



**BANCO CENTRAL DO BRASIL**

**Nova Iorque, EUA, 19 de setembro de 2017.**

**Notas em Inglês**

**Apontamentos do presidente do Banco Central do Brasil, Ilan Goldfajn**

**para**

**Reunião com Investidores**

**durante a**

**Missão de Nova Iorque**

**na semana de 18 a 22 de setembro de 2017.**

## Introduction

- Good afternoon. Thank you for the invitation – I appreciate this opportunity to talk about the Brazilian economy and the ongoing work at the Central Bank of Brazil.

## The Brazilian economy – an overview

- The set of recent indicators of economic activity remains consistent with a gradual recovery of the Brazilian economy. After a two-year recession, the Brazilian GDP grew 1% in the first quarter of this year, in relation to the previous quarter, and an additional 0.2% in the second quarter. Consumption grew 1.4% in the second quarter, its first positive result since the end of 2014. Likewise, the external sector contributed to the recovery, with a 0.5% exports' growth and a 3.5% decline in imports.
- In addition to the good performance observed in the first half of 2017, data from the third quarter continue to convey a gradual recovery of the economy. In July, an indicator of economic activity released by the BCB (IBC-Br) grew by 0.4%, seasonally adjusted. July also brought the net creation of 36,000 jobs and a 0.8% growth of the industrial production in comparison to the previous month, positive results observed for the fourth consecutive month.
- It is important to follow data on activity to assess the pace of the recovery.
- Consumption has been determinant to the economic recovery. The fast decline in inflation led to an increase of the population's purchasing power. The consumption growth tends to be resilient, since it is based on a permanent income gain and on household deleveraging over the past two years.
- The economic recovery is also due to the reorientation of economic policy and to the decline in inflation due to monetary policy.
- The investment's recovery is the next step to promote sustainable growth in the medium- and long-terms. The government's efforts in infrastructure and privatization are important to the investment recovery.

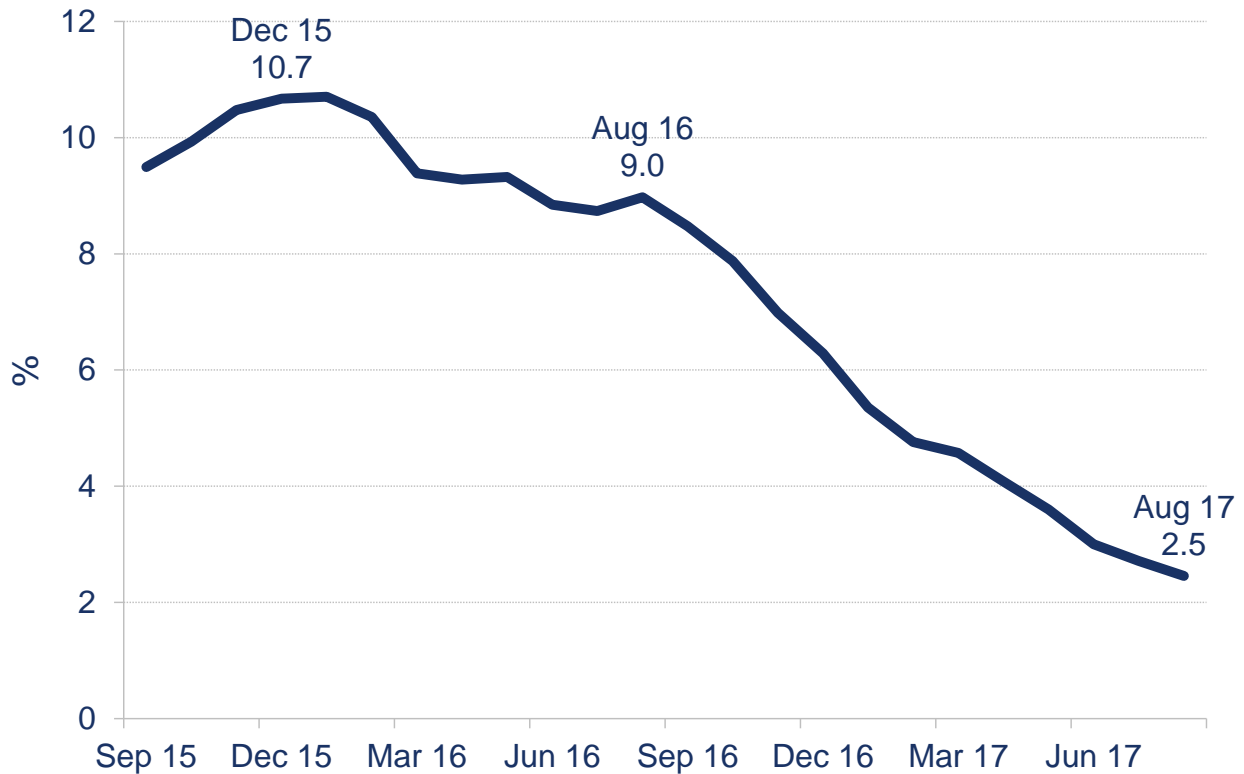
- The gradual recovery occurs in a context of high levels of economic slack, reflected in the low industrial capacity utilization indices and, mainly, in the unemployment rate.
- The global outlook has been favorable, as global economic activity remains on a gradual recovery path, without pressuring financial conditions in advanced economies. This supports risk appetite towards emerging economies, providing a more serene environment for the Brazilian assets' market.
- Brazil is now less vulnerable to external shocks.
  - Brazil's balance of payments' position is more comfortable. In July, the current account deficit in twelve months reached 0.7% of GDP. Foreign Direct investment reached 4.4% of GDP, more than six times the deficit.
  - Trade balance accumulates a surplus of 41 billion dollars this year until July, a 50% increase over the same period last year.
  - International reserves exceed US\$380 billion, around 20% of GDP, which works as insurance during periods of turbulence.
  - The country risk assessment of Brazil improved significantly. The CDS fell from around 500 bps at the beginning of 2016 to around 180 bps currently.

## **Inflation**

- Inflation has showed a substantial decline since the last quarter of 2016. Such decline has several causes, including the economic slack. It is worth noticing that, despite the recession going back over 2 years, high inflation rates were observed until the third quarter of 2016. In fact, 12-month inflation fell only modestly from 10.7% in December 2015 to 9.0% in August 2016. The persistence of high inflation, along with recession, brought up several requests to target an inflation above the level of 4.5%, the official target to 2017. The Central Bank of Brazil opted to follow the seemingly harder path, targeting the original inflation goal, arguing that it was a credible one.
- The decline in inflation this year, reaching 2.5% in August, shows that the goal was not only credible, but also possible, given that inflation expectations became anchored. The monetary policy strategy adopted in the third quarter of 2016, which consisted in

anchoring expectations before easing the monetary stance, might have contributed to change the binomial from inflation/recession to disinflation/recovery.

**Figure 1: CPI (IPCA), 12-Month Percent Change**

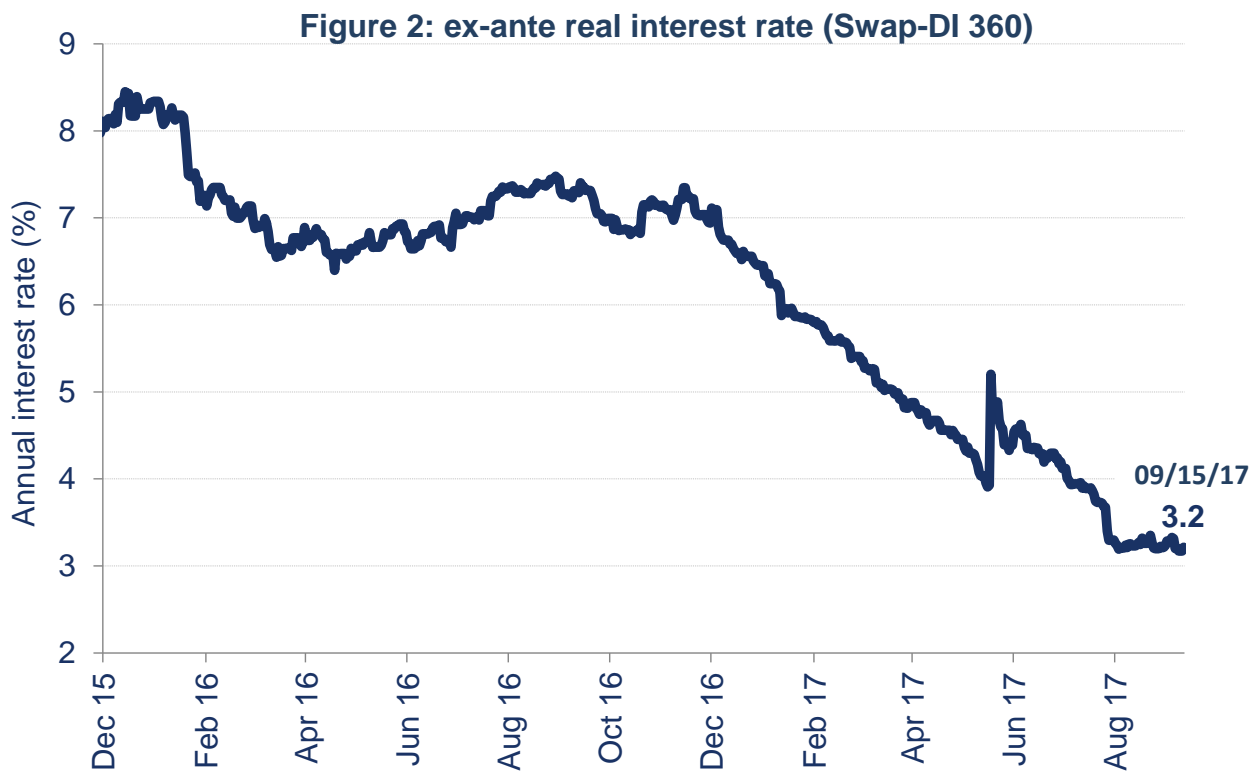


- There is evidence in the literature – in papers such as Bryan, Meyer & Parker (2015), Correa, Petrassi & Santos (2016), and Meier (2010) – that helps to rationalize such change of scenario. Initially, in an environment of uncertainty and high-inflation expected ahead, firms avoid lowering their prices even in a recession context, given the perceived risk of a rapid growth of their costs, which could lead to losses that might threaten their businesses' viability, especially for small and medium firms.
- The risk of negative margins overpowers the fear of a fall in sales. Firms sell less, but still with higher prices. As a macroeconomic consequence, this defensive behavior deepens the recession without causing a decline in inflation.
- In this sense, the change of direction in monetary policy, as well as the work towards anchoring inflation expectations, might have lessened the need of such defensive mechanisms and, thus, enabled the inflation decline observed in the past months.

- In general, inflation developments remain favorable, with various measures of underlying inflation running at low levels. This includes the components that are most sensitive to the business cycle and monetary policy.

### **The monetary policy in the current Brazilian context**

- Copom's projections indicate that inflation is under control. Under the scenario with interest rate and exchange rate paths extracted from the Focus survey, the Committee's inflation projections for 2017 and 2018 retreated to around 3.3% and increased to around 4.4%, respectively. Such scenario assumes a path for the policy interest rate that ends 2017 at 7.25%, edges down to 7.00% in early 2018 and reaches 7.5% by the end of the year.
- Given the inflation expectations anchored around the target, the declining inflation, and the high level of economic slack, the Selic rate fell 600 basis points since October 2016, with further declines expected ahead.
- In its last meeting, the Copom unanimously decided to reduce the Selic rate by one percentage point, to 8.25% p.a., without bias. The convergence of inflation to the 4.5% target over the relevant horizon for the conduct of monetary policy, which includes 2018, is compatible with the monetary easing process.
- The economic conditions prescribe accommodative monetary policy, i.e. interest rates below the structural level.
- Regarding the next Copom meeting, provided that the Committee's baseline scenario evolves as expected, and due to the stage of the monetary easing cycle, the Committee views a moderate reduction of the pace of easing as appropriate at this time. In addition, under those same circumstances, the Copom foresees a gradual ending to the cycle. Notwithstanding these perspectives, the Copom emphasizes that the monetary easing process will continue to depend on the evolution of economic activity, the balance of risks, possible reassessments of the extension of the cycle, and on inflation forecasts and expectations.



### Current risks

- The Committee's baseline scenario involves risk factors in both directions.
- On the one hand, the combination of (i) possible second-round effects of the ongoing favorable food price shock and of low current levels of industrial goods inflation, and (ii) the possible propagation through inertial mechanisms of the low level of current inflation, including the components that are most sensitive to the business cycle and monetary policy, may lead to a lower-than-expected prospective inflation trajectory.
- On the other hand, (iii) frustration of expectations regarding the continuation of reforms and necessary adjustments in the Brazilian economy may affect risk premia and increase the inflation path over the relevant horizon for the conduct of monetary policy. This risk intensifies in the case of (iv) a reversal of the current benign global outlook for emerging economies.

- Given such scenario, the economic easing cycle has led to the fall in *ex-ante* real interest rates (nominal rates minus inflation), which are close to the lowest historical values. Several measures confirm this fact:
  - The real ex-ante interest rate, measured by the 12-month pre-fixed interest rate (from the swap DI market) minus the 12-month expected inflation, after reaching approximately 9% per annum in September 2015, has remained stable at around 7% during 2016 and declined afterwards, reaching the current level of 3.2% per annum.
  - When using the Focus expected Selic (instead of the pre-fixed interest rate) trajectory for the next 12 months to calculate the current real interest rate, we find values close to 2.9%.
  - When we consider the real interest rates implied from prices of NTN-Bs (inflation-linked government bonds) traded in the market, we also observe a decline to the current level of 3.3%.
- At their current level (around 3%), real interest rates already provide stimulus to the economy. The real ex-ante interest rate is below the structural rate, which means there are two possibilities ahead: (i) the structural rate might decline over time; or (ii) the policy rate might go up. Or, still, a combination of both possibilities.
- In this context, the evolution of reforms and of adjustments in the Brazilian economy contributes to the reduction of its structural interest rate. In particular, recent credit measures have contributed to the decline of the structural interest rate.
- Along this agenda of reforms, the Central Bank of Brazil has acted in several fronts through its work agenda called BC+. The Agenda BC+ is structured in four pillars aiming at: increasing financial citizenship; improving the Central Bank legal framework; increasing the efficiency of the financial system and reducing the credit cost.
- Example of actions of the Agenda BC+ are:
  - Law approving the electronic registration of collateral and guarantees;

- New law setting a market-oriented interest rate (TLP) of the Brazilian Development Bank (BNDES);
- New punitive code and plea agreement tools;
- Positive credit bureau: New piece of legislation.

### **Final remarks**

- The Brazilian economy is experiencing a period of disinflation and economic recovery due both to the recent economic policy reorientation and to monetary policy.
- The international economic outlook is benign for emerging economies, but it should not be expected to last forever.
- In this context, I would like to emphasize that reforms and adjustments are essential to sustainable disinflation and economic recovery.
- Thank you very much.