“The crisis is serious, but will be overcome.”

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The Brazilian economy has sound fundamentals, is well-diversified, and has a large and expanding consumer market. This, and not interest rates, is what attracts the foreign investor, explains Henrique Meirelles, Governor of the Central Bank of Brazil. He therefore believes that a drop in the Central Bank’s policy rate will not trigger a confidence crisis. Having been at the helm of the monetary authority from the start of the Luís Inácio Lula da Silva presidency, Meirelles has no doubt that Brazil will emerge from the current crisis in better shape than it was when the crisis broke out. “We have reserves, and the Central Bank can offset insufficient foreign credit by extending credit lines to exporters and by implementing anticyclical monetary policy. We have conquered room to maneuver to address the crisis,” he stresses. And what does the future hold for Meirelles? “At the moment,… my priority is to work to help Brazil out of the crisis as swiftly as possible. There will be plenty of time to think about the future later.”

The Brazilian Economy — This is the last part of the Lula term and of your administration of the Central Bank of Brazil. Is it possible to identify the best and worst moments of your time in command of the monetary authority? Henrique Meirelles — That is a difficult question to answer. There have been many challenges, difficulties, but also positive moments. In the current crisis there have been some difficult moments, especially because the crisis came from abroad and through several channels. However, without any doubt, the worst point was at the beginning of my term in January 2003, when annual inflation exceeded 20%, our reserves were less than US$20 billion, the country was on the brink of insolvency, and economic activity was contracting. Raising interest rates was the right choice under the circumstances, but it was a very hard decision. At a certain point, the Central Bank had to decide against selling more international reserves, hoping that investors would have confidence in the measures adopted by the government. That was particularly difficult. The most gratifying event occurred in December 2006, when President Lula paid tribute to me in his year-end speech of thanks to his ministers. Another very gratifying moment was the day Brazil received the investment grade rating from a very respected foreign rating agency.
You often state that Brazil has become more resilient to international shocks over the past few years. What are the signs of this resilience almost a year since the onset of the international subprime crisis?

Let me emphasize that there are two very different stages to the current international crisis. The first phase started after the collapse of the subprime market in the US, in mid-2007; it mainly hit the developed countries and was characterized by correction of the excesses of the so-called “great moderation” period, with low real interest rates, excessive credit growth and leverage of the banking system, and asset prices inflation. This correction process triggered a severe loss of capital from American and European financial institutions; otherwise, there were no major ruptures in the system.

The second stage of the international crisis started in September 2008, prompted by the bankruptcy of Lehman Brothers. That paralyzed credit around the world and affected economic activity in countries everywhere, including countries that, like Brazil, had been spared up to that point. The scarcity of international credit was the main channel of contamination, compounded by the contraction of international trade and the waning of confidence in both the business community and consumers. So the crisis struck Brazil in its second global phase.

Now, returning to the issue of Brazil’s resilience to external shocks, let us compare the situation today with previous crises that hit the country. Unfortunately, Brazil has had to face rather frequent external crises over the past 15 years — Mexico in 1995, Asia in 1997, Russia in 1998, and Argentina in 2001 — and in all of them the pattern of adjustment was similar: a massive loss of reserves, higher interest rates, and fiscal tightening.

Today, the circumstances are different. We have reserves, and the Central Bank can offset insufficient foreign credit by extending credit lines to exporters and by implementing anticyclical monetary policy. We have conquered room to maneuver to address the crisis. The crisis is serious, but it will be overcome, and Brazil will be in better shape than it was when the crisis broke out.

Are you satisfied with the results produced by the measures introduced to improve the availability of credit and stimulate the economy in general? Are there further measures that could be envisaged for the short and medium term?

The Central Bank continuously monitors credit and the economy in general. This is not the time to anticipate new measures. Our assessment is that the measures introduced since last September have been successful, and indeed authorities around the world have acknowledged their timeliness and precision. We have acted with determination to provide liquidity to the credit market using a variety of mechanisms, particularly the reduction of bank reserve requirements, which in Brazil are a prudential instrument to ensure liquidity, as well as incentives to transfer portfolios out of institutions with liquidity problems. Incidentally, no bank has had to resort to the discount window, demonstrating that these initiatives were quite effective. More recently, we have extended deposit insurance for time deposits, a measure that has been crucial for normalizing the credit supply of small and medium-size banks.

Brazil’s high foreign reserves have functioned as a sort of insurance against the crisis. Because the Central Bank continues to intervene in the...
exchange market, reserves are increasing. For what purpose? In fact, foreign reserves have been an important defense against the turmoil, and their pre-crisis level seems to be just right. In the past, some analysts who tried to determine the optimal level of reserves often reached the conclusion that Brazil had already exceeded it. Today, the same analysts recognize that they were mistaken...

Since the beginning of May the Central Bank has once more acquired dollars in the market, taking advantage of the favorable circumstances of foreign inflows into Brazil. It should be noted that the objective of acquisitions of foreign currency by the monetary authority is to take advantage of opportunities; the intervention does not intend to influence the exchange rate but simply to reduce its volatility.

That said, the level of reserves today is higher than before the crisis. That is not a consequence of the Central Bank policy of sales and purchases but is rather the result of investments in assets that in the past few months have appreciated significantly.

The productive sector continues to criticize the government’s monetary policy, suggesting that the Central Bank policy rate could be pushed down further. When President Lula’s mandate comes to an end in December 2010, the policy rate will be comparatively lower than it was a few years ago, yet it remains one of the highest in the world. Would it be possible to change this before December 2010?

What is decisive for economic activity is not the policy rate but the longer-term market rates, particularly the 360-day term negotiated at the BM&F (the Brazilian Securities, Commodities and Futures Exchange). If we analyze the correlation with economic activity, we see that market rates are much more significant than the Central Bank policy rate. It is also important to recognize that the market rates are not fully linked to the policy rate—they also anticipate monetary policy decisions and the behavior of future inflation. As a matter of fact, if we compare the 360-day rate to inflation expectations, we see that both track each other very closely. Thus, it is not the policy rate but rather expectations about inflation that orient market rates.

It is clear that lowering the policy rate by decree is pointless unless expectations about inflation warrant it. Any attempt to manipulate the policy rate would push up market rates and would translate into costs to economic activity, as has happened in Brazil in the past. On the other hand, when we analyze the evolution of interest rates over the past few years — both policy and market rates — we see an indisputable declining trend. For instance, at the end of the 1990s, the policy rate exceeded 40%; at the June Monetary Policy Committee (Copom) meeting it was set at 9.25%. In other words, we can observe a significant structural adjustment over time. The real interest rate shows this declining trend as well; today it is the lowest in the country’s recent history.

Economic analysts keep referring to a “crisis of confidence.” As interest rates continue to fall, will Brazil still be attractive to foreign capital?

Our economy has sound fundamentals, is well-diversified, and has a large and expanding consumer market. These — not interest rates — are what attracts the foreign investor. Data from both before the crisis and now clearly indicate that most capital inflows are being
invested in productive capacity and in the stock market, which is a way to finance Brazilian corporations. In other words, what is motivating capital inflows are the opportunities in the real economy. The short-term moves of interest rates are far less important.

By implementing measures to rescue their economies since the outset of the financial crisis, the US, the EU countries, and the United Kingdom have witnessed a rapid rise in public debts. How do you see the issue in Brazil? Brazil is one of the few economies in the world with a balanced fiscal position. The G7 countries in general, and the United States, the United Kingdom, and Japan in particular, project substantial fiscal deficits not only in 2009 but also in 2010. Some estimates indicate that by 2012 the public debt in those economies will be double that in 2007. Even some emerging economies that traditionally recorded a balanced fiscal position, such as Russia and the Gulf countries, forecast significant deficits in 2009. In all those cases, the cost of adjustment to the financial crisis is being transferred to future generations in the form of higher public debt.

In Brazil the circumstances are more favorable. We will maintain a positive primary surplus consistent with the targets established by the government. In 2009 specifically, the fall of the primary surplus is offset by the cut in interest rates, helping to hold the nominal deficit at about 2% of GDP this year and bring it down to 1% or less next year. Those figures are consistent with the falling path of public debt that we have been witnessing since 2002. In other words, Brazil is one of the few economies that will end the year with a net debt-to-GDP ratio lower than it was at the outset of the crisis.

Recently, President Barack Obama approved measures to control fees and interest rates charged by credit card issuers in an attempt to reduce consumer indebtedness. The Central Bank of Brazil has conducted a study of the credit card market that suggests that the interest rates charged in Brazil are too high. The Chamber of Deputies has opened a debate on changes to the rules governing credit cards with the idea of creating specific rules for this sector. What is your assessment of the credit card market in Brazil?

In Brazil, as in other countries around the world, the relative share of electronic means of payment in retail transactions has increased. Among these, payment cards (credit and debit) show the highest growth. That is good in terms of efficiency, as there is solid empirical evidence that replacing payment in cash and checks with electronic payments reduces transaction costs significantly. Given that preserving the population’s confidence in the currency and in the payments system is a major concern, payment cards have deserved the attention of the central banks and other authorities in many countries, including Brazil.

The United States is dealing with a specific issue. The measures approved by President Obama focus on the credit function of the cards, i.e., the part that is financed (after the grace period, during which the card holder pays no interest); this part has a bearing on consumers’ decisions about indebtedness.

In the case of Brazil, back in 2006 the Central Bank signed an agreement of technical cooperation with the SDE (Office of Economic Law) of the Ministry of
Justice and with the SEAE (Office of Economic Surveillance) of the Ministry of Finance aimed at coordinating actions to enhance the efficiency of the payment cards industry. This led to the above-mentioned study, which was conducted by the three authorities. The conclusions address the payment (rather than the credit) function of the cards. This highly technical study identified as the main problems related to the card industry: (1) evidence of market power; (2) barriers to entry that prevent competition; (3) lack of transparency regarding type and amounts of fees and interest rates charged; and (4) evidence that the rule prohibiting the business owner from charging different prices according to the method of payment distorts the market and harms the consumer, reducing his bargaining power. Our intention is to continue our efforts to promote better functioning of this activity.

During your tenure as governor of the Central Bank, Brazil managed to settle its foreign debt and today is a creditor of the International Monetary Fund (IMF). The IMF has established a flexible credit line, which Mexico, Poland, and Colombia have already signed up for. What is your view on the changes in the IMF and other international financial institutions in the aftermath of the crisis? I see as very positive the new Flexible Credit Line (FCL), which was created by the Fund for countries with sound economic fundamentals. It is a credit mechanism without conditionalities, and with rapid approval, for economies facing momentary liquidity problems brought about by external rather than by domestic factors. Fortunately, Brazil has more than US$200 billion in reserves and does not plan to apply for that — or any other — IMF credit line.

In addition to its role of surveillance, the IMF should now play a more decisive role in the development of crisis prevention and early warning tools. The key feature that has made fighting the present financial crisis difficult is the fact that, for decades, the IMF concentrated on preventing crises solely in emerging markets, apparently because of the assumption that advanced economies followed best practices in the management of their domestic financial systems. Things now have changed. What the IMF needs to do now is to be active in all important economies and to develop instruments to detect and prevent crises like the current one, including the need to take full account of the interdependencies and cross-border transactions of the global economy.

In 2002 you were elected to be federal representative for the state of Goiás with an impressive vote count. Do you still conceive the idea of running for a political office? Rumors say that you would like to be governor of Goiás.

At the moment, I am totally concentrated on my work at the Central Bank. My priority is to work to help Brazil out of the crisis as swiftly as possible. There will be plenty of time to think about the future later.