Brazil and the international crisis

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In order to assess the probable impacts of the international crisis on the Brazilian economy today, it is worth recalling our reaction to the 2008 crisis.[2] On that occasion the main channel of transmission of the international crisis was the international credit crunch. Domestic financial fragilities amplified the recessive impact of the credit contraction: large companies that were leveraged using foreign currency derivatives, negotiated in the OTC market with large banks, suffered heavy losses. Despite the underlying health of the Brazilian financial system, small and medium-sized banks, and even one large bank, encountered great financial difficulties due to the severe contraction of liquidity. Various ways of freeing up liquidity were used: releasing reserve requirements, encouraging larger banks to purchase the portfolios of smaller ones with liquidity problems, improving and lengthening the rediscount window loans, and finally creating insurance for bank CDs of up to R$ 20 million, the DPGE (Time Deposit with Special Guarantee), guaranteed by the FGC (Credit Guarantee Fund). Liquidity in US$ was also provided by the CB (Central Bank) through ingenious ways. The final result was deemed satisfactory, with the domestic financial system escaping serious damage, notwithstanding the severity of the crisis.

Regarding the macro-economic policy mix, there is less agreement on the appropriateness of government actions. Graph 1 shows four series: the Selic rate, accumulated inflation in the last 12 months (IPCA), forecast of inflation for the next 12 months (IPCA) and the industrial production index (scale on the right). On the eve of the outbreak of the 2008 crisis, with both past and forecast inflation above the target (4.5%), the CB had been raising the Selic rate that stood at 13.75%. The CB is criticized by many for supposedly making the mistake of keeping the Selic rate unchanged during the last quarter of 2008, despite the collapse of the level of activity. However, one should remember that the exchange rate rose significantly: the real suffered a 62% devaluation against the dollar between August and December 2008. The relatively subdued inflationary impact of the currency's devaluation was due to the fact that the price of commodities, in dollar terms, collapsed, which is not currently the case, as can be observed from Graph 2. It is noteworthy that, even with the level of activity's sharp decline, both forecast and actual inflation fell only slightly, hovering around the inflation target (4.5%), thus showing that the CB was fulfilling its inflation targeting mandate.

The standard international reaction to the crisis was to resort to fiscal expansion only when monetary expansion had already run its course, with interest rates close to zero. Thus, various countries reduced interest rates significantly, whereas the CB cut the Selic rate to only 8.75%. This occurred because fiscal and parafiscal (the expansion of subsidized credit via public banks, especially the BNDES) policies were quickly and vigorously expanded, limiting the CB's ability to reduce rates further without putting

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[2] In a study undertaken for ANBIMA, available at http://www.anbima.com.br/mostra.aspx/?id=1000001381, I review the reasons for the resilience shown by the Brazilian economy during the 2008 crisis.

the control of inflation at risk. It would have been better to engage in a looser monetary policy rather than fiscal expansion, because the former acts much faster and in a more homogeneous fashion, affecting all economic agents. Not to mention that with lower interest rates, the real exchange rate would be less appreciated, thereby helping to stimulate the economy. One may debate forever who was to blame for the wrong mix of macro-economic policies used to combat the last crisis – the Finance Ministry or the CB. However, this now belongs to economic history.

In the reaction to the current crisis, the CB has already decided to lower interest rates, in the belief that fiscal and parafiscal policies will not be expansionist as they were during the past crisis. Indeed, the minutes of the last (161st) COPOM (Monetary Policy Committee) meeting and recent interviews given by its chairman make it clear that the CB is determined to follow a very different path from the one chosen in its reaction to the 2008 crisis, emphasizing the impacts of the world crisis on inflation. The scenario that seems to be guiding the COPOM's decision is based on a computer model and assumes the existence of an external crisis with have a smaller impact on the Brazilian economy (1/4 of 2008's impact), albeit with a longer duration (does not specify the period). The minutes (paragraph 18) say that, in this scenario "*... domestic economic activity decelerates and, despite the occurrence of a devaluation of the exchange rate and a reduction in the basic interest rate, the rate of inflation will be lower than would be the case if the above-mentioned effect of the economic crisis were not considered"* This is in effect a new model whose reliability will still have to be tested over time. The reaction of private-sector analysts who also use econometric models seems to indicate that unless the external crisis is indeed extremely serious, leading to significant reductions in the price of commodities that enter into the composition of our inflation index (especially foodstuffs, see Graph 2), inflation's convergence to the target (4.5%) in 2012 will be seriously threatened.

There are other threats that are also mentioned in the minutes. Wage increases exceeding productivity gains is one of them. The increase in the minimum wage in January 2012, which will be in the region of 14%, is an element that will make it very difficult to contain wage increases in negotiated settlements. With a heated labor market, it is highly unlikely that the inflation target of 4.5% will serve as a basis for determining wage increases.

Another threat is that fiscal policy will continue to be expansionary. In a precautionary stance, the CB states (paragraph 27) that "*The COPOM reaffirms that the baseline inflation scenario takes into account the materialization of the trajectories assumed for fiscal variables".* Regarding the expansion of subsidized credit via public banks, it also emphasizes (paragraph 28) that *"... considers that it is appropriate to introduce initiatives that moderate the granting of subsidies through credit operations",* although it makes no mention of the importance of moderating the total volume of credit via public banks and not just the subsidies.

Unfortunately, there is very little evidence that the government will indeed significantly alter fiscal and parafiscal policies. Even though Brazil's fiscal situation is comfortable in the short term, there are various short and medium-term threats that the country should be addressing, starting with the social security deficit.

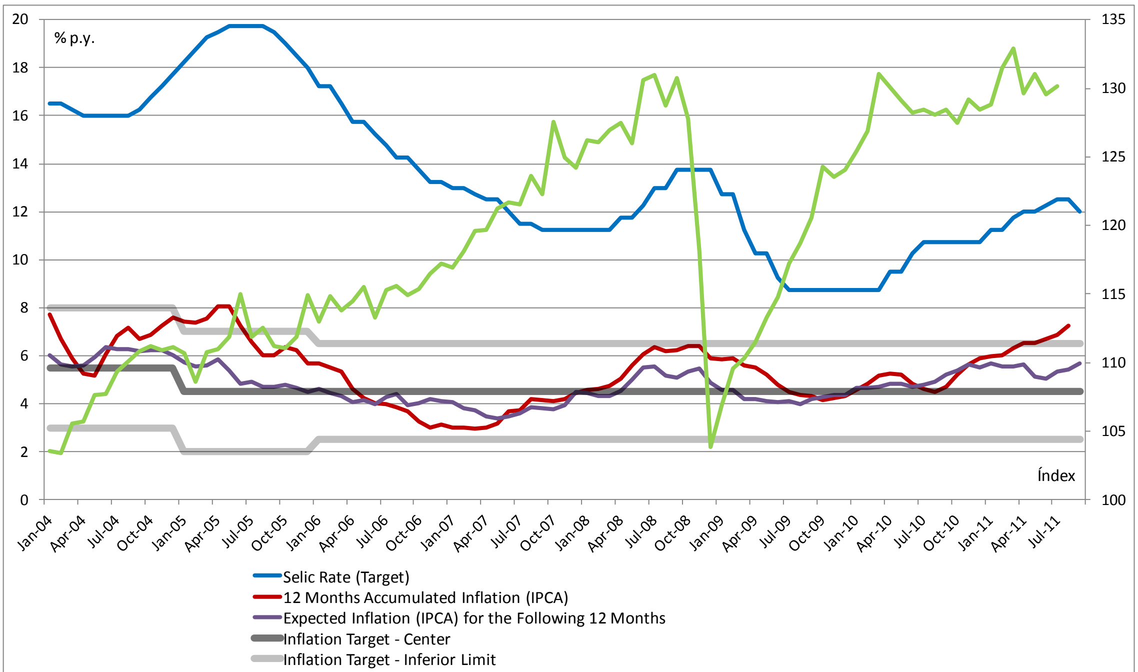
In sum, the CB took the decision to cut the Selic rate based on a international scenario of a much deeper and longer crisis, the cooling off of wage demands in the context of a heated labor market and the hope that the government will reverse its expansionary fiscal and parafiscal policies. Will it work? Maybe, and we are rooting for this outcome. However, good monetary policy technique does not recommend that central banks take such risky decisions. Given that the decision to reduce the Selic, which will continue at the next COPOM meetings, has already been taken, the only course of action we have left is to make sure that the government fulfill its part by tightening fiscal policy.

It is important to discuss the issue of the CB's credibility. As we all know, monetary policy's success lies fundamentally in economic agents' belief that the CB will keep inflation close to its target. This credibility has been affected because doubts have begun to appear regarding the COPOM's autonomy in setting interest rates. This impression may in fact be false, but it exists. And this has a negative effect on the CB's credibility and thus on the power of monetary policy. In order to avoid an even greater loss of credibility it will be necessary – if the hypotheses contained in the COPOM's minutes are not confirmed and inflation in coming months does not converge to the target – for the CB to reverse the decline in the Selic rate.

As for the exchange rate, its future trajectory will depend, as regards external influences, on the development of the international crisis and its impacts on international credit, level of activity and commodity prices, as well as, domestically, on the monetary and fiscal policies management. A sharp devaluation, like the one that occurred during the 2008 crisis, is unlikely, given that there is no evidence that companies are once again speculating using currency derivatives. However, the BRL's recent and rapid devaluation has changed the focus of concern, bringing its inflationary impact to the forefront.

In sum, these are time of enormous uncertainty in the developed economies with very deep repercussions that go far beyond the bounds of the economic sphere. Our economy will be negatively affected, even though Brazil's relative situation is good. The CB's reaction to the crisis, by reducing interest rates, has increased inflationary risks. More than ever the Brazilian economy's future growth lies in containing fiscal expansion, as well as the structural reforms that must be discussed once again by civil society and Congress.

Graph 1: The CB's reaction to crises



Source: Brazilian Central Bank

Graph 2: Commodity price index (US$)

Source: Bloomberg