BANCO CENTRAL DO BRASIL

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Speech from Mr. Alexandre Tombini, Governor of the Central Bank of Brazil, in the meeting of the Emerging Markets Advisory Council (EMAC) of the Institute of International Finance (IIF).

1. Introduction: International context and domestic adjustment

I would like to take this opportunity to elaborate on the ongoing process of macroeconomic adjustment in Brazil and the associated challenges. I will start my remarks by addressing how the international developments affects our domestic economy. Then I will focus on the adjustments underway on three different fronts: the external sector, the fiscal side and the monetary stance. I will also reflect on recent turbulences in Brazilian markets.

Two major movements in the international economy have affected Brazil: the first being the strengthening of the dollar and the process of normalization of monetary conditions in the U.S.; and the second is the slowdown in China's growth rate and uncertainties regarding its pace. The latter has affected the Brazilian economy mainly by the fall in commodity prices and the associated deterioration in the terms of trade.

We have prepared ourselves for this challenging period in different ways, such as maintaining robust external indicators with sizeable amount of international reserves, keeping a solid financial system with low exposure to FX risks, providing FX hedging instruments to the economy, and tightening monetary policy.

Against this backdrop, the Brazilian economy has responded as expected, by means of significant currency depreciation, as has been the case of other emerging market economies (EMEs). In the Brazilian case, however, domestic factors have also played an important role in recent exchange rate dynamics. Uncertainties surrounding the trajectory of fiscal variables and noneconomic events have increased the country risk premia and added volatility to domestic markets, beyond the effects of changing global economic and financial conditions.

In this challenging international and domestic context, we are conducting a classical macroeconomic adjustment, to eliminate fiscal imbalances, remove distortions between regulated and market prices, improve external accounts, and reanchor inflation expectations.

As a matter of fact, we have already seen some important progress in this process, although each adjustment — external, fiscal and monetary — has developed at their own pace.

2. External sector adjustment

The results in the external sector are changing rapidly. Despite the fall in the terms of trade, the trade balance has turned positive, benefiting from exchange rate depreciation and domestic economic conditions.

The volume of exports is already increasing (5.6% year-to-date). The gains in competitiveness are evident, as shown by the decreasing labor costs, when measured in dollar terms.

There has also been evidence that goods produced abroad are being replaced by domestically produced goods. This means that the drop in import volume is not only related to economic activity, but also to changes in relative prices.

Other items in our current account have also responded in a positive manner. As a consequence, the current account deficit is already decreasing and should fall by almost 40% this year in US dollar terms, fully financed by foreign direct investments.

From the National Accounts perspective, the external sector will have a positive contribution to GDP growth for the first time in the last ten years. We expect that net exports contribution to GDP will be around 2.4 p.p. in 2015. As a matter of fact, exports will be an increasing driver for growth. As to the level of production capacity, the subdued domestic demand is creating idle capacity in the tradables sector that can potentially be filled up under the new relative prices. Sectors that represent approximately 15% of GDP can take advantage of these changes in relative prices.

In the present case, these adjustments involve short-run trade-offs, as the currency depreciation, which contributes significantly to the improvement in the external sector, poses additional difficulties for the conduct of monetary policy.

Nevertheless, in contrast to previous experiences in Brazil, exchange rate depreciation has not been a source of distress or financial instability. In the past, substantial depreciation of the domestic currency led to strong balance sheet effects on the public and private sectors, which resulted in significant macroeconomic disequilibria.

The Brazilian economy is currently much less exposed to exchange rate risks than in the past. This more comfortable present situation is a result of policies implemented to strengthen the resilience of the economy. In particular, the public sector has been a net creditor in foreign currency since 2007, as a consequence of the accumulation of international reserves, which at present amount to USD 370 billion. High reserve levels have played a fundamental role in weathering the global financial crisis and, more recently, in mitigating the effects of the process of normalization of monetary conditions in the U.S. and the uncertainties surrounding Chinese economic growth.

In the case of Brazil, international reserves are also fundamental for our FX swap program. The FX swap program was implemented to secure financial stability after the taper tantrum, and has been successful in achieving that goal. FX swap contracts provide protection to the economy against domestic currency volatility, and consequently reduce financial risks due to balance sheet effects. These contracts are settled in domestic currency, that is, international reserves are not involved in these transactions. However, the BCB is able to use this instrument without being exposed to FX risks precisely because of its holdings of international reserves. The amount of reserves currently exceeds the notional value of the FX swaps book by more than three times.

In other words, international reserves not only provide protection for the public sector, but also allow selling part of this protection to the economy. As a result, agents' balance sheets, and consequently the economy, are less exposed to foreign exchange rate risks.

In this regard, the corporate sector in Brazil is not excessively exposed to foreign exchange risks. Most of corporate foreign-currency debt is owned by companies that are major exporters, have substantial assets abroad or have hedged their exposures through derivatives. In any case, we are monitoring closely the developments in the corporate sector.

I should emphasize that the Brazilian financial system is also very resilient to exchange rate fluctuations. Foreign sources of funding comprise only a small part of banking system liabilities, and strict regulation prevents financial institutions from being exposed to excessive exchange rate risks. In this sense, the stress tests in our recently released "Financial Stability Report" show that the financial system is able to withstand scenarios that include even further exchange rate depreciation. In short, the Brazilian financial system is well capitalized, well provisioned and highly liquid.

3. Recent developments in domestic markets

We are also monitoring the recent developments in the foreign exchange and interest rate markets which have led to higher risk premia across the board and distorted the term structure in recent weeks. The BCB is acting accordingly, using its tools to curb undue volatility and make sure markets stay functional. We are also working in coordination with the National Treasury to reduce market risks during periods of high volatility in foreign exchange and interest rate markets.

We do not have a target for the level of the exchange rate. However, we do have the tools to manage the current turbulence. The public sector's net credit position in foreign currency and the resilience of the financial system work as shock absorbers rather than amplifiers of volatility. We should also keep in mind that floating exchange rates act as an automatic stabilizer as exchange rate depreciations improve the current account balance and make domestic assets more attractive to non-resident investors.

In the past, the public sector was a net debtor in foreign currency. This implied that exchange rate depreciations led to deterioration in the public sector's balance sheet, increasing the country risk premium, and consequently feeding into the exchange rate, in a self-reinforcing negative feedback loop.

In contrast, nowadays exchange rate depreciations improve the public sector's balance sheet. In effect, what was an amplifier mechanism has turned into a shock absorber. External indicators, such as external-debt-to-GDP ratio and short-term-debt-to-international-reserves ratio, are considerably lower than in the past.

4. Fiscal adjustment

On the fiscal front, the government has started an important process of fiscal consolidation this year. It has undertaken several measures, such as expenditures cuts, reduction in subsidies, increase in regulated prices and adjustment of regulatory taxes.

The improvement in the fiscal outlook, however, is taking place at a slower-than-expected pace. In any case, the government continues determined to improve its fiscal performance.

As an example, discretionary spending has fallen substantially. Yet further reductions in the majority of government expenses, as well as increases in tax revenues, require changes in legislation. In this regard, the government has already sent to the Congress important proposals to improve the fiscal outlook in the coming years. It is not an easy task, but we should consider that there is a growing perception by Congress of the need to approve these measures.

The process of fiscal consolidation involves measures aiming at the short-, medium- and long-term outlooks. We know that structural changes ideally should be pursued during good times, but history, in both advanced and emerging market economies, shows that it is in challenging times that we see support for tough measures. In particular, the last two decades of Brazilian history show that the country has been able to overcome even tougher obstacles.

5. Inflation convergence

Finally, I will elaborate on the adjustment in monetary conditions. We are facing two important relative prices shocks. The first originates from the marked exchange rate depreciation. The second change comes from increases in regulated prices, which should reach around 15% in 2015.

Although the correction of regulated prices has had a negative impact on inflation in the short run, it has positively affected medium-term inflation expectations, as it contained expectations of increases in future inflation.

In this challenging environment, we have tightened monetary conditions in order to contain the second-round effects of these changes in relative prices to maximize the probability of convergence of inflation to target by the end of 2016.

As a consequence of the shift in relative prices, twelve-month inflation should remain elevated until the end of this year, closing at around 9.5%, requiring determination and perseverance in order to curb its transmission to longer horizons. Over 2016, the inflation numbers impacted by these relative price changes shall be replaced by numbers reflecting the state of monetary conditions, leading to a substantial decline in annual inflation over the year.

In this sense, conditions in the labor and output markets shall contribute to the decline of inflation in a significant way. In fact, the adjustment in the labor market is taking place at a faster pace than forecast, driven by both demand and supply factors. Until recently, labor market conditions seemed not to respond to the economic slowdown, but now they are responding to the business cycle. In one sense, the labor market is catching up with the economic environment. On the other hand, the presence of wage rigidities makes disinflation more challenging.

Lackluster aggregate demand, hindered by noneconomic events, also works to rein in price increases. The output gap is by any measure negative and widening.

However, it is important to remember the lags associated with the different shocks hitting the Brazilian economy and the transmission mechanism of monetary policy. Empirical evidence shows that the pass-through from the exchange rate to consumer prices operates more quickly than the transmission from the gaps in output and labor markets. Consequently, in the short run, the inflationary pressure from the exchange rate depreciation tends to be larger than the disinflationary effect from economic conditions. However, in the medium term — a more relevant horizon for monetary policy — the disinflationary effect will likely be larger.

Despite high current inflation, we have succeeded in containing inflation expectations at longer horizons. Inflation expectations for the period from 2016 through 2019 fell in the months between January and July, in spite of the increase in the expectations for 2015 by almost 3 percentage points.

Nevertheless, the recent rise in uncertainty, translated in additional domestic currency depreciation, has led to upward revisions in inflation expectations.

We believe that there are now excesses in markets, and asset prices are reflecting, to a large extent, a variety of market gyrations that are being addressed by the BCB. The balance of risks to inflation has deteriorated, but we are closely monitoring markets to assess the degree of persistence of recent movements in asset prices and expectations. We are seeing abnormal levels of uncertainty and do not know yet if they will persist. In this context, it is important that the BCB does not overreact to short-run market movements, which could actually add volatility.

The BCB understands that maintaining the current level of the policy interest rate, for a sufficiently prolonged period, is necessary for the convergence of inflation to target by the end of 2016.

6. Final remarks

Brazil is undertaking a necessary and classic macro adjustment in three dimensions: external sector, fiscal accounts, and monetary stance. We already see some important progress in this process, although each adjustment has developed at their own pace. The external sector is evolving rapidly, and will be increasingly an important driver of growth.

In the current context, the most important contributions that the BCB can provide are to work to reduce market dysfunction, keep monetary policy vigilant and ensure financial stability.

As we would expect in any macroeconomic adjustment, costs appear before results. In other words, it is necessary to incur costs in the short run in order to reap the benefits in the medium and long run. We know that the present context is challenging, but our economy is more resilient than in the past, and our history shows that we have been able to overcome even harder obstacles.

Thank you.