Davos – Suíça, 17 a 19 de janeiro de 2017.

Apontamentos do Presidente do Banco Central, Ilan Goldfajn, nas Reuniões do World Economic Forum
The diagnosis of the current crisis

- Brazil suffered a severe type of “supply shock”.
- The same shock that led to recession, led also to high inflation.
- The shock was a combination of:
  - The end of a golden period in 2011 for exporting commodities countries marked by the reversal of favorable terms of trade in place for a decade.
  - During the boom public and private expenses grew at unsustainable rates and led agents to debt overhang.
  - The shock was mistakenly taken as temporary and anticyclical policies were excessively interventionist, generating several distortions in the Brazilian economy, including excess deficits, public debts and artificially low administrative prices. Key to monetary policy, inflation expectations became unanchored.
- Once prices were freed, inflation increased and reached almost 11% by the end of 2015.
- Brazil is still experiencing the most severe recession of its history. GDP fell 7% in the last year and a half. Unemployment has reached 12%.
- There is an overall deleveraging process. Public and private.
- The consequences of this process are still unfolding.

Monetary policy strategy

- In the context of a “supply shock”, the disinflation process is much more difficult and policy choices are hard.
If monetary policy does not anchor expectations, inflation will remain high and may even become adrift. Bringing inflation back to target will become more costly in the future. Postponing the problem would only aggravate the economic downturn in the future.

The main monetary policy goal in Brazil throughout 2016 was re-anchoring inflation expectations through enhanced communication and maintaining monetary policy tight.

Working for the convergence to the target was important, particularly after some years off target. Postponing this convergence had costs.

Last year results

- Monetary policy has been effective in containing inflation as well as in anchoring inflation expectations.

- Inflation fell from 10.7% in 2015 to 6.3% at the end of 2016, well below expectations held a few months ago and within the tolerance limits of the target.

- Inflation expectations for 2017 fell to around 4.8%. Expectations for 2018 and longer horizons are anchored, at 4.5% (the current target).

Consequences of the strategy

- As inflation expectations are now anchored, the BCB can work to avoid second-round effects of shocks (for instance, oil, exchange rate or electricity shocks). It can also take into account the costs of disinflation in terms of economic activity.

- The anchoring effort must be preserved. This is what allows lower interest rates in the future.
Current Monetary policy implementation

- The BCB is now easing monetary policy.

- The following is our Baseline scenario:
  - The set of indicators suggests weaker-than-expected economic activity. Available evidence indicates that the economic recovery should be delayed further, and be more gradual than previously anticipated.
  - The global outlook remains quite uncertain. Nevertheless, the end of the benign environment for emerging economies has had a limited impact so far.
  - Recent inflation releases were more favorable than expected. There are signs that the more widespread disinflation process has reached IPCA components that are most sensitive to the business cycle and monetary policy.
  - Central bank forecasts (using professional interest and exchange rate forecasts) are now at 4.4% and 4.5% for 2017 and 2018, respectively. In the reference scenario, with constant interest and exchange rates, forecasts for 2017 and 2018 are around 4.0% and 3.4%, respectively.
  - The process of consideration and approval of fiscal reforms by the Congress has been positive so far.

- The Committee concluded that convergence of inflation to the 4.5% target over the relevant horizon for the conduct of monetary policy, which includes 2017 and, with a gradually increasing weight, 2018, is compatible with an intensification of the ongoing monetary easing process.

- In face of the environment with anchored inflation expectations, the Committee judged that the current scenario with more widespread disinflation and weaker-than-expected economic activity makes it already appropriate to frontload the monetary easing cycle, and allows the new pace of easing.
Therefore, in its last meeting, taking into account the baseline scenario, the current balance of risks, and the wide array of available information, the Copom unanimously decided to reduce the Selic rate to 13.00 percent per year, without bias. A 75 basis point cut.

The extension of the cycle and possible revisions of the pace of easing will continue to depend on inflation forecasts and expectations, and on the evolution of the following risk factors:

Cons:

- Highly uncertain global outlook might make disinflation more difficult.

- The process of disinflation of some IPCA components that are most sensitive to the business cycle and monetary policy requires continuous attention.

- The process of approval and implementation of the necessary reforms and adjustments in the economy is lengthy, and carries uncertainty.

Pros:

- Weaker economic activity and a high level of economic slack may produce disinflation at a faster pace than the one embedded in the Copom’s conditional forecasts.

- Short-run inflation behavior has been more favorable, which may signal lower inflation persistence.

- The process of approval and implementation of the necessary reforms and adjustments in the economy may be faster than anticipated.
The neutral rates

- Neutral rates are determined by many economic variables, including the level of productivity, economic uncertainty, and business environment, among many others.

- Natural rates also depend on fiscal reforms (that will put public expenditure in order) and on microeconomic reforms to improve the business environment.

- Such reforms will make it possible to reduce the interest rate in a sustainable way.

Growth Recovery and the role of Monetary Policy

- Monetary policy should help economic recovery but should not be viewed as the “only game in town”.

- GDP growth depends on investment and on increasing levels of productivity.

- The reduction of uncertainties, particularly those from political and other non-economic events, is also an important development.

- It is essential the joint efforts of several instruments, as we are undertaking in Brazil.

- Persistence, serenity and focus on economic fundamentals are key for sustainable GDP growth.

Exchange Rate Policy

- The balance of payments situation is currently comfortable. Current account deficit is around 1.1% of GDP while FDI is running at around 4.4% of GDP.
➢ Brazil stock of international reserves beyond US$ 370 billion (20% of GDP). It acts as an insurance coverage against disruptive movements and market distortions.

➢ The floating exchange rate regime is the first line of defense against external shocks. Exchange rate fluctuations work as an automatic stabilizer, preserving both the balance of external accounts and the domestic macroeconomic equilibrium.

➢ This does not prevent the BCB from using its tools to avoid excessive volatility or lack of liquidity in FX market.

➢ In Brazil, the level of total external indebtedness of nonfinancial sector is around (18% of GDP). It has declined since 2015. Also, the debt maturity has steadily increased over the years.

➢ In Brazil, most of corporate debt denominated in foreign currency is held by exporters, subsidiaries of foreign corporates and/or hedged against FX depreciations in derivative markets. In fact, only 18% of this debt is not entirely hedged (representing 3.2% of GDP).

➢ The Central Bank of Brazil could always provide hedge to corporations due to its large reserves if markets are not functioning well and there are liquidity problems. Today the stock of exchange rate swap is around U$ 26 billion (down from U$108 billion at its peak).

Final remarks

➢ Inflation is declining and expectations are currently anchored in Brazil. This provides room for monetary easing. Changes in the new pace and the extension of the cycle will continue to depend on expectations and forecasts as well as risk factors.

➢ Monetary policy will help the economic recovery. But it is not the only game in town. It complements other government policies and structural reforms currently being implemented.

➢ Beyond monetary policy, it is important to persevere and approve fiscal reforms (especially social security reform) as well as other reforms to
boost productivity and create conditions for sustainable economic recovery, with low and stable inflation.