

## **Henrique de Campos Meirelles: Inauguration speech**

Inauguration speech delivered by Mr Henrique de Campos Meirelles, Governor of the Central Bank of Brazil, at the Ministry of Finance in Brasilia on 7 January 2003.

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I am honored to take up this position that requires permanent and rigorous defense of the currency.

In these past elections, society expressed its legitimate wishes. We all want high economic growth, low inflation, a stable exchange rate, high levels of international reserves, a low external deficit, low interest rates, abundant credit, and a fair distribution of income. These are certainly goals of both the government and society at large. The ultimate target of any policy is economic growth and social welfare. Among the several government entities and institutions that seek to fulfill society's wishes and achieve the government's targets, the task assigned to the Central Bank is to maintain a low level of inflation.

The outgoing government chose price stability as a priority target, or at least that is what was perceived by society. There were several consequences of this choice, among which we highlight the extraordinary public attention drawn to Central Bank's role. We will work to keep price stability as a centerpiece of the Brazilian economic landscape, and we will work with resoluteness and long term horizons.

President Luis Inácio Lula da Silva's government has clearly stated its objectives of economic growth and social inclusion. Many misunderstood this as a precipitously abandonment of monetary discipline and fiscal austerity. This analysis contains an important misperception. Stability is not an end to itself. It is a necessary condition for growth and social justice.

An environment of stable prices establishes a necessary condition for output growth by reducing uncertainties and distortions, lengthening decision-making horizons and allowing for an increase in investments and productivity gains.

There is no dichotomy between price stability and economic growth, as stability paves the road for growth. Price stability allows the country to plan government actions. Moreover, it should be made clear that there is no such thing as a choice of higher sustainable growth with higher inflation. No country in the world has experienced prolonged periods of economic growth with high rates of inflation. Nonetheless, examples abound of short periods of growth driven by mistaken policies, usually inflationary, which were followed by recession and stagnation that lasted for much longer periods. The Central Bank's goal is, therefore, to contribute to economic growth by maintaining price stability.

In the long run, higher productivity is the element that underpins economic growth. To achieve higher productivity growth, it is essential to increase the public sector's savings rate, thereby allowing society to invest in production as opposed to primarily financing the public sector.

Aside from its effect on output growth, a permanent reduction in inflation inherently and unmistakably brings about a reduction in poverty, with the consequent social inclusion, in addition to sowing the seeds for reducing inequality.

This government is committed to price stability, the inflation targeting framework, fiscal austerity, a realistic economic policy, and a quest for management excellence. My level of comfort has increased with every meeting in which I have participated, with every speech and the first decisions made by Minister Palocci, as well as by our friends at the other Ministries and by the President of the Republic.

In regard to the autonomy of the Central Bank, I would like to emphasize that this is a proposal of the government, and not the Central Bank. This issue was not part of the discussions I had when I was invited by President Lula and Minister Palocci to take this position. The Central Bank's autonomy as proposed by Minister Palocci aims at institutionalizing the Central Bank's role as a guardian of the currency and signals Brazil's permanent commitment to price stability. The modern central banks in the world count on clear rules in regard to their roles, composition and renewal of the board of directors. In this context of the transition to a new Central Bank law, it was important to count on the contribution of the entire board of directors of the Brazilian Central Bank, so as to avoid problems in the conduct of their actions. This is the case of the inflation targets that are defined by the government.

This government is entirely committed to Democracy, to the federal Constitution, and to the Codes of Law. We will honor the laws of the nation and our international agreements. There will be no imprudent adventures.

The social and political choices will be carried out within the federal budget, with a review in priorities and a quest for excellence in management of the resources.

I am positive of this evaluation. As the head of a financial institution for 28 years, of which 12 were served as President in Brazil, I have carefully followed the President's and his party's trajectory since 1989, when I first met with the President and his team. I had many chances to interact with the Party, including in successful partnerships in the social area. This allowed for increasing comfort with the personal relationship. In summary, President Lula and I started from different points of view but Brazil brought us close together.

On the other hand, within my duties in the administration of a Global Corporation I was the person with ultimate responsibility for the Bank's investments and those of its clients in all countries in which we operated. Under these responsibilities, it was required that we track the evolution of the governments and economic policies of some 30 countries around the world. I saw amazing examples of success and of failure. I can assure you that my experience allows me to be confident in what I see from President Lula's government. Brazil is on the right track.

It is important to note, however, that the main focus of an investment policy evaluation rests in the model of the Central Bank's actions. Having been responsible for the areas of Capital Markets, Currency, Operations Desks, and Corporate and Sovereign Credits, I am confident in concluding that there is a consensus in the world today that the Central Banks that have been assigned a multiplicity of functions and targets are doomed to fail. Successful Central Banks are those that have price stability as their only mandate.

In this regard, I would like to emphasize that competence, seriousness and patriotism are a legacy of Arminio Fraga's administration at the Central Bank. There is no doubt that the implementation of a floating exchange rate regime and of the inflation targeting regime in Brazil at a critical moment for the Brazilian economy in 1999 are a hallmark in the history of Central Banks in emerging economies. The substantial improvement in transparency and credibility that has taken place over the past three years has been incorporated into the working structure of the Brazilian Central Bank. Arminio, thank you for the loyalty and professionalism you showed in the transition process.

Although there are many instruments a government can use to implement its economic policy, the task assigned to the Central Bank is to keep the rate of inflation at a low level, mostly because the Central Bank has only one instrument, which is monetary policy.

Even with only one goal and with only one instrument, in theory Central Bank actions can be organized in different ways. For a long time in the past, monetary policy was conducted through the control of monetary aggregates. This practice, however, proved to be increasingly inefficient as economic systems designed new substitutive mechanisms to create money that had not been supplied by the monetary authority. With advances in information technology and its effects on the productive processes of commercialization and of consumption, this element of endogenous money creation made control of money ineffective, which in turn led Central Bankers to abandon the use of targets for monetary aggregates. It is important to highlight that this does not mean that the evolution of the monetary aggregates will be watched or treated carelessly. They are still closely monitored, but they have ceased to be the policy variable.

Another choice available to the Central Bank is to conduct monetary policy through the control of the exchange rate, which implies that the focus of the monetary authority is aimed at managing the exchange rate's trajectory. This option has been also abandoned due to its high costs and to its limited effectiveness when the economy goes through significant changes and shocks.

The option that has proven to be most efficient to conduct monetary policy is the inflation targeting regime. This system has explicit targets for the monetary authority, which brings transparency to the targets being pursued and allows for reporting to society the absolute commitment to the control of inflation. It is a system that reduces the monetary authority's discretion, and is especially effective in eliminating the risks of political influence in policy decisions. Many countries have adopted this regime, among the developed economies, these include the United Kingdom, Canada and Sweden; while among emerging economies they include Chile, Thailand and South Africa.

A key purpose of the inflation target regime is to coordinate inflation expectations. That contributes to fulfilling the targets and once the targets are achieved, credibility is enhanced. Therefore, it is essential that we work towards preserving this credibility, eliminating any doubt as to the commitment to fight inflation. It is important to highlight that this fight against inflation should be carried out with no artificial measures, as the effectiveness of such measures is temporary, and they introduce short and long-term distortions in the economy.

An ally in the inflation targeting regime is the floating exchange rate regime. In our country, where there is still dependence on foreign capital, this regime is adequate, as it directly absorbs part of external shocks. The exchange rate in this regime has as a purpose establishing equilibrium in the balance of payments. Its flexibility helps ensure that the demand for foreign currency will equal the supply without draining the Central Bank's international reserves.

The inflation targeting regime helps to buffer the shocks hitting the economy. The flexibility of this system facilitates the absorption of these shocks, while transparency in the rules allied with explicit targets reinforce credibility in the fight against inflation.

Last year, due to a confidence crisis and doubts on the Brazilian public debt and the Brazilian economy the exchange rate depreciated strongly and, as a result, we have observed an increase in the current inflation rate and a contamination of future inflation expectations. The conduct of monetary policy will have as strategic priority the avoidance of this transitory hike in inflation being perceived as permanent. We will fight, unrelentlessly, against the expectation of an increase in the level of inflation and the indexation of the economy.

The goal is to bring inflation back to the trajectory defined in the targets already set by the National Monetary Council (CMN). The Central Bank will pursue a path of convergence to the already defined inflation targets, taking into account that this convergence will not occur instantaneously. It is a common practice among Central Banks in the world to dilute the convergence of inflation to the targets over a period longer than a year. This is particularly important when an inflationary bubble arises due to a supply shock, as has been the case in Brazil. Therefore, we will proceed by aiming at an inflation rate that takes into account the inertia inherited from inflation in 2002, and the supply shocks stemming from the increase in administered and monitored prices in 2003.

Therefore, monetary policy will maintain the goal of ensuring that inflation will return to its target path within a time period that does not result in unnecessary costs to the economy. Transparency in the process is essential.

At this juncture, the transparency of the process is fundamental through the detailed explanations of the actions and of the context in which the decisions were taken. Following the purposes of the inflation-targeting regime, the timely release of the Monetary Policy Committee minutes provides the public with the Committee's view on the economy and its prospects, providing the rationale for the policy adopted by the Copom. (At the same time, contact with analysts from several segments of the public was enhanced by the creation, especially for this purpose, of an Institutional Communications Group, which allows a more efficient two-way communication through the use of surveys of expectations and other specific research.)

The production of reports and the release of studies and research is also fundamental aiming at increasing the transparency of the Bank's activities to the public. In addition to the monthly bulletins and annual reports, other key reports are the Inflation Report, which deals with the inflation-targeting framework, the Financial Stability Report, which deals with the stability of the Brazilian Financial System, the Banking Economics and Credit Report, development of the Interest Rates and Banking Spread Project, the Working Papers Series and the Technical Notes Series of the Central Bank.

Thus, the Central Bank will emphasize not only the improvement of statistics and models, but also its transparency and communication. For instance, the increase of information and data available to the public on the Central Bank website has been outstanding. More than eight thousand statistical series are already available, with increasingly easy access.

In accordance with the goal of stability and its role as guardian of the currency, the CB has as a permanent objective the maintenance of a sound financial system. The quest for excellence in supervisory standards, in line with the best international practices, is a permanent challenge for the CB.

In this respect, it is important that the modernization process be sped up in the supervision and regulation areas, with the aim of solidifying the Country's position in risk management and the

prevention of banking crises. There are many examples of severe financial system crises in emerging countries which led to significant losses of income and production, with disastrous impacts on society. Brazil may face challenges but will work to avoid crises. Banking supervision and the set of prudential rules play a major role in this process.

In the short run, important challenges include the improvement of methods to evaluate the quality of financial system information, and the implementation of the new Credit Risk Center, which aims at enhancing the effectiveness of off-site supervision. In the long run, we will seek to enhance supervisory transparency and the implementation of the new Basel capital accord, without forgetting the issues related to supervisory autonomy and legal protection for supervisors.

I am committed to maintaining rigorous supervision procedures, because this is the only way to assure the stability of the system. But it is also important for inspections to have a beginning, a development and an end. To sum up, supervision is something that must work based on a regime of verification, analysis and conclusion.

It is important to highlight the intensity and deepness of government-owned banks supervision, which brought us the knowledge of their existing problems and the costs involved in their recovery.

Significant restructuring has been carried out in federal banks, after deep and comprehensive general consolidated inspections done by the CB. The adjustments that were made aimed at making the government-owned financial institutions sounder, more efficient and more competitive, rendering them apt to meet the same requirements faced by the private financial system.

The maintenance of this behavior will reveal the true costs of governmental programs and will avoid recursive expenditures, which could become skeletons (hidden liabilities) in the public accounts.

The continuation of reforms is important in other areas of the CB. In the external area, the CB must aim at intensifying transparency and communication with the markets and investors, while seeking to increase flexibility and to simplify the regulations on foreign currency operations, within a process intended to increase the country's participation in world trade and international financial markets.

In the banking area, the restructuring of the Brazilian Payment System improved risk reallocation, and favored a higher efficiency of the system. This is due to the fact that the Central Bank no longer has any role in financing the institutions that did not have the necessary funds for their operations, reducing moral hazard. Moreover, there must be additional efforts to induce the entities in charge of clearing and settlement services to become more effective, as well as to popularize the use of electronic payment instruments, which will gradually reduce the use of paper instruments.

The area of financial system regulation and organization will increasingly be focused on the following aspects:

- improvement of prudential rules and practices, aiming at maintaining the soundness of the financial system as a whole;
- improvement of the analysis of several authorization processes related to financial institutions and alike;
- creation and improvement of financial instruments and activities, including those intended to broaden and cheapen credit;
- adoption of international standards and practices. Additionally, it is a priority to improve the regulation of mechanisms that broaden the population's access to the financial system, as in the case of "banking correspondents," credit cooperatives, and credit concessions to small and micro firms.

I would also like to acknowledge the employees of the Central Bank for their competence, "esprit de corps" and qualification. I have a human resources goal of qualifying and offering even more opportunities for this outstanding group of public servants.

I thank President Luis Inácio Lula da Silva and Minister Palocci for their confidence in myself.

Lastly, I would like to emphasize that the most effective and lasting way to ensure a more stable and prosperous future, with lower interest rates for both private investment and public sector financing, is a clear commitment to fiscal and monetary responsibility and progress in micro and macroeconomic reforms. The attainment of stability is a permanent and complex challenge, but it will be accomplished, as long as there is consistency in economic policies over time.

In Brazil, we have experienced periods of high inflation, periods of high interest rates, and both, with deleterious consequences for society. An important factor in this scenario has been the low quality of the public sector accounts and credit. We must create conditions to keep both low inflation and interest rates, at the same time. But this is not a matter of Central Bank's desire. The Central Bank's role is to set the necessary and sufficient interest rate so that the inflation target is achieved. This is what we will do.

A fiscal surplus, which unmistakably guarantees the stability of the public debt, associated with the social security reform, as a first step, and of tax reform, in a second round, together with the Monetary Responsibility Law, are the most direct way to reduce country risk and interest rates. Minister Palloci's speech in this auditorium clarifies this matter.

These actions and measures must be complemented by microeconomic measures, such as the proposals to reduce banking spreads, the new bankruptcy law, aiming at cheapening and increasing credit, which also includes the micro credit project, together with the credit dissemination through cooperatives, the deepening of the capital markets, of the funding mechanisms and of the on-lending of domestic and external resources to foster investment.

I publicly assume the commitment of working at the limit of my possibilities, to make feasible investments, economic growth, employment creation and the inclusion of millions of people excluded from the formal economy. Price stability is a necessary condition for these achievements of the Brazilian people. Thank you very much.