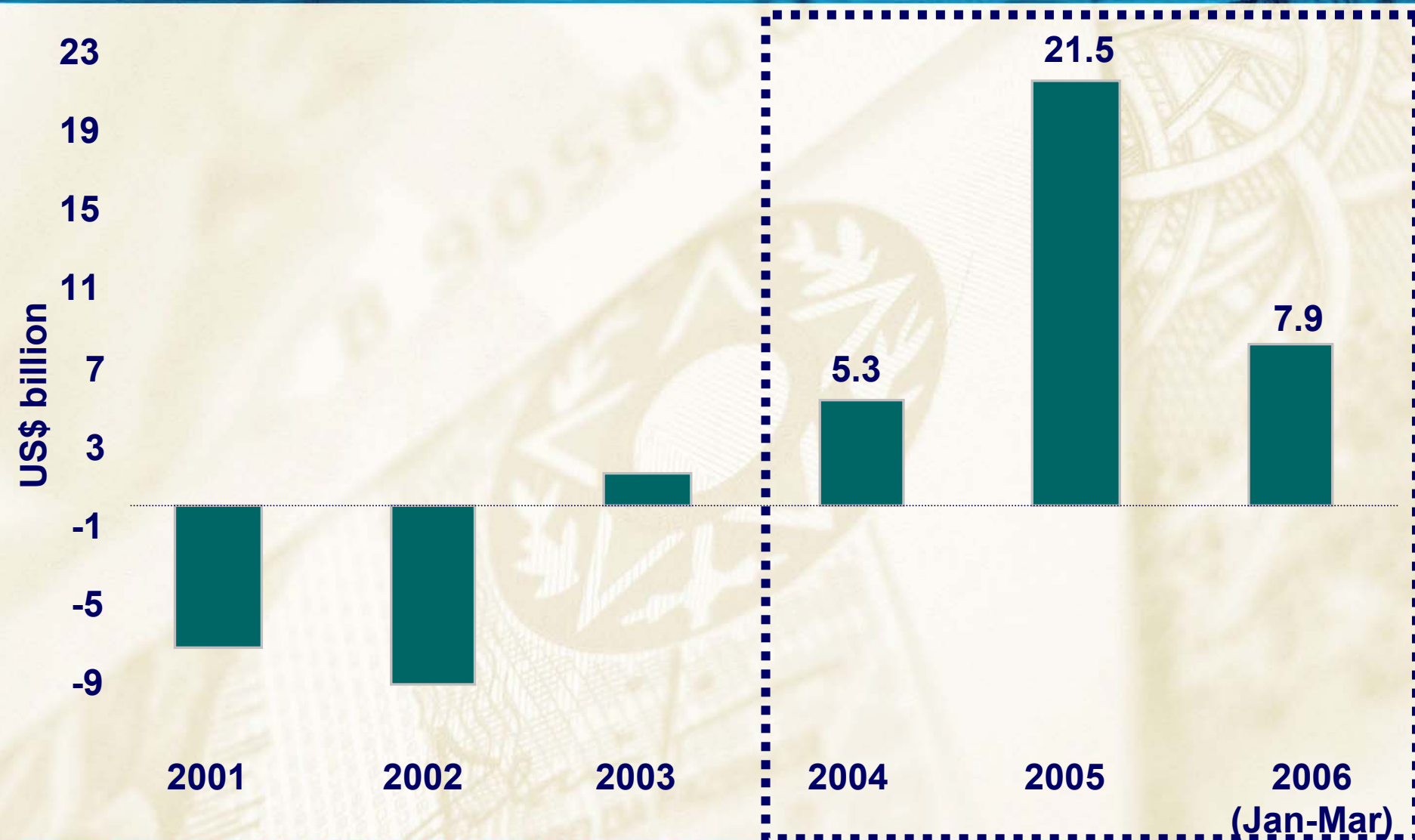


# Real Exchange Rate vs. Commodities Prices

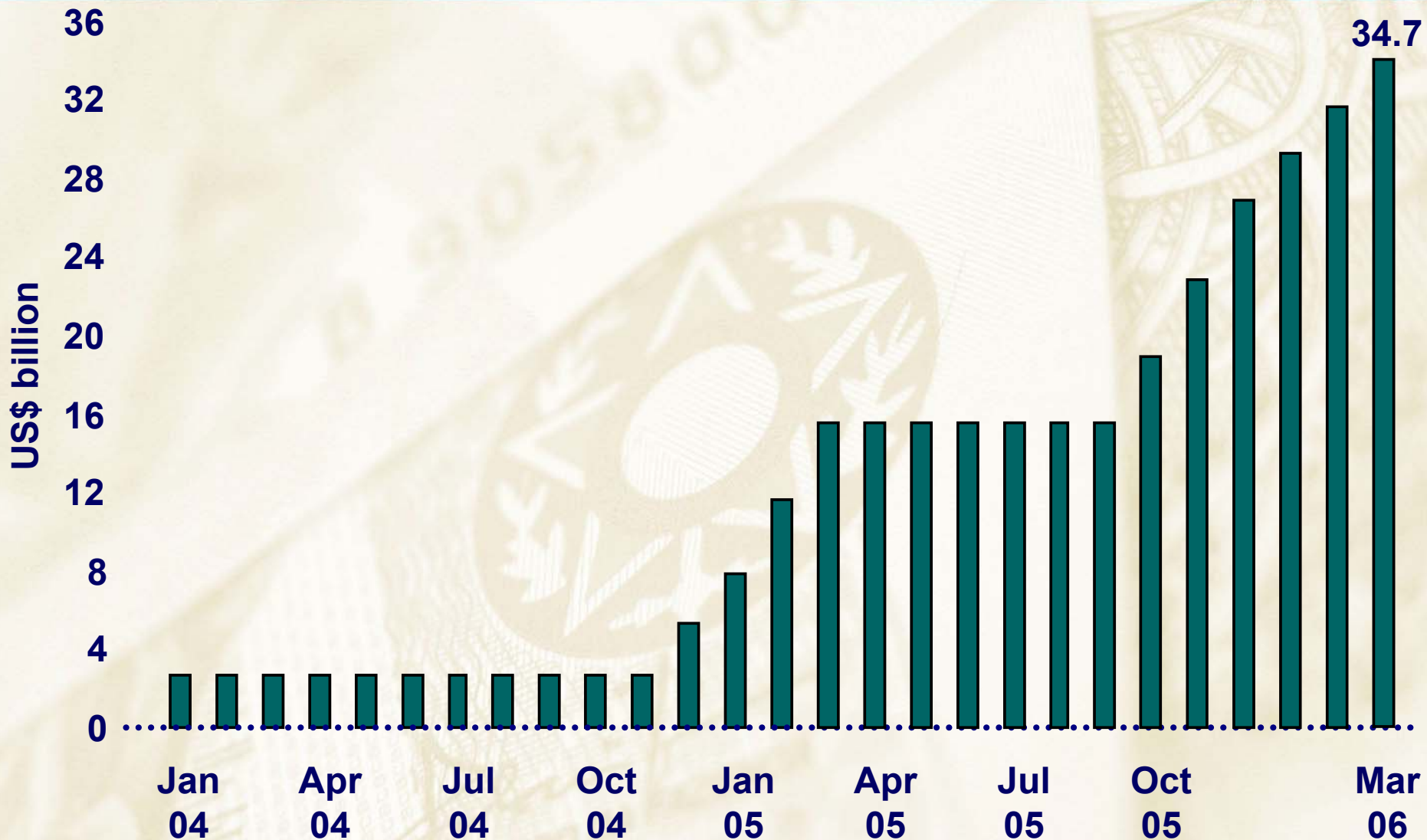


- **Favorable Balance of Payments conditions enabled the Central Bank to accumulate international reserves.**

# BCB Acquisitions in the FX Market

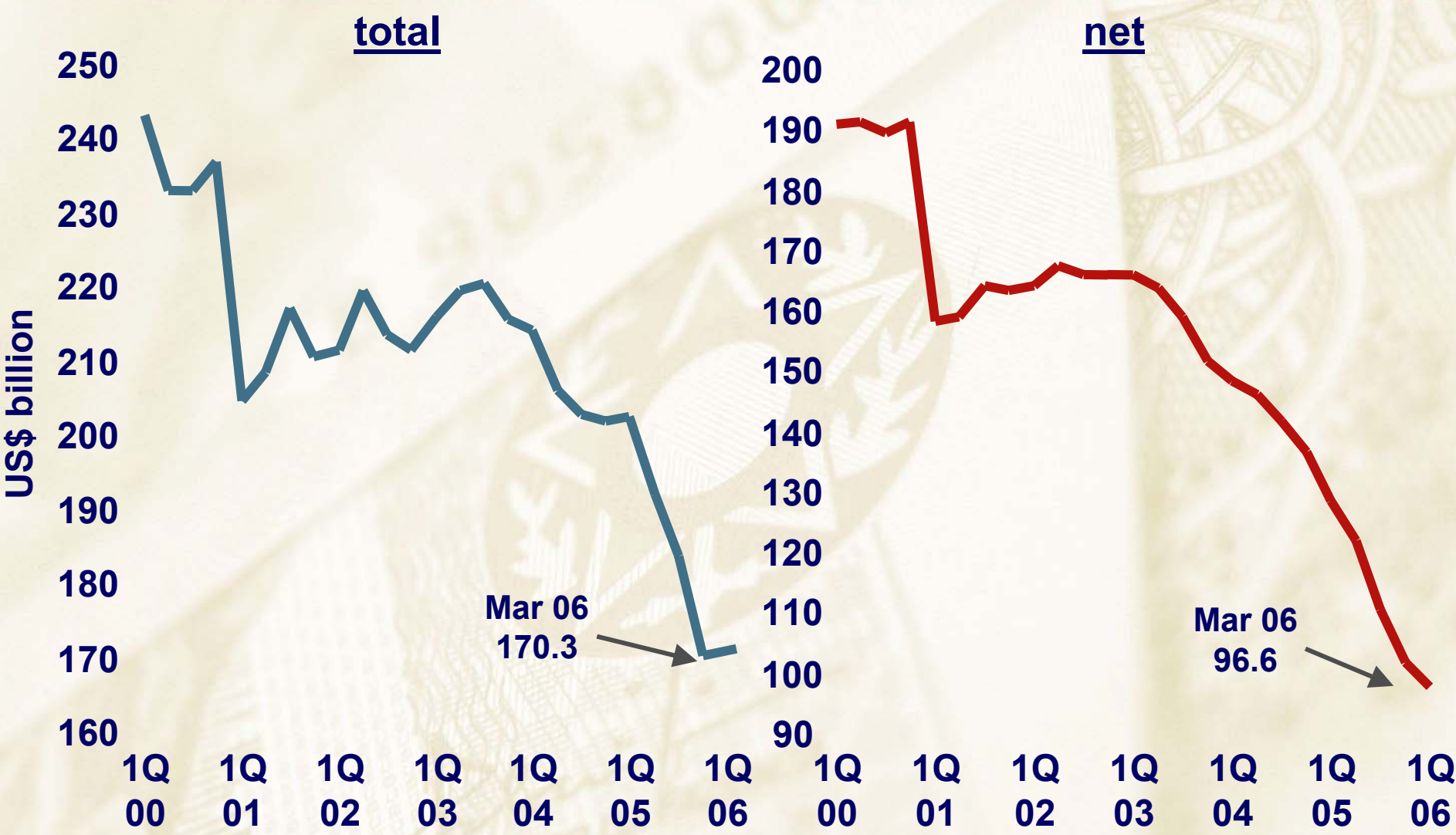


# BCB Acquisitions in the FX Market (Cumulative Since Jan/2004)



- **External debt (total and net) presented sharp declines in last three years.**

# External Debt

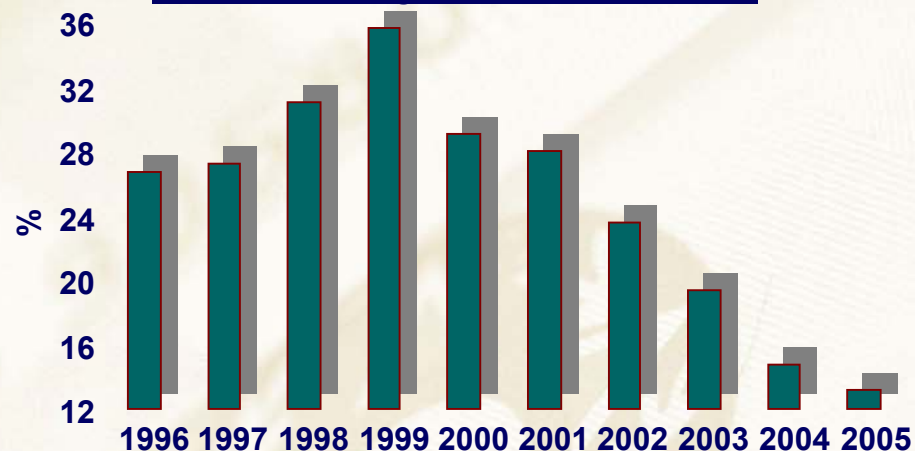




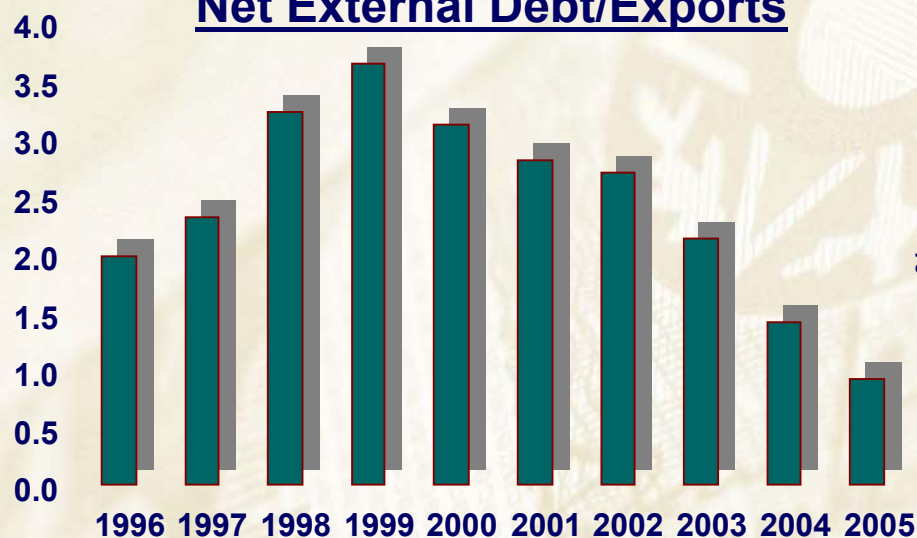
- **In consequence, solvency ratios at historical lows, and still improving....**

# Solvency Ratios

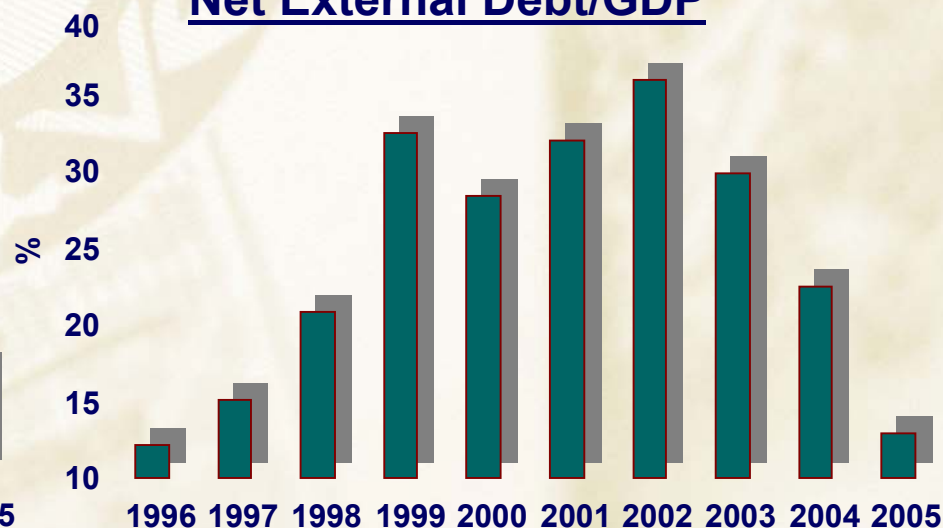
## Interest Payments/Exports



## Net External Debt/Exports



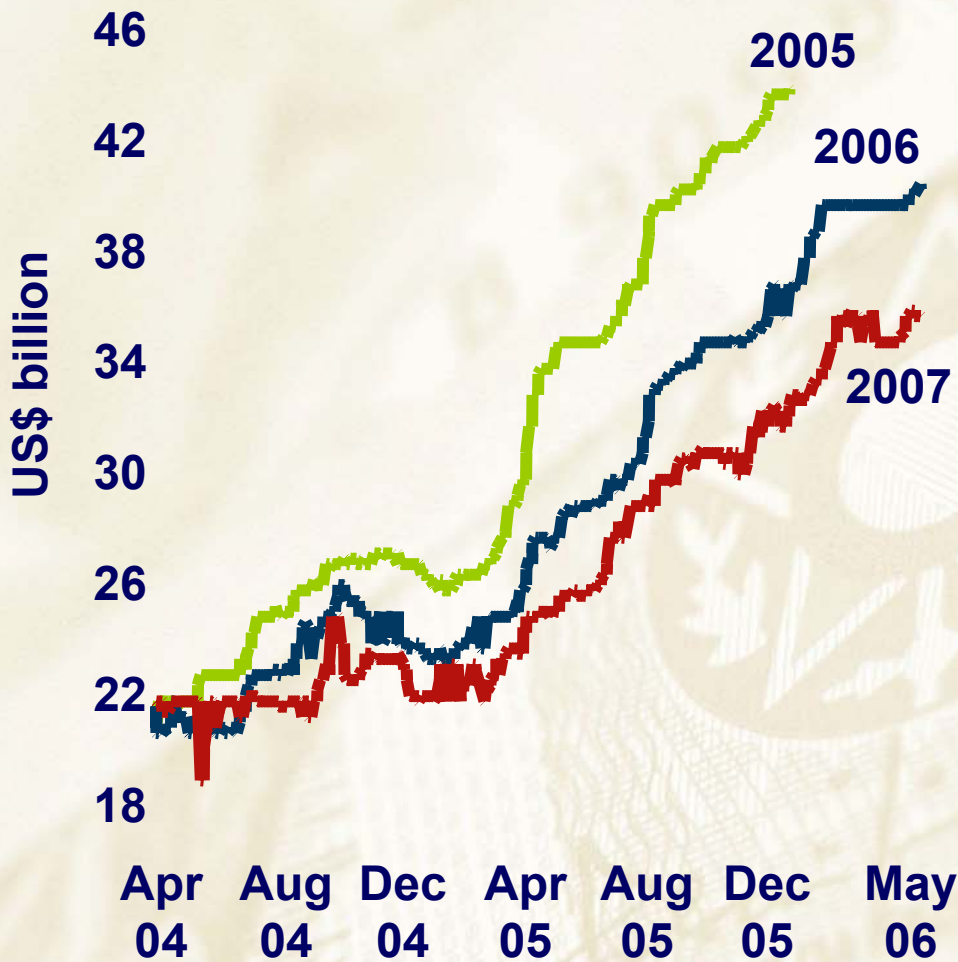
## Net External Debt/GDP



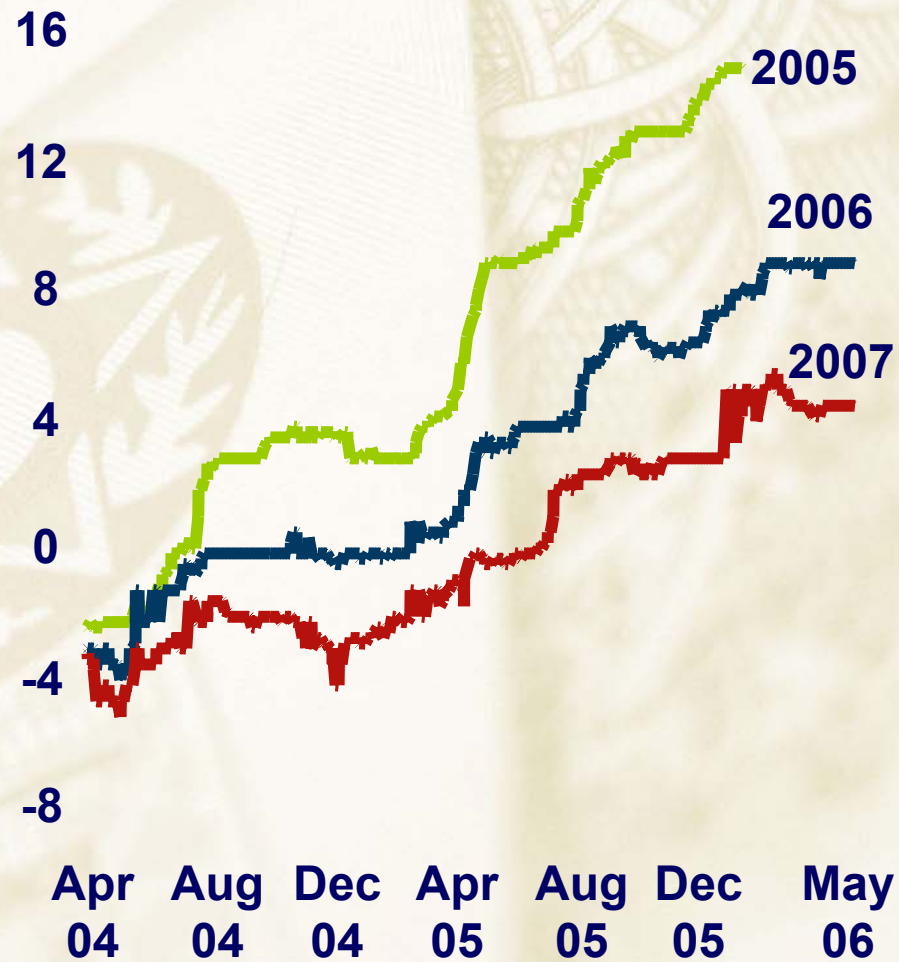
- **Market participants remain bullish about 2006-2007 Balance of Payments perspectives.**

# Market Expectations for the Trade Balance and Current Account 2006-2007

Trade Balance



Current Account



## 4. Economic Activity

# Some Factors Behind Recent Economic Growth

- **Increase in employment;**
- **Real wage gains (partly attributable to disinflation);**
- **Monetary stimulus: interest rate reduction and credit growth;**
- **Recovery in consumer confidence;**
- **Rebound in business sentiment and investment;**
- **Growth of agriculture output and oil production;**
- **Strong external demand;**
- **Reduction in sovereign spread.**

# Formal Job Creation

accumulated in 12 months



# Real Earnings

at Mar 2006 prices, deflated by INPC  
(3-month moving average)

1005

980

955

930

Jul  
03

Jan  
04

Jul  
04

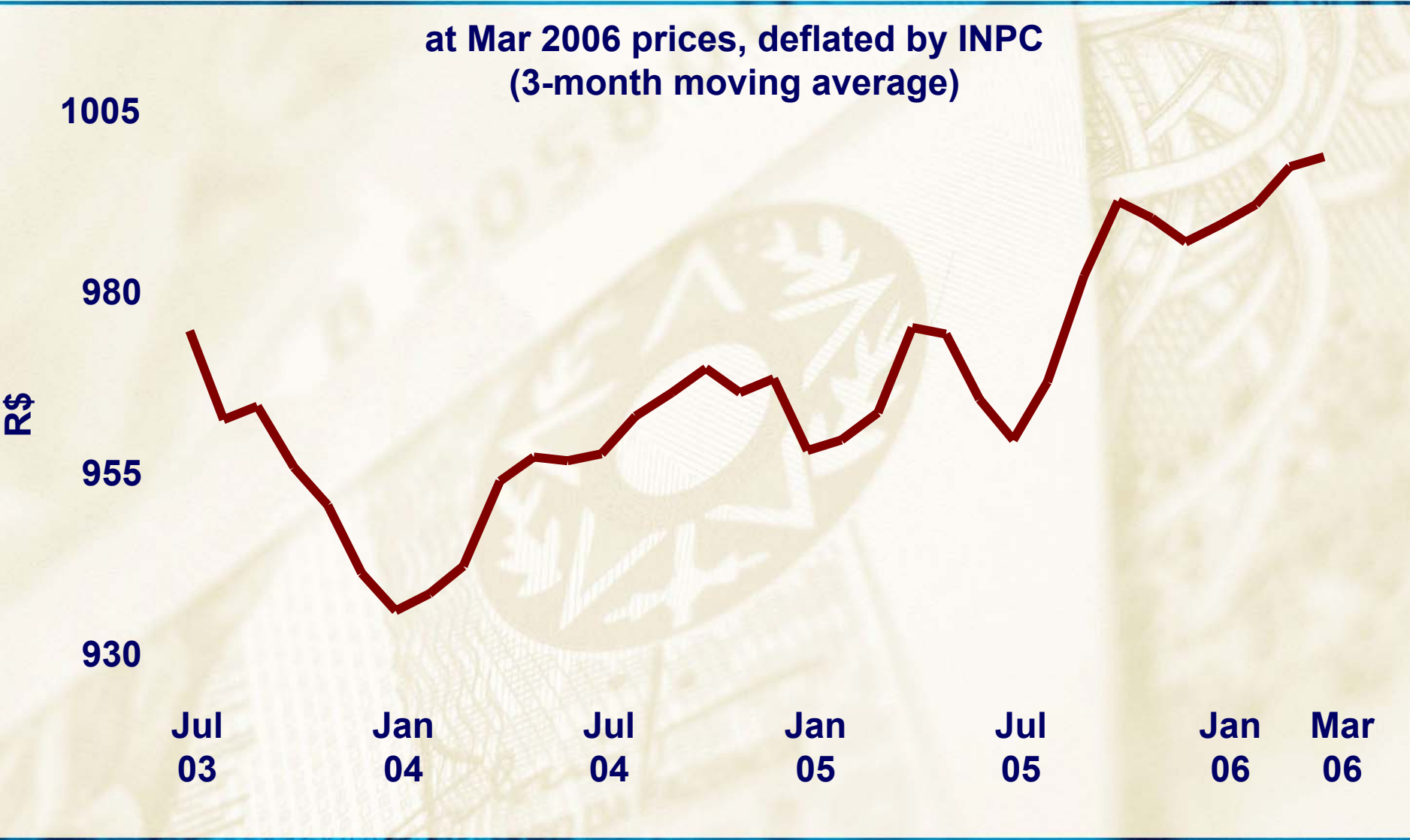
Jan  
05

Jul  
05

Jan  
06

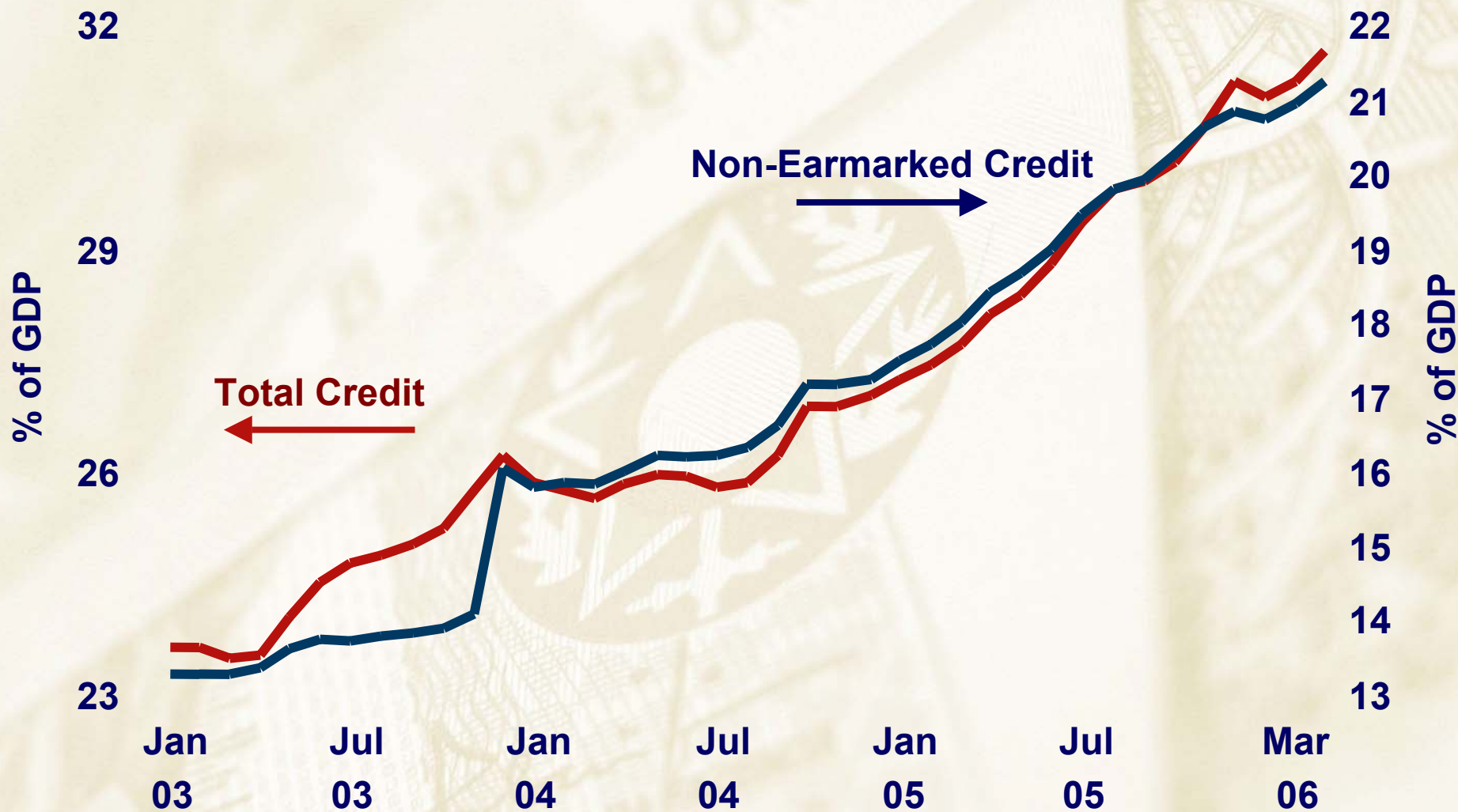
Mar  
06

R\$

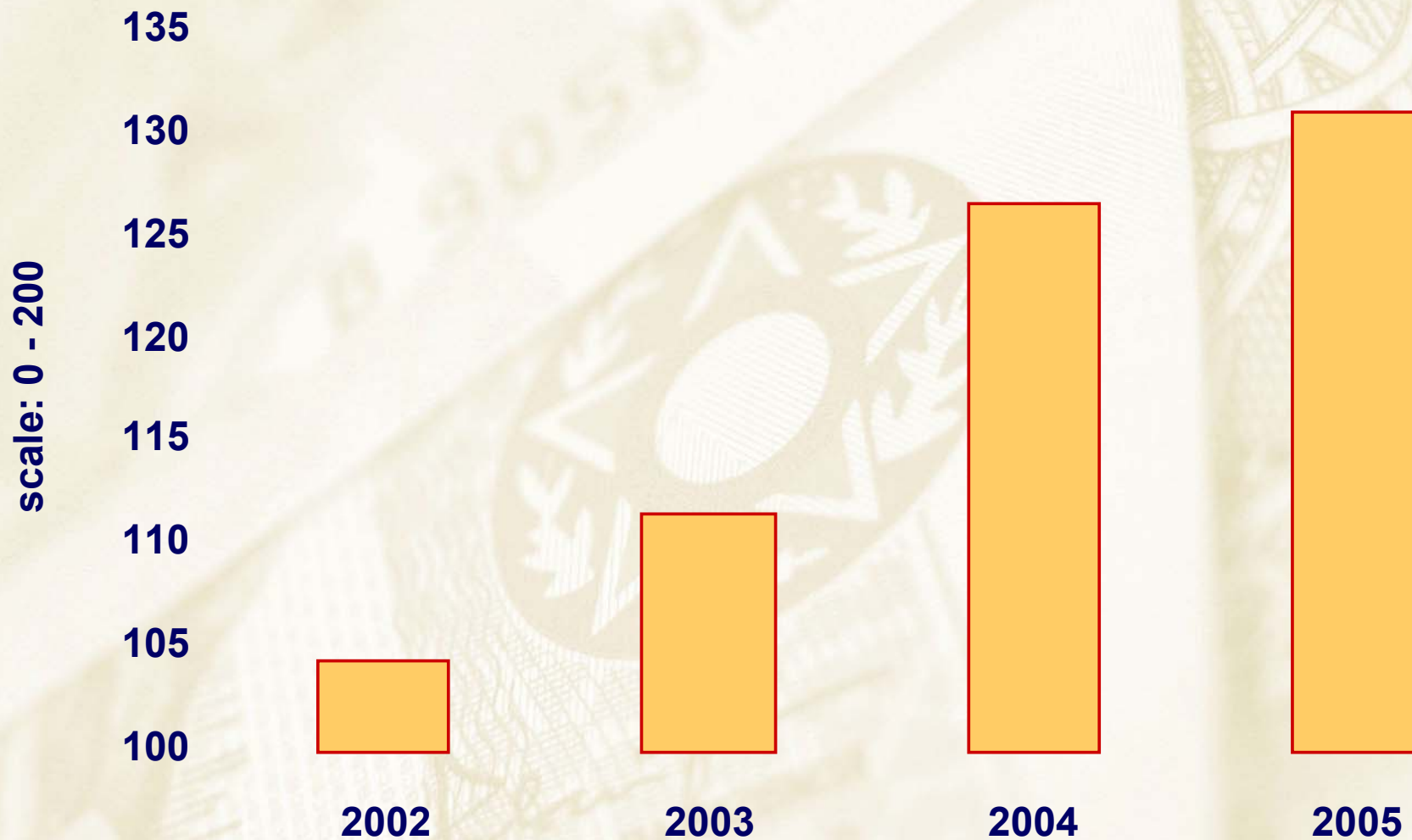




# Credit-to-GDP Ratio



# Consumer Confidence

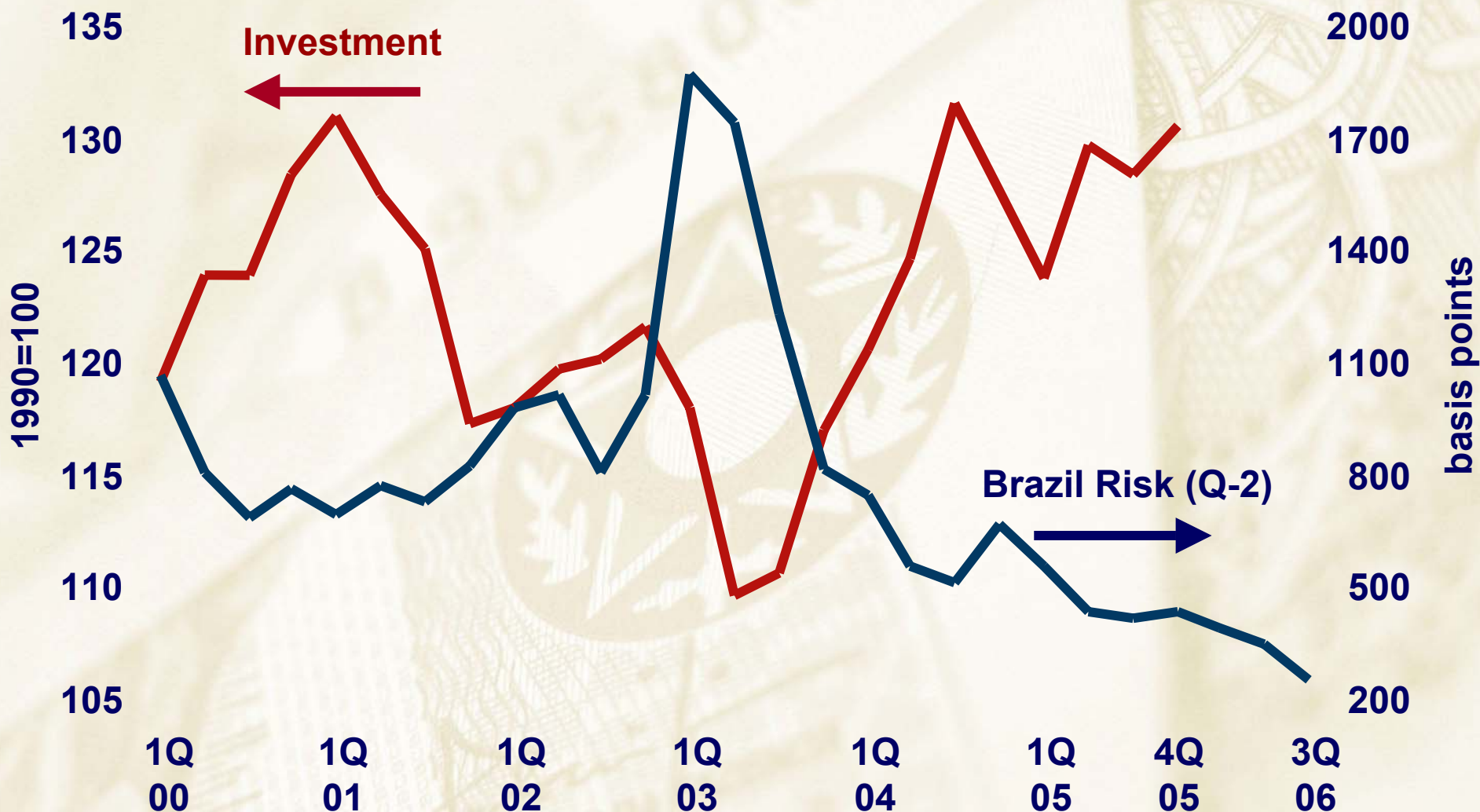


# Retail Sales

3-month moving average

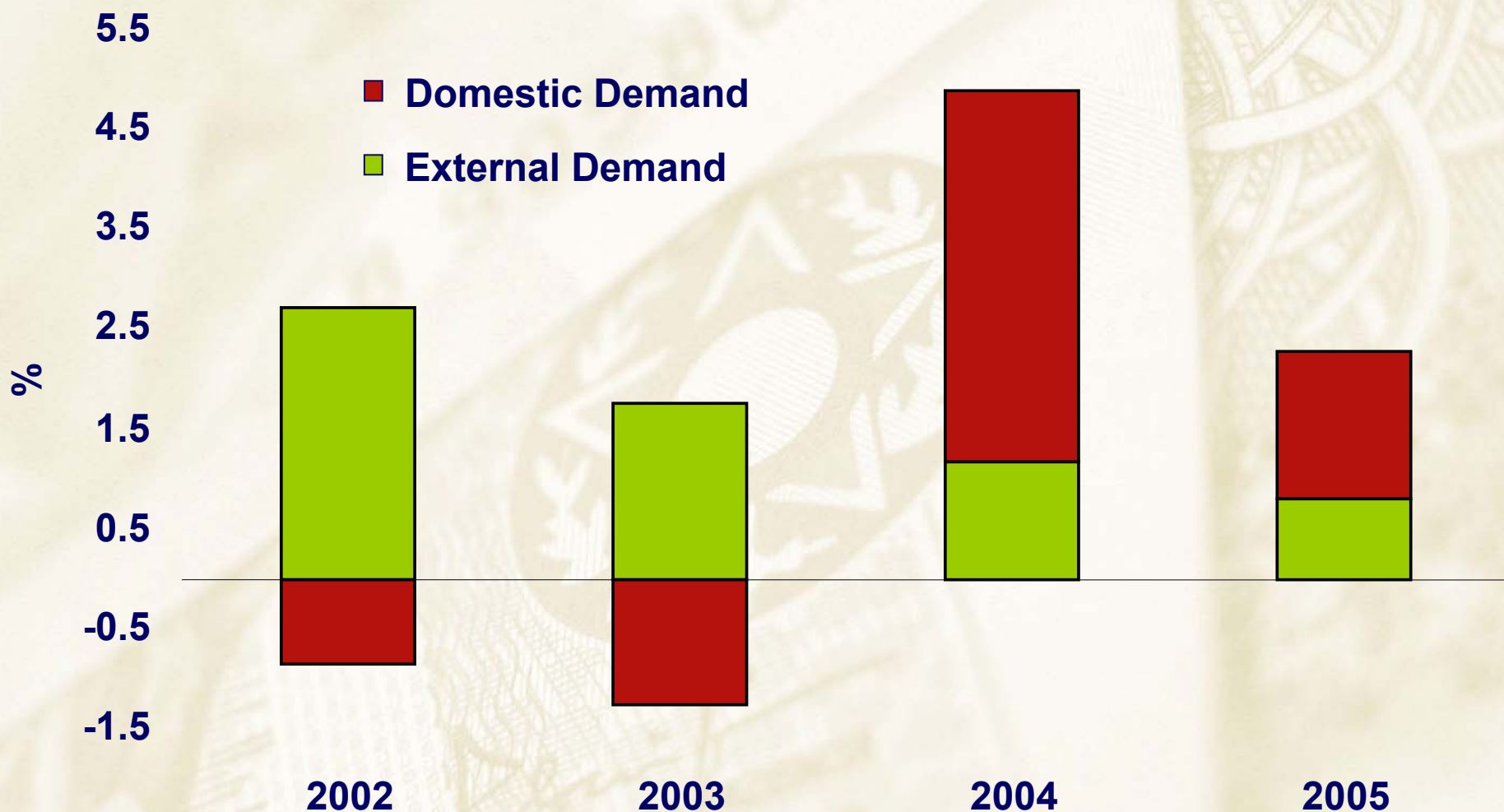


# Investment vs. Sovereign Risk

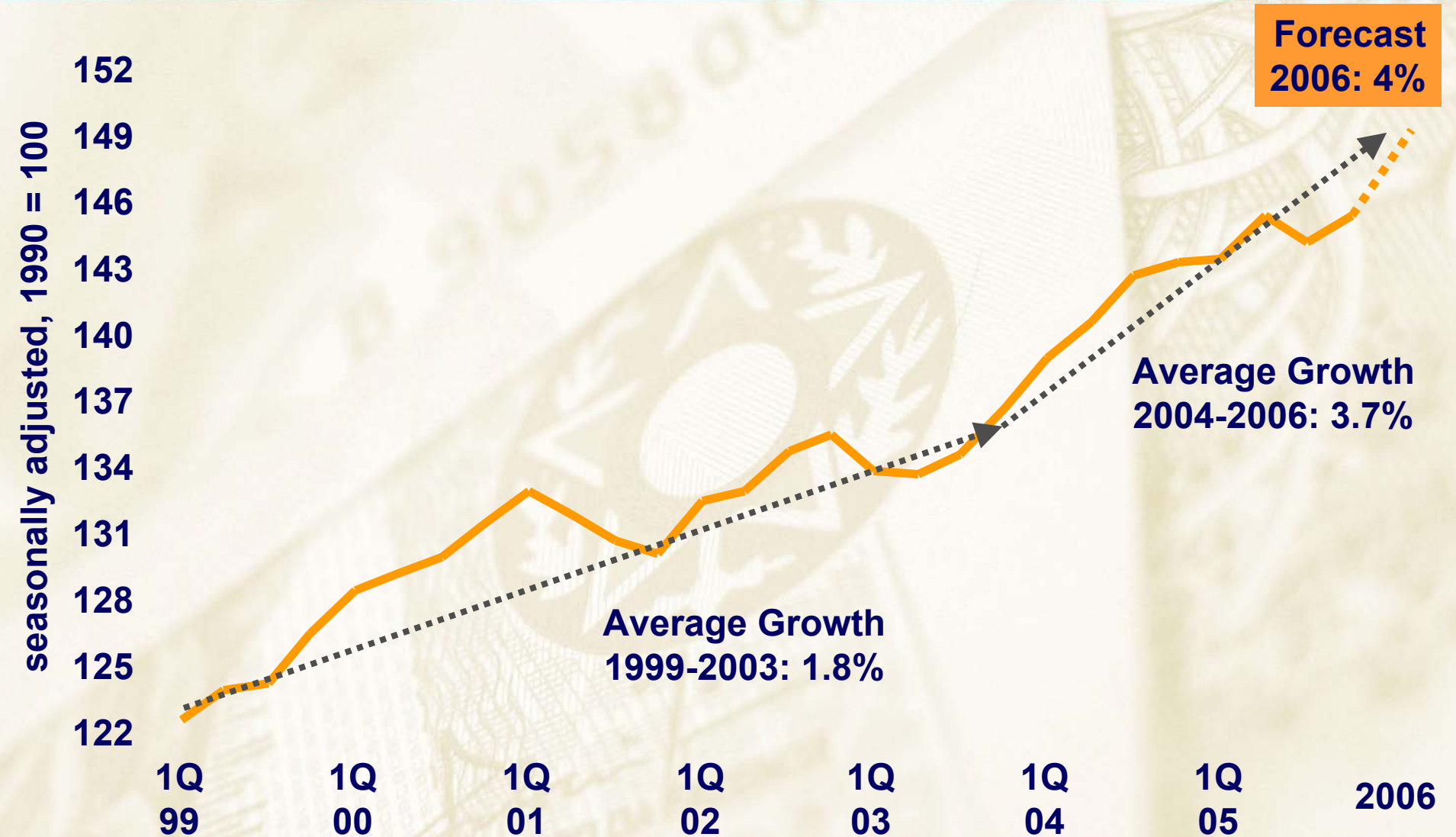


# Contribution of Domestic and External Demand to GDP Growth

compared to previous year



# GDP Growth



# Recent Market Developments

## Contents:

- 1. Domestic Debt Management**
- 2. External Asset Liability Management**
- 3. Changes to the FX Legislation / Regulation**
- 4. Improving the microstructure of the FX Interbank market**

## 1. Domestic Debt Management

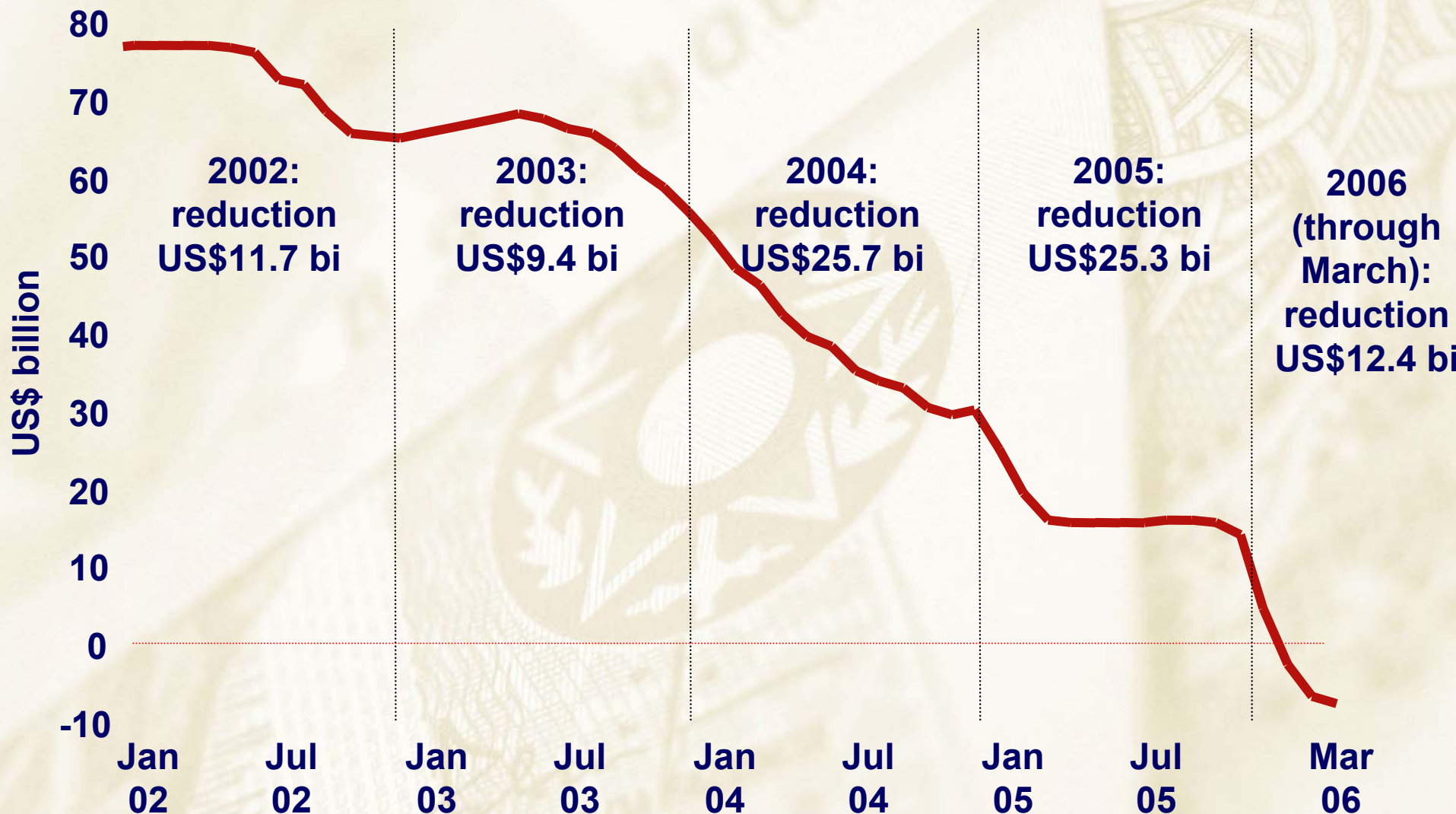


# Domestic Debt Management Initiatives

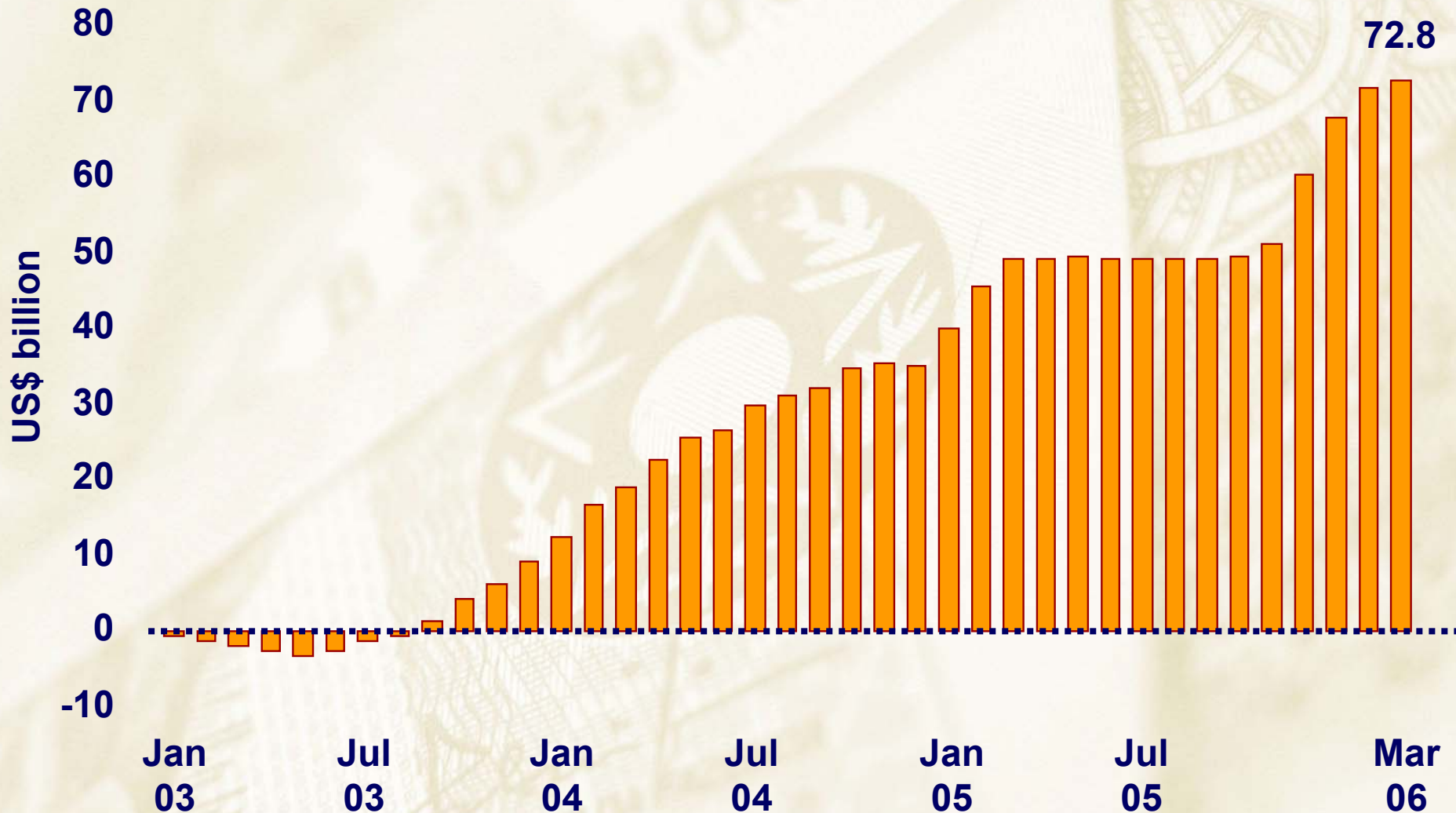
## Changing the domestic debt profile:

- **Elimination of the FX-linked domestic debt;**
- **Increase in the share of fixed-rate and inflation-linked instruments;**
- **Reducing rollover risk: lengthening tenor and lowering concentration in the short term;**
- **Changing profile of money market liquidity.**

# FX-linked Domestic Debt



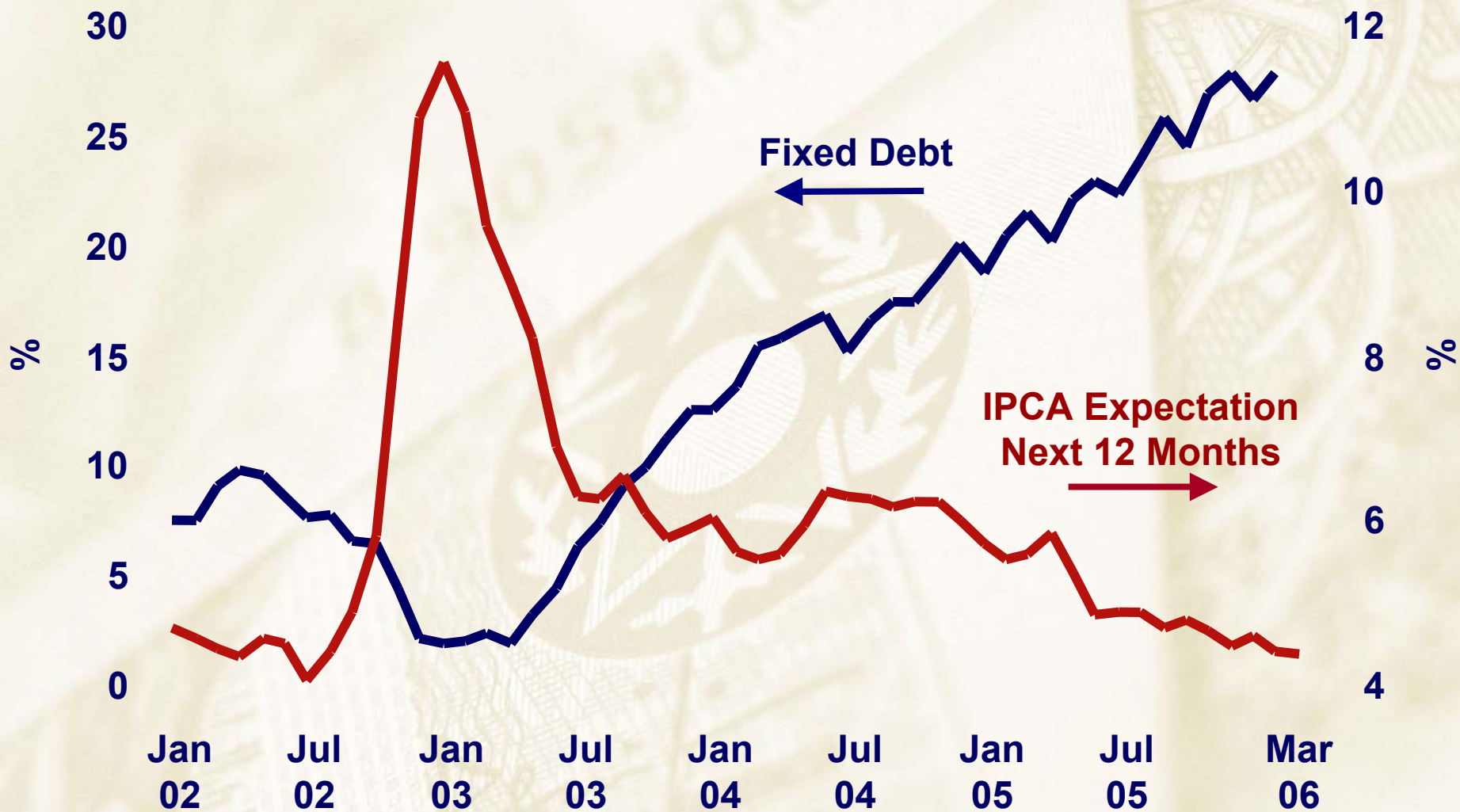
# FX-Linked Domestic Debt Retired (Cumulative Since Dec/2002)



# Share of FX-Linked Debt in Domestic Debt



# Share of Fixed Domestic Debt vs. Inflation Expectation



# Share of Inflation-Indexed Domestic Debt



# Average Tenor of Domestic Debt

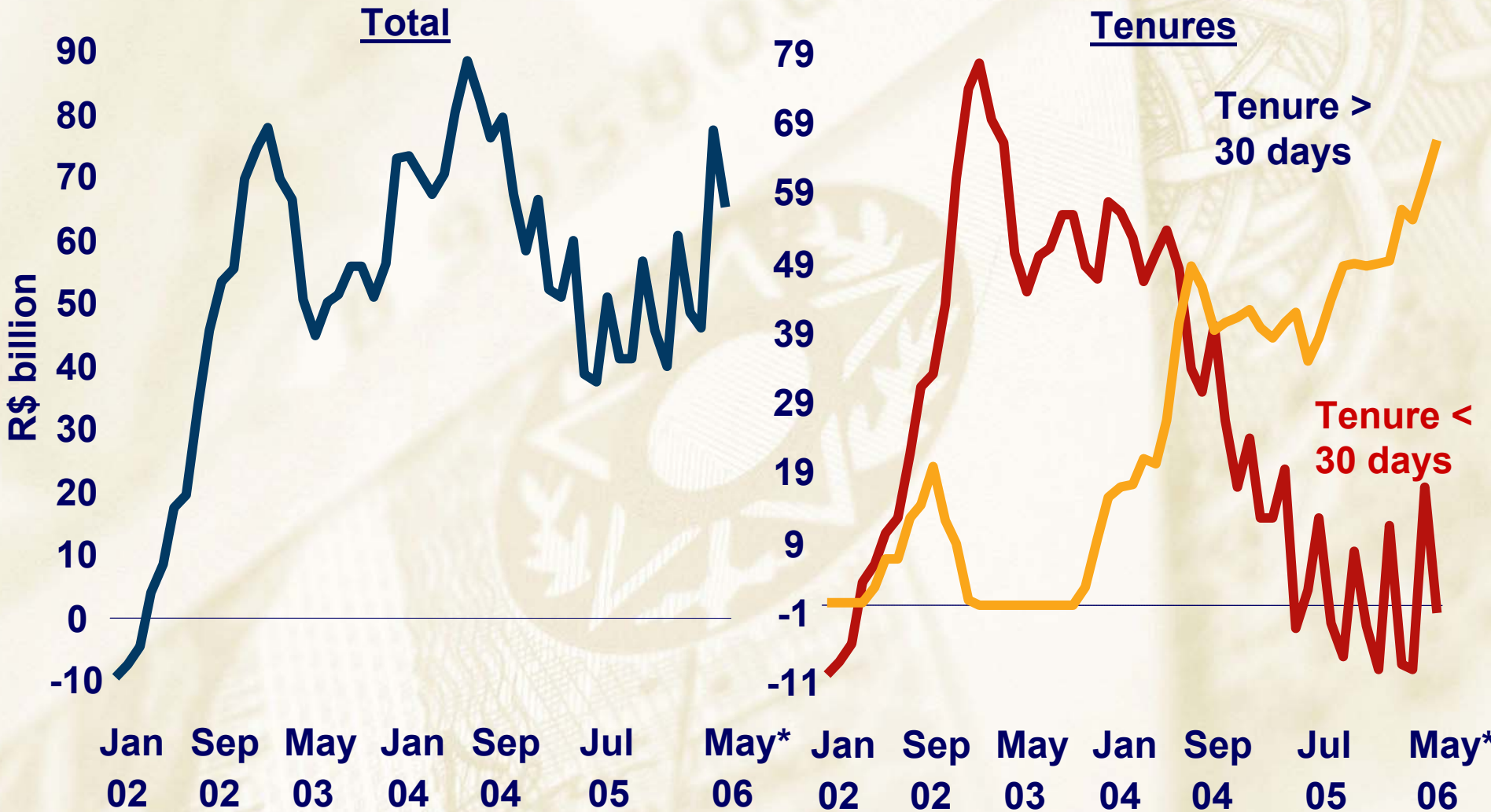


# % of Domestic Debt Maturing in 12 Months





# Money Market Liquidity



## 2. External Asset Liability Management

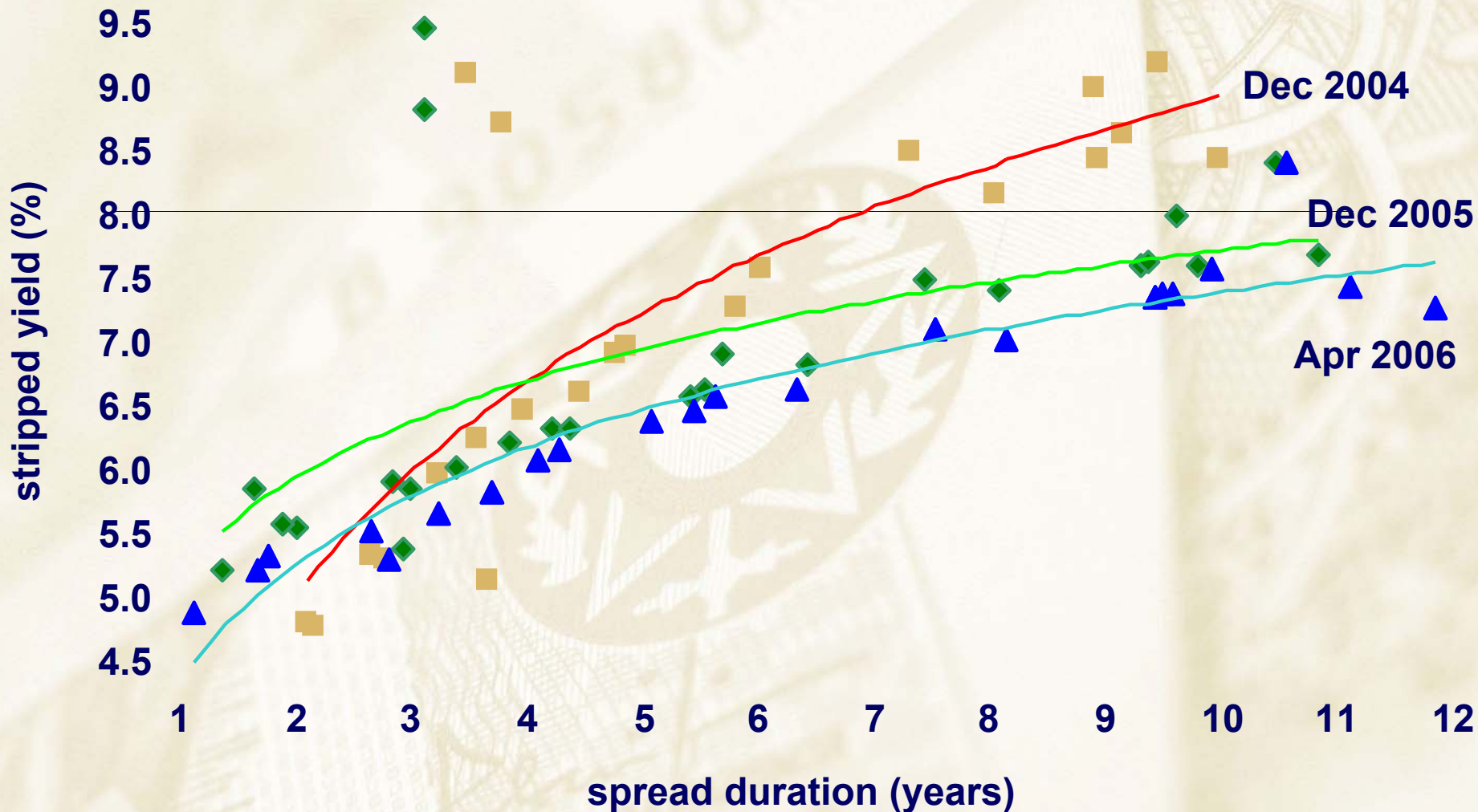
# External Debt Management Initiatives

- **Positive environment enabled authorities to adopt several initiatives to improve external debt management:**
  - **Accumulation of International Reserves (US\$ 45 billion in 3 years)**
  - **Swap of "old" C-bonds for new A-bonds (US\$ 4.4bn)**
  - **Issuance of global bond denominated in *reais* (US\$ 1.5bn)**
  - **Repayment of multilateral debt (IMF and Paris Club)**
  - **Exercise of the call option on Brady debt (US\$ 6.6bn)**
  - **Buy-back program, focusing on outstanding Brady bonds and debt maturing before 2010**

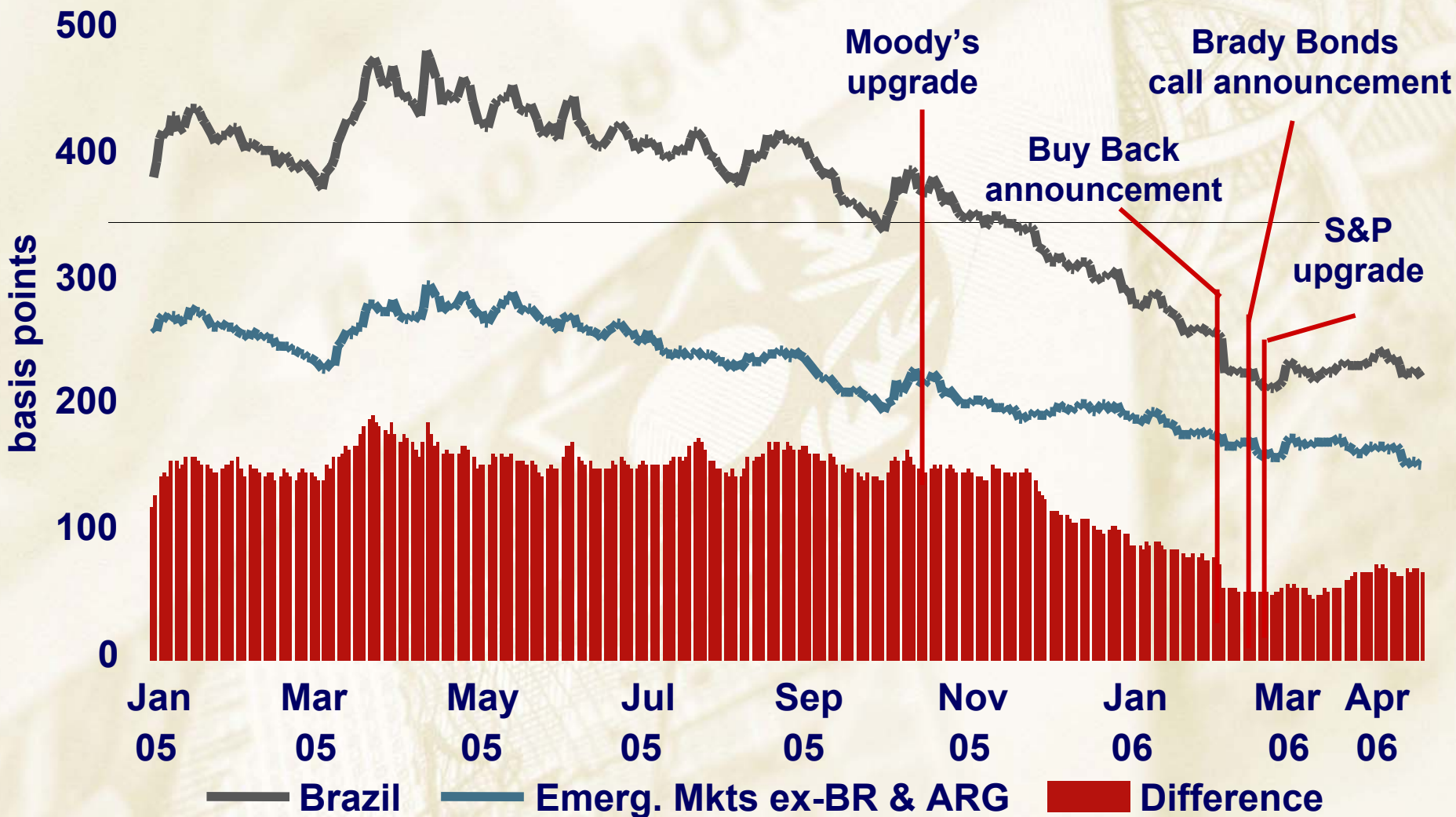
# International Reserves (Net of IMF Loans)



# External Debt: Yield Curve



# Lower Country Risk and Ratings Upgrade



## 3. Changes to the FX Legislation / Regulation

# FX Legislation Reform

- **Central Bank conducted in 2005 a major restructuring of the FX legislation;**
- **“Old” legislation reflected history of BoP crises;**
- **Main aim of “old” legislation was to allow, if necessary, stringent controls on hard currency outflows;**
- **Existing structure imposed large transaction costs on FX flows, reducing economic efficiency;**
- **Growing perception that the arrangement was no longer necessary and needed to be modernized.**

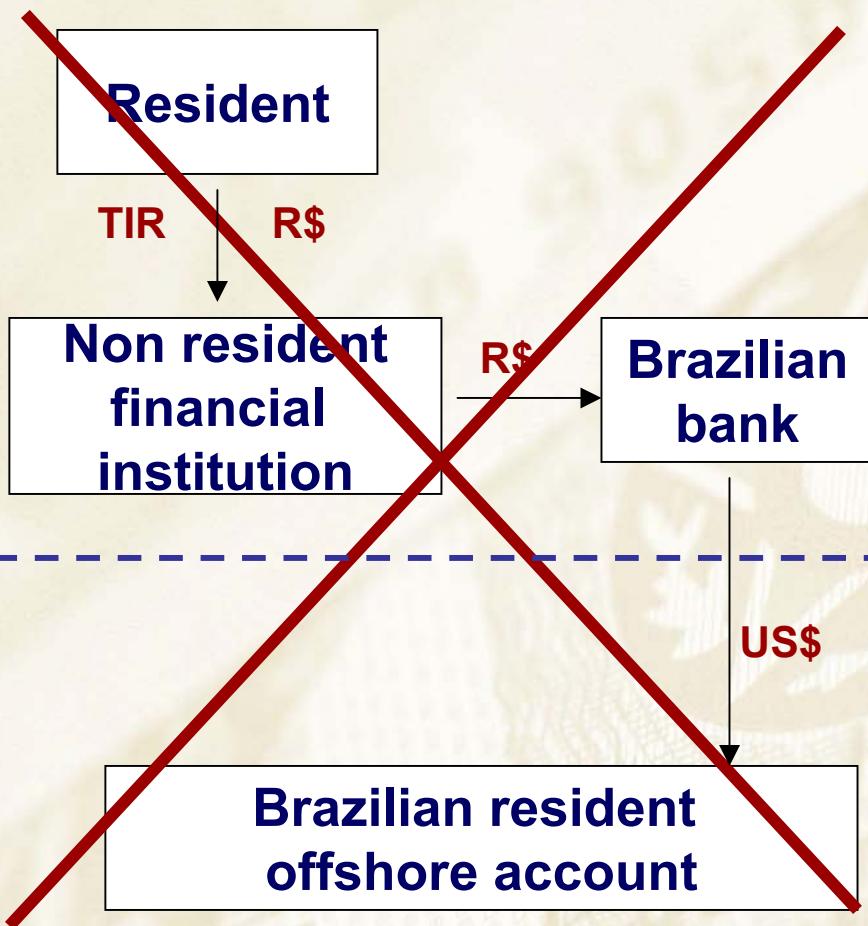


# FX Legislation Reform

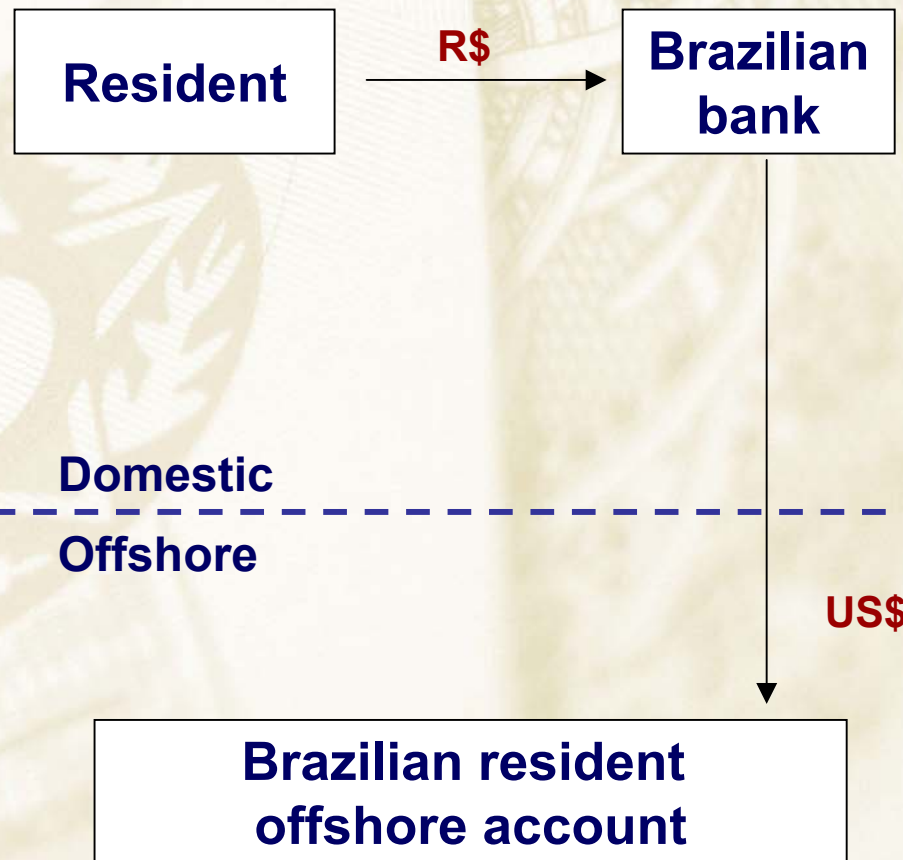
- In March 2005, the “floating” and “free” markets were placed under a single regulation umbrella;
- Main change: under the previous regulation, everything not explicitly allowed was forbidden (but “CC5” remittances allowed virtually everything);
- There are no longer transactions that require previous approval;
- All transactions that took place through the “CC5” accounts can materialize via the FX market;
- Non-resident accounts are allowed, but no longer can make transfers for third parties.

# CC5 Transactions

Before: CC5



Now: directly through the FX market



# FX Legislation Reform: Gains

- **Simplification:** Central Bank no longer defines documentation → parties keep documents to support transactions;
- **Transparency:** transactions classified as “CC5” remittances are now properly classified;
- **Central Bank no longer has to authorize transactions;**
- **Money laundering control became *marginally* more stringent, as all FX transactions are registered whereas “CC5” below R\$10,000 were not;**
- **Regulatory uncertainty was substantially reduced;**
- **Layman view of “CC5” transactions had tainted this channel.**

# New Export Regulation

- **Internalization of export proceeds remains in place;**
- **Previous regulation established complex control system;**
- **In theory, an exporter had 180 days to bring in the hard currency, but the web of regulations imposed a shorter period and a series of cumbersome “checkpoints”;**
- **All “checkpoints” were eliminated and allowed exporters 210 days to internalize proceeds;**
- **Our prior at that time was that the internalization requirement was not a binding constraint;**
- **Preliminary evidence does not contradict prior.**

# Unsolved Issues

- **Despite simplification, internalization requirement still implies costly practices for both the Central Bank and private sector;**
- **FX contract requirement also adds up to the cost of doing business;**
- **Foreign capital registry has created problems over the course of 43 years (“contaminated capital”).**

# Next Steps

- **Proposal to change legislation that requires repatriation of export proceeds**
  - ✓ **Can we move in steps?**
- **Reform of Central Bank systems (undergoing process)**
  - ✓ **Under new regime CB no longer generates FX contract and should capture only information deemed relevant;**
  - ✓ **New system architecture expected to reduce FX contract cost**
- **Solution for the “contaminated capital” issue on the way.**

## **4. Improving the Microstructure of the FX Interbank Market**

# Problems of the FX Interbank Market's Microstructure

- **Over-the-counter market for spot interbank transactions:**
  - ✓ Different FX brokers spread out liquidity, reduce transparency and increase transaction costs.
- **Registration requirements at Central Bank were outdated and occurred with long intra day lags**
- **Central Bank restrictions on long USD positions by banks created distortions for the onshore USD yield curve**
- **Very liquid USD futures contract and futures/spot arbitrage market leading FX price to be formed on the derivatives market.**



- **Creation of a centralized environment for FX trading: the FX spot trading floor at BM&F (the so called “Roda de Dólar Pronto”). Expected effects:**
  - ✓ **Concentration of liquidity leading to more efficient and transparent interbank FX market;**
  - ✓ **Better pricing with lower transaction costs, elimination of arbitrage between different brokers, and lower volatility;**
  - ✓ **Strengthening of spot vs. futures market for FX.**
- **A planned step is to move to electronic trading.**

# Measures (continued)

- **Elimination of deposit at Central Bank for long FX positions above US\$ 6mm: better pricing for the onshore USD yield curve**
- **And also:**
  - ✓ **Transparent registration for “turn over” operations;**
  - ✓ **Transactions to be recorded in Central Bank systems within a maximum 30 minutes lag;**
  - ✓ **Bid/Offer spread reduction for other foreign currencies than the US Dollar;**
  - ✓ **New rules for choosing Central Bank dealers, with more weight given to interbank transactions.**

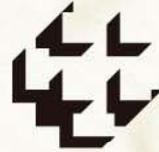
## 5. Financial Regulation

# Financial Regulation: Relevant Measures

- ✓ Prudential regulation (capital requirements for credit risk and market risk, control of liquidity risk, risk diversification, more strict licensing procedures, “chinese wall”)
- ✓ Elimination of existing barriers for risk mitigation and deepening of financial markets (credit transfers, netting, derivatives, securitization)
- ✓ Measures to increase competition (credit bureau, portability of bank files)
- ✓ Measures to improve access to financial services (bank correspondents, microcredit)

# Next Steps

- ✓ **Convergence with international prudential and financial accounting regulation (Basel II, IASB)**
- ✓ **Improved regulation of specific financial products (leasing, credit transfers)**
- ✓ **Regulation concerning government credit policies (housing finance, access to financial services, credit unions)**
- ✓ **Anti-money laundering measures**
- ✓ **Competition/ Consumer rights (improved disclosure on banks fees)**



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