BANCO CENTRAL DO BRASIL

Basel - Switzerland, Jun 28, 2015.

Remarks from Mr. Alexandre Tombini, Governor of the Central Bank of Brazil, in the Panel of Governors following the Andrew Crocket Memorial Lecture in the 85th Annual General Meeting of the Bank for International Settlements

Our discussion here today follows a rich and instigating lecture from which I derive various issues, all interesting, out of which I take three:

- First, using a single representative-consumer in our models to account for the complexity of monetary policy transmission might miss important heterogeneity effects that can have macro consequences like over-estimating responses to cutting policy rates and to UMP instruments;

- Second, in crisis-time, the policy response to a debt-driven financial meltdown should precisely take into account this heterogeneity and inject resources to prop up households with negative net worth and with a higher propensity to consume, i.e., be more aggressive on mortgage-restructuring; and

- Third, in normal times, in addition to adequate regulation, the financial industry should provide better risk-sharing through, *inter alia*, debt contracts that could be transformed into "shared responsibility mortgages".

For the sake of time, I will not address all these three important issues in depth but rather focus on the issue of monetary policy and household demand from an emerging market perspective.

In a sense, Brazil is a special country-case where households are indeed heterogeneous; past monetization of high unsustainable public debt led to hyperinflation; and, learning from our crises, we stabilized our macro some 20 years ago and are now busy developing the housing market using micro and macroprudential tools.

From Brazil's experience, two lessons can be drawn: first, that one of the most robust empirical findings is that household demand does respond to movements in the policy interest rate; second, that prevention of excessive household indebtedness is paramount in emerging economies and can be done using a toolbox comprising intrusive supervision, conservative regulation and sound macroeconomic policies.

Regarding the first issue, although several transmission mechanisms are in play, the most important is banking rates. Movements in the policy rate and inflation expectations are translated into changes in deposit rates and market-base lending rates having an impact on household consumption.

But beyond the impact of monetary policy on household demand through the classic channels, one fundamental change is macroeconomic and institutional stability: those explain the sea change and financial deepening that the credit market has undergone in the last ten years, when credit to households expanded from around 10% to more than 25% of GDP.

First, macroeconomic stability and lower inflation allowed households to extend their planning horizons and raised their confidence, which are key elements to engage in debt markets.

Second, inclusive economic growth has led to a sharp decline in poverty and inequality. More than 40 million people joined the middle class, and millions entered the formal labor market.

On the institutional and microeconomic front, credit market reforms reduced legal risks and led to the creation of new financial instruments and distribution channels, which were often more suited to the needs of potential new clients, thus contributing to financial inclusion.

Therefore, the scope of people that are directly sensitive to credit conditions has risen significantly in recent years, enhancing the effectiveness of monetary policy.

So, are we following the footsteps of advanced economies that allowed excessive household debt, especially in housing loans, and that led us all to the financial collapse of the GFC? Are we not listening to the warnings of Professor Sufi?

I don't think so. We are precisely treating this risk with preventive measures. In a sense, because our inequality has been reduced, our households are now more homogeneous today and respond better to monetary policy action, we can develop a solid housing market with controlled systemic risk. From this financial

stability perspective, we always had a very strict set of micro and macroprudential rules.

The Brazilian housing market has been highly regulated. The market has embedded features that make it less prone to financial distress: the LTV ratios are relatively low; the vast majority of borrowers hold only one mortgage; and most of mortgage contracts are characterized by a constant amortization system, by which the initial installments are higher than the final ones. Securitization in the system is also very limited.

Moreover, after the outset of the global financial crisis, we have used macroprudential tools to mitigate risks. The objective was to make the financial system even more resilient and avoid excessive household leverage in a moment where easy global money was creating a bit of an excessive euphoria among Brazilian households.

For instance, we adopted a number of measures in 2010 and 2011 to mitigate risks associated to increasing LTV ratios and stretching maturities of car loans and other durable goods financing. Essentially, we doubled the capital requirement relative to Basel standards for certain risky operations.

And we got the “proof of the pudding” now with the GFC. In recent years, credit expansion has become more moderate, in line with a long-term sustainable path. The credit slowdown is taking place uneventfully from a financial stability perspective.

Having said that, we do share Professor Amir Sufi’s concerns related to the risks arising from highly leveraged households and to the asymmetry of risk sharing in modern financial systems. But we need, as an emerging market, to allow for growth in our debt market, while ensuring that individual and systemic risk remains under control. The route we took has been to use regulatory tools to control and limit excessive leverage. For instance, we set maximum values for the LTV ratio for household credit in 2013; we also set limits for the associated debt service-to-income ratio for payroll-guaranteed loans; and raised the minimum payment for credit cards balances.

Atif Mian and Amir Sufi’s findings also suggest that despite the use of prudential tools, household debt retains a potential destabilizing effect on the

macroeconomy. In fact, their central policy prescription is to introduce more risk-sharing in debt contracts; that is, to make them more equity-like. A natural question is why financial systems have evolved to be so reliant on debt. One reason that has been pointed out by many scholars, including Atif and Amir, is that debt often has a favorable tax treatment relative to equity. For example, corporations usually can deduct interest payments from pre-tax profits and therefore reduce their corporate income tax bill, but they cannot deduct dividends.

In Brazil, however, this is not quite the case. Alongside with dividends, corporations can pay their shareholders, up to a limit, interest on their share capital. This “interest on own capital” can be deducted from pre-tax profits just like interest on liabilities. This reduces the tax advantages of debt relative to equity.

Amir’s suggestion on making the mortgage more equity-like, and less debt-like, is thought provoking and deserves thorough consideration. I believe, however, that there are some issues that need to be carefully considered.

One concern is the risk of asset-liability mismatches given the fixed value bank deposits. It seems that a large part of the population has a clear preference for safe assets, that is, they might not be willing to hold risky assets instead of deposits. And of course, we need to keep in mind the fundamental role of bank deposits in the modern economy, particularly in the payments system.

A further question is whether this mechanism would not lead to a meaningful reduction in the size of the mortgage market. The Brazilian experience shows that frameworks that do not provide the right balance between debtors and creditors hinder the development of credit.

To conclude, let me provide you with some final thoughts on the current juncture in Brazil, where the economic slowdown has creates some challenges for the management of household finances. As you may know, we are conducting a classic economic adjustment, which is necessary to reduce domestic and external vulnerabilities, put public debt back on a declining path and send inflation back to its target by the end of 2016.

This adjustment process takes a toll on short-term growth, but is key to restore sustainable growth in the upcoming years.

Against this background, households are adjusting their balance sheets in an orderly way, moderating consumption and the acquisition of new credit. Many are also renegotiating credit conditions. The debt service-to-income ratio, which had increased during the credit expansion and peaked in 2011, has since stabilized. Non-performing loans in the financial system have remained low, and the banking industry remains well capitalized and well provisioned.

In conclusion, the next consumption recovery should take place at a moderate and sustainable pace, hand in hand with sustainable credit expansion, and consistent with an envisaged investment-based growth.