

## **Mr Lopes' speech before the Economic Affairs Commission of the Federal Senate**

Summary of a speech by the new President of the Central Bank of Brazil, Mr Francisco Lopes, before the Economic Affairs Commission of the Federal Senate in Brasilia on 26/1/99. Translated from *Jornal do Brasil* of 27/1/99.

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### *Inflation*

I am sure inflation will not come back. Of course, there will be some adjustment in relative prices but there is no possibility of resuming the old inflationary process. We will have to put in place tight monetary policy and prevent any forms of indexation, opportunism or speculation. As the Brazilian economy is relatively closed - imports correspond to 8% of GDP - a devaluation of 50%, (i.e. the exchange rate stabilising at the very depreciated level of R\$ 1.80), would add about 4 to 5% to the rate of inflation.

### *Overvaluation of the real*

The use of the exchange rate anchor made an exchange rate overvaluation inevitable. Nevertheless we had imagined it would be possible to shift from the mini-band regime to the free floating regime in a rather gradual way, while the economy was still attracting foreign capital. But reality sometimes frustrates the best intentions. With the benefit of hindsight (after the Asian and Russian crises), the widening of the exchange rate band in April last year, which widened the amplitude of the exchange rate fluctuation by 1% per year, was a rather timid movement. But it is easy to be wise after the event.

### *Wider exchange rate band*

The attempt to shift from the mini band to the wider band lasted for 48 hours. We knew that it had limited chances of success. Within four days we had lost almost US\$ 6 billion in international reserves. And the free floating exchange rate regime, supported by a solid fiscal stance, has become our new objective. The idea of widening the band under the model designed and issued as of January 13<sup>th</sup> was good, but unfortunately it came too late.

### *Centralisation of Foreign Exchange Transactions*

Suggestions about centralising exchange market operations shock me. Because centralising exchange market transactions in the central bank amounts to having no foreign exchange regime, it leads the country to the moratorium, with the re-negotiation of debts. Credit lines to Brazil would be cut. It means violating the rules of the game. It would be a completely arbitrary act which would have terrible consequences.

### *Economic Growth*

The first semester of this year will be hard. But I believe that from next year we will achieve high rates of growth - maybe spectacular rates of growth.

### *Interest rates*

Interest rates will be kept high at first, but not for a long time.

### *Dollarisation*

I do not see any case for dollarisation in Brazil. It is a little bit strange for a country to be without its own currency. There will come the day when the adoption of a single currency within the MERCOSUR will be taken into account by its member countries. But then a common currency

of the region, not the dollar, will be agreed upon and the first step in this direction is to have a strong real.

### *Responsibility*

I have been in the government since the beginning of 1995. I feel myself responsible for what has been done during this whole period. Pedro Malan has a key role in the government. Few Brazilians have his international credentials. He has good relations with men that make this world of international finance. His continued presence is essential to consolidate this transition period. But we should care about *policies* rather than *names*. Malan and I are carrying out a mission.

### *Devaluation of the real*

No economy in the world could sustain a devaluation in real terms of 40%. The difficulty in maintaining a devaluation of that magnitude is that inflation would resume. The exchange rate has overshot, but it will come back, appreciating as time elapses.

### *Currency Board*

I would like to stress my opposition to the idea of adopting a currency board in Brazil. This subject has already been examined and the government has decided against it. The Brazilian economy is not dollarised and I believe it would be a disastrous policy option. Brazil tried a similar regime in 1906. Nowadays, money supply in the expanded concept (M4) comes to R\$450 billion, while international reserves reach US\$ 36 billion. To implement this regime we would have to dollarise and lengthen the maturity of these deposits. This government is definitely committed to avoid such measures.

### *Future*

The devaluation of the real will improve the fiscal balance, as it will permit interest rates to fall in the future. Foreign investors will return, sustaining economic growth. My optimism is not foolish. The next six months will be very hard. I am optimistic on what will take place after that.

### *Unemployment*

I believe that the unemployment rate has to do more with the overvalued exchange rate than with the level of economic activity. Enterprises were being crushed.