



## **International Monetary and Financial Committee**

**Twenty-Eighth Meeting  
October 12, 2013**

### **Statement by the Honorable Alexandre Tombini, Governor, Central Bank of Brazil**

On behalf of Brazil, Cape Verde, Dominican Republic, Ecuador, Guyana, Haiti, Nicaragua, Panama, Suriname, Timor-Leste, Trinidad and Tobago



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Governor of the Central Bank of Brazil**

**On behalf of the Constituency comprising Brazil, Cape Verde, Dominican Republic,  
Ecuador, Guyana, Haiti, Nicaragua, Panama, Suriname, Timor-Leste, and Trinidad  
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## **Introduction**

Five years into the financial crisis, we are in a transition period. Indeed, the global economy is beginning to show some signs of recovery in the United States and Japan. Of course there are still many uncertainties, some are due to local political economy issues in the US. The Eurozone countries, although with still almost no growth, are going rather successfully through a difficult period of macroeconomic adjustment. China is managing to slowly change its model with a shift of its source of growth toward consumption and Japan is experiencing a long overdue policy change that is affecting business and consumer confidence.

In this transition period, emerging market economies (EMEs) that had done quite well through the crisis are perhaps living through a paradox in terms of perceptions: a while ago there was an excess of exuberance and now perhaps an excess of pessimism. The optimism could be explained by the way most of us sailed through the global financial crisis with quick V-shaped rebounds. The pessimism might be in turn linked to the consequences of the present financial market volatility associated with the anticipation of changes in the US monetary policy, especially its unconventional component (UMP). There has been, since May, a movement of repricing of the EMEs asset class in part due to the possible exit from UMP. Concurrently, growth in EMEs has been slowing down, although coming from a high base, driven by external and domestic factors.

Therefore, EMEs in general and Brazil in particular will have to deal with financial instability during/after the exit from UMP, and address their external imbalances and debt dynamics with lower growth and less tailwinds. We believe that these challenges are not significant enough reasons to cast an overall pessimistic view on all EMEs alike. In addition, there are differences between EMEs and policies can improve prospects. In Brazil, especially, our strong buffers can mitigate risks.

These are the questions that I will address and I will show that EMEs in general and Brazil in particular are more prepared than currently portrayed to sail through this transition well and to reach a growth pattern that will be strong and sustainable in the near future.

## **Issues and Outlook for Advanced Economies (AEs)**

Starting with the outlook for AEs, growth prospects have indeed improved since we last met in April this year. Growth is picking up in the United States, yet it is critical to protect the still fragile recovery from the impact of unwinding the unconventional monetary support and, more recently, from the possible confidence and contractionary effects of the 2013 US government shutdown.

Since the Federal Reserve (Fed) began communicating in May that it could start moderating its purchases of mortgage backed securities and long-term Treasury bonds, long-term interest rates rose sharply and worldwide market volatility ensued. Recent events, however, have unveiled the difficulties of exiting from unconventional monetary policies (UMP), including important related policy dilemmas. A particularly thorny one stems from the fact that if long-term real interest rates rise too steeply, the US recovery could stumble and the negative effects would be felt worldwide, while prolonging QE would compound the risk of triggering new asset bubbles.

Another big challenge for the world economy comes from Europe. The Eurozone is moving out from a long lasting recession, but growth is uneven within the region and in many European countries unemployment remains at very high levels, especially amongst the youth. In addition, banks may still be suffering from low quality assets. The European Central Bank was entrusted as the Eurozone single supervisory authority and seems to be prepared to produce a credible asset quality review. The completion of the banking union would provide needed backing for such a critical exercise.

But a piece of good news is perhaps coming from Japan. The set of policies implemented by the new administration represents indeed a new departure but entails risks. The large liquidity injections provided by the authorities might change entrenched macroeconomic behavior but can trigger higher than anticipated inflation and create financial imbalances in balance sheets of corporations. That could be especially worrisome if the planned increase in consumption taxes slows down activity and raises unemployment.

## **Issues and Outlook for Emerging Market Economies (EMEs)**

Emerging market and developing countries remain the driving force of the world economy, although growth is slowing down in many countries. In fact, such deceleration may entail positive aspects which shall prevail overtime. In particular, China moving towards a more sustainable growth model, even if at somewhat lower rates, is good news for the world economy as a whole, which would become more robust with this contribution to lower and more stable commodity prices and the correction of protracted global imbalances.

However, emerging market economies are fully aware that this transition in advanced economies could trigger financial volatility in global markets. Indeed we have seen a new set

of questions posed by investors, market analysts and reverberated by the media. Despite a recognition that EMEs are stronger now, there are still doubts going forward: financial volatility seems to have exposed larger-than-foreseen current account deficits, high debt ratios, higher-than-targeted inflation, all explaining higher risk aversion that compounds currency depreciation.

This new pessimism neglects our preparedness, our long experience with “sudden stops” and much improved fundamentals. Since the Fed signaled the exit from UMP in May, indeed, EMs experienced a reversal in capital flows, a rise in bond yields, a decline in equity prices and an increase in the volatility of the currency market. As a matter of fact, perceptions toward emerging countries seem to have shifted in a more dramatic way than fundamentals suggest and the exuberance of the post-crisis was replaced by a gloomy pessimism. Nevertheless, a more careful and realistic assessment would give no reason to lean towards either extreme, providing the basis for a relatively favorable view of these countries looking forward.

Drawing lessons from past experiences may be difficult, since the amount of liquidity injected through large-scale purchases of long-term assets has been unprecedented. EMEs will need to carefully choose and calibrate policies to ring-fence their economies from negative spillover effects of the unwinding of UMPs. But one shouldn’t forget that EMEs are now in a much stronger position than in the past to withstand turbulence, given their improved fundamentals, more flexible exchange rates and higher international reserve buffers.

In any event, in Brazil, we first used textbook and well-tested policies: exchange rate flexibility and international reserves accumulation up to about US\$380 billion. We built very strong buffers to protect financial stability and prepared for the exit from UMP. Right now, with the current volatility in part due to the perspective of exiting from UMP, our foreign exchange reserves are capable of absorbing shocks and will provide for a predictable, smooth adjustment of asset prices, including the nominal exchange rate.

To deal specifically with excessive exchange rate volatility and to provide hedge and liquidity to the domestic foreign exchange market, the Central Bank of Brazil committed to a US\$60 billion (equivalent) program through the end of the year based on derivative instruments, in such way that safeguards our international reserves. The strategy is comprised of daily US\$ 500 million (equivalent) FX-Interest rate swap auctions, Monday through Thursday, as well as US\$ 1 billion in FX Repo auctions on Fridays. The program has proved successful in curbing volatility and could be extended beyond year end if necessary.

Other policy levers will continue to be strengthened. Monetary policy responded firmly to inflationary pressures since the beginning of 2013, first through communication and then raising the policy rate since April. Monetary policy is contributing to making inflation retreat and limiting FX pass-through.

Finally, Brazil’s financial system is strongly capitalized and provisioned and relies little on external sources of funding. Our short term external debt (about US\$ 40 billion, or 2

to 3 percent of GDP) is small compared to our international reserves, making the quality of Brazil's signature solid, safe, stable and unquestionable. Overall, the usual external debt ratios for Brazil appear in zones of comfort (between 20 and 30 percent of GDP). Finally, our stability, payments' capacity and size of Brazil's economy make it the usual destination of about US\$60-65 billion a year of Foreign Direct Investment, thus making our current account position largely financeable, especially now that we are tightening our current policy stance.

## **Issues and Outlook for Low Income Countries and Small States**

The low income countries and small states are coping with the drop in demand from Europe, a decline in development assistance and have little access to concessional financing. Their predicament would be seriously compounded if the aforementioned risk to the US recovery materialized. This segment of the Fund's membership requires increased attention. We call on the Fund to work with these countries' authorities, help them step up revenue mobilization, including from natural resource exploitation, and find appropriate and innovative tools to address their debt overhang.

## **IMF Quota and Governance Reforms**

Finally, while we are confident in Brazil that we can go through the current transition, we have always been a proponent of a transparent and important role for the IMF to help countries that are affected by turbulence while keeping good fundamentals. In that respect, the IMF governance reforms have entered a stage of complete paralysis and this has further eroded the Fund's legitimacy and credibility. The institution has been missing target after target.

The obstacle to the entry into force of the 2010 reform remains the delayed approval by the US Congress. The United States is now the only G20 country not to have ratified the 2010 reform. That reform would bring some improvements to the IMF's outdated governance structure. We supported it, as the US did, because we saw it as indispensable to enhance the IMF's representativeness and make it more responsive to emerging markets and developing countries. We are aware of the efforts of the US Administration to get Congress approval and praise it, but it is hard to understand why the host country of the Fund is holding back this reform.

The preparatory work for the 15th General Review of Quotas, which the membership agreed to complete by January 2014, has not yet started and the discussions on the quota formula review have not led to any practical result. In this case, the main hurdles have been determined resistance to change on the part of overrepresented countries and somewhat flagging determination from IMF management to push the process forward. As quotas have not been augmented, the IMF's assistance to countries – as those in the Eurozone – is

increasingly relying on voluntary borrowing from members. Brazil is supporting this voluntary financing, but it was not meant to be permanent. It was agreed as a bridge to quota increases that would allow a realignment of quota shares and voting power in the institution.

We underscore, once again, that the IMF reform process is based on a high-level political agreement and that delaying reform would have negative consequences for all the membership. After the crisis erupted in the United States and Europe in 2007/2008, the G20 decided to substantially increase the IMF's borrowed resources with strong participation of the BRICS and other emerging market countries. This was done together with the commitment to reform and update the institution's quota and governance structure so as to reflect their increasing weight in the world economy. Emerging market countries have honored their part of this political agreement. It is time for the United States and Europe to deliver theirs.

### **BRICS Contingent Reserve Arrangement and New Development Bank**

We do not want to see the difficulties at the IMF triggering a multitude of uncoordinated Regional Financial Arrangements. We need them, but as complements to an international multilateral framework. In that sense, BRICS countries have continued to work to implement their commitment to establish a New Development Bank (NDB) and a Contingent Reserve Arrangement (CRA). On the NDB, which will have an initial subscribed capital of US\$ 50 billion, progress has been made in negotiating its capital structure, membership, shareholding and governance. On the CRA, which will have an initial size of US\$100 billion, consensus has been already achieved on several key aspects, and the operational details of the CRA agreement are currently being negotiated. Tangible progress on both the NDB and the CRA is expected to be announced by the time of the next BRICS Summit in Brazil in March 2014.

### **Conclusion**

Brazil and many emerging economies in general are in a much stronger position than usually portrayed to withstand the current transition turbulence. We have large foreign exchange reserves, improved economic fundamentals, sound financial systems and policy-readiness and experience dealing with "sudden stops". For Brazil, despite the recent volatility, the normalization of monetary conditions in the US is a net positive as it reflects better prospects for a US and global recovery.

Brazil continues to strengthen its macro-financial framework while implementing a wide range of reforms to enhance productivity and competitiveness in order to consolidate its economic growth model with social inclusion.