

March 2017

Latin America

The International Outlook

The current world outlook is particularly interesting, with more policy uncertainty and geo political risks, however within a context of finally a gradual recovery of global economic activity.

- There is uncertainty about the implementation and possible international repercussions of the new US government economic policy.
 - ➤ Trade protectionism, de-globalization, should impact the global economy and indirectly affect Brazil in the long run.
 - ➤ There is also uncertainty regarding the normalization of the monetary conditions in US. Further expansionary fiscal policy, while the economy is close to full employment, may lead to an increase in inflation and to a tighter monetary policy.
 - ➤ In other regions, as in Europe, it is more likely that global stimulus boosts growth and monetary policy is less responsive.
 - ➤ This asymmetry tends to strengthen the dollar and put an upward pressure on US interest rates.

- This uncertain global outlook will likely have implications for emerging economies.
 - ➤ Higher interest rates in US will result in less favorable financing conditions for emerging economies.
 - Protectionism should affect directly some economies but more important it may affect global growth.
- In spite of all uncertainties over the external outlook, both US and other advanced economies are recovering.
 - So far, global economic activity is stronger and the resulting positive impact on commodity prices (recently reversed in some markets) have mitigated the effects of changes in economic policies in some central economies, particularly in US, on the Brazilian economy.
 - ➤ We cannot disregard the possible realization of a more benign growth recovery scenario.

Brazil is now less vulnerable to external shocks

- Our balance of payment position is satisfactory. The current account deficit was 1.3% of GDP in 2016, while direct investments reached 4.4% of GDP (3% as equity and 1.4% as intercompany loans).
- Our international reserves stocks exceed US\$370 billion, around 20% of the GDP. This buffer works as insurance during periods of market turbulence.
- The floating exchange regime is our first line of defense against external shocks. It does not prevent the BCB from using instruments at our disposal to avoid excessive volatility in the FX market.
- The BCB reduced the stock of FX swaps from US\$108 billion to a current level of US\$22 billion.
- Brazil less vulnerable due to the progress in the disinflationary process and in the anchoring of expectations.

The diagnosis of the Brazilian crisis

- This uncertain external scenario coincides with a period of economic stabilization and improving economic fundamental of the Brazilian economy.
- Since 2011, Brazil has suffered a setback comparable to a supply shock.
 - ➤ The same shock has led us to the current state of recession and high inflation.

- This shock was a combination of:
 - The end of a golden period in 2011 for commodities exporting countries marked by a reversal of favorable terms of trade.
 - During the boom, public and private expenses grew at unsustainable rates and led agents to debt overhang.
 - The shock was mistakenly perceived as temporary and anticyclical policies were excessively interventionist.
 - These policies caused various distortions in the Brazilian economy, including excessive deficits, public debt and artificially low utilities and energy prices.
 - In this context, inflation expectations were unanchored.
 - ➤ As a consequence, Brazil has experienced the most severe recession of its history. GDP fell 7.5% in last two years and unemployment has reached 12 million Brazilians.
 - ➤ There is an overall deleveraging process, public and private. And consequences of this process are still unfolding.
- ➤ The recession we live today is a result of past excesses

The domestic economic outlook: economic policy in the right direction.

- The current government has shifted course and the reform agenda have already shown positive results.
 - Several reforms and adjustments have boosted confidence and reduced risk perception of the Brazilian economy.
 - On macro reforms, I would like to highlight the approved public-spending growth cap and the pension system reform, currently in Congress.
 - Other reforms, including tax and labor reforms should lead to efficiency gains, higher flexibility of the economy, and improvement of the business environment.
 - On the micro agenda, the government announced last December new measures to stimulate growth through productivity gains and efficiency.
 - ➤ The country risk assessment of Brazil improved significantly. The CDS fell from around 500bp at the beginning of 2016 down to 230bp currently. This year alone, the CDS fell 50bps. It comes at a result of the increased confidence of external investors in the country solvency, in the result of the reforms, in the determination to fight inflation, and in the recovery of economic activity.

- ➤ Inflation fell from 10.7% in December, 2015, to 4.8% in February, 2017. Inflation expectations for the end of 2017 have declined continuously and reached 4.15%. For 2018 and longer horizons, market analysts' inflation expectation remain anchored in 4.5%, the current inflation target.
- ➤ Again, the empirical evidence has corroborated the important role of monetary policy, and of the overall economic policy, for inflation control.

Economic growth recovery and the role of monetary policy

- Available evidence suggests a gradual recovery of economic activity during the course of 2017. (Reaching 2.5% growth in the last quarter of 2017 against the last quarter of 2016). We expect growth next year to improve further.
- Monetary policy should contribute to the economic recovery supported by other policy efforts.
- Economic growth depends on increasing levels of productivity.
- For this reason, it is imperative to persist in several efforts as we are doing in Brazil.
- First, the approvals of the macroeconomic reforms, particularly the fiscal reforms.

- Second, it is important to implement investments in infrastructure through concessions and other mechanisms.
- As a recent development, concession auctions of airports were well received.
- The investment in infrastructure plays an important role in boosting productivity. These investments have a multiplier effect by reducing costs and risks of productive activities, increase the expected return on other investments and turn new projects more appealing to investors.

Monetary policy, the real and the structural interest rate of the economy.

- Currently, the policy rate (Selic) is in a downward path, due to anchored inflation expectations around the target, declining current inflation and the high level of economic slack.
- Real interest rates are also decreasing. Several measures confirm this fact.
 - ➤ The real *ex-ante* rate, measure by the 12 months pre-fixed interest rate (*swap* DI market) minus expected inflation also for 12 months reached the current level of 5%.
 - ➤ When using the Focus expected Selic path for the next 12 months (instead of the pre-fixed interest rate for this period) to calculate the current real

interest rate, we find values around 5.3% for the real interest rate.

- ➤ When we consider the real interest rate implied by the NTN-Bs (inflation indexed government bonds) exchanged in the market, we also observe a decline to levels around 5.0 5.5%.
- In a historical perspective, the current level of real interest rate is low. Over the past decade, the real interest rate of the Brazilian economy has fluctuated, but showing a clear downward trend. It has declined from over 20% during the nineties to around 10% over the past decade, reaching an average of 5% since then (considering a period of unsustainable real rates around 2% during the previous administration). During recent crisis, rates reached approximately 9% in September, 2015, remained stable, around 7% during 2016 and declined afterwards.
- The real interest rate of the Brazilian economy is still converging and it depends on the structural (neutral) interest rate of the Brazilian economy.
- The structural rate of interest depends on factors like productivity growth of the economy, fiscal dynamics, quality of business environment, efficiency of resource allocation through the financial system and reform agenda in general.
- A more efficient financial system, with more free market credit, contributes to increase the power of monetary policy.

The sustainable reduction of credit cost.

- The structural and sustainable fall in the cost of credit increases the efficiency and productivity of the economy.
- The current monetary easing process together with structural measures the Central Bank of Brazil is implementing, should contribute to reduce the cost of credit.

Final Remarks

- The current global policy outlook is particularly uncertain, however within a context of gradual recovery of the global economic activity
- In Brazil, several reforms and adjustments have boosted confidence and reduced risk perception of the Brazilian economy. We expect growth to resume this year, starting in the first quarter.
- Persistence in this policy direction, in particular regarding the approval of the pension system reform, as well as other reforms to boost productivity will be crucial to support the economy.
- The empirical evidence has corroborated the important role of monetary policy, and of the overall economic policy, for inflation control. The monetary policy easing in Brazil (fall of the policy rate Selic) should contribute to growth resumption, supported by other policy efforts.
- International experience shows that an economic policy focused on reforms allied to a monetary policy focused

on reaching the inflation target lead to long lasting results: sustainable growth with low and stable inflation within a framework of lower interest rates.

 The more Brazil pursues the reforms and adjustments, the faster will be the economic recovery, and the creation of jobs and income for the Brazilian people.