



BANCO CENTRAL DO BRASIL

São Paulo (SP), 13 de dezembro de 2016.

Mensagens do Ministro Ilan Goldfajn, Presidente do Banco Central do Brasil, na Conferência “Strategies for Growth: the Changing Role of the State” da Columbia University.

Conference – Strategies for Growth: the Changing Role of the State
Keynote Speech – Overcoming the Crisis in Brazil: The Role of Monetary Policy

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São Paulo, December 13th 2016

The situation in Brazil

- Brazil is experiencing the most severe recession of its history. GDP fell 7% in the last year and a half. Unemployment has reached 12%.
- Inflation reached almost 11% by the end of 2015 and is now expected to end 2016 around 6.6%.
- It was equivalent to a severe supply shock, due to a global negative commodity shock magnified by distorted reaction by domestic policies.
- Fiscal primary surplus declined over time from 3-4% of GDP to -2.8%. Gross debt reached 70%.
- Political and other non-economic events aggravated the crisis.
- There is an overall deleveraging process. Public and private.
- The consequences of this process is still unfolding. Timing of recovery is always hard to predict.

The global economy is in transition to a new steady state

- The perspective of normalization of monetary policy in the US and recent political outcomes in major economies has increased the level of uncertainty for EME.
- EMEs should seize the opportunity to reform and adjust their economies.
 - The normalization of monetary conditions in advanced economies should end the capital "flight from zero interest rates" to EMEs. Needed reforms will, then, become more costly.
 - Normalization of global monetary condition should not be interpreted as bad news in the medium and long terms.

- But bouts of volatility are possible.
- Reforms are urgent.

Brazil's strategy and domestic economic outlook

- **The policy strategy is:**

- Strengthening the policy framework based on: fiscal responsibility, inflation targeting and flexible exchange rate regime.
- Two main fiscal reforms: spending cap (approved in the Lower House and in a first round in the Senate) and social security reform (in analysis in the Congress).
- Beyond fiscal policy, advance on a broad agenda of structural reforms to boost productivity and long-term economic growth and to improve business conditions in Brazil: infrastructure, privatization, labor reform, tax reform, trade agreements.
- Initiatives are important to recover growth and deliver low and stable inflation.
- As a result, less uncertainty and lower risks.

- **Baseline scenario**

- Economic activity below expectations in the short run
- Recent negatives figures for growth do not mean the economy will not recover ahead.
- Gradual recovery in economic activity in 2017. Expectations for growth in 2018 better than 2017.
- High level of economic slack. Unemployment is high.
- Deleveraging process is under way.
- Disinflationary process is underway with positive surprises.

- **Floating exchange rate regime.**

- 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.
- Brazil has a stock of US\$ 370 billion in international reserves. It is an insurance coverage against disruptive movements and market distortions.

- **Monetary Policy**

- Recent inflation figures came in more favorably than expected.
- Inflation expectations are anchored.
- Expectations for 2016 fell to 6.5%. For 2017, the expectations are around 4.9%. Expectations for 2018 and longer horizons are already at 4.5%.
- Under the reference scenario (constant interest and exchange rates), the forecast for 2017 inflation fell to approximately 4.4%, whereas the forecast for 2018 sits around 3.6%.
- Anchored inflation expectations with falling current inflation is allowing the central bank to ease monetary policy and signal possible intensification of the initial pace.

- **The issue is: what is the role of monetary policy to overcome the crisis in Brazil?**

- **There are three main issues to address:**

1. How to calibrate monetary policy under a severe type of "supply shock"

- The convergence to the target is important, particularly after some years off target. Postponing this convergence has its own costs.
- However, the BCB takes into account in its decisions the associated costs of disinflation in terms of GDP growth, in two ways:
 - First, the level of activity affects our inflation forecasts.
 - Second, economic activity is considered a cost associated to disinflation.

- This is in fact an underlying principle of inflation target regimes
- We are indeed acting under this principle since the beginning of our administration.
- We consider that the cost of bringing inflation to the target in 2016 would be too high in terms of activity.
- This principle requires anchored inflation expectations, which is now currently the case.
- The same applies when a central bank decides to accommodate relative price shocks.
- In this case, the central bank works to avoid second-round effects.
- This highlights how important it was to anchor inflation expectations in the recent months
- This effort must be preserved! This will allow lower interest rates in the future.
- We all want lower interest rates, and the BCB is no exception. The point is how to get there.
- It is important to do it properly in order to be sustainable in the long run. Otherwise, interest rate will inevitably increase again.
- The Copom meets regularly to analyze current and prospective economic conditions. In those meetings, the Copom members may adjust their decisions to different scenarios.

2. Reducing neutral rates in Brazil

- However, this discussion is about policy rate and must not be misunderstood as a debate over the level of natural interest rate.
- Neutral rates are determined by many economic variables, including the level of productivity, economic uncertainties, business environment, among many others.
- Natural rates also depend on fiscal reforms that put in order public expenditure and on microeconomic reforms to improve the business environment.
- This is a reason for our insistence in supporting such reforms.
- Only such structural reforms will make it possible to reduce the interest rate in a sustainable way.

3. The role of monetary policy in the recovery.

- Monetary policy should help 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 many government actors, as we are undertaking in Brazil.
- This is the broader context where monetary policy, the debate over the interest rate, and the economic recovery should be placed.
- Any impulse to economic activity generated exclusively by monetary policy would be temporary.
- Persistence, serenity and focus on economic fundamentals are key for sustainable GDP growth and for lower interest rates in the long term.

Final remarks

- A more challenging global environment calls for EMEs to speed adjustments and reforms.
- Inflation is declining and expectations are currently anchored in Brazil. This provides room for monetary easing.
- Beyond monetary policy, it is important to persevere and approve fiscal reforms (spending cap and social security reform) as well as other reforms to boost productivity and create conditions for sustainable economic recovery, with low and stable inflation.
- Infrastructure investments and concessions as well as measures to improve business conditions in Brazil are also important.
- Three issues arise in terms of monetary policy in the crisis:
 1. How to calibrate monetary policy in a severe type of supply shock? First anchor expectations and then start easing, taking into account activity level and the cost of disinflation, as current inflation falls.
 2. Important to separate the debate in monetary policy between high frequency calibration and what is the neutral rate in Brazil. Reforms and

adjustments reduce the neutral rates and allow for lower sustainable interest rates.

3. What is the role of monetary policy in the recovery? Monetary policy should help the recovery. But it is not the only game in town. It complements other government policies and structural reforms currently being implemented.
- The more Brazil perseveres in making the necessary adjustments and reforms, the faster we succeed in achieving sustainable growth.
 - Thank you.