Brazil, failing to turn the corner…

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In an article last year for *Foco, Economia e Negocios*, I suggested that Brazil might be getting very close to missing its best opportunity ever to "turn the corner," which I defined as the capability to issue treasury bonds in Reais at fixed interest rates of no more than 10% per annum for tenures of at least 10 years. I argued this through comparison with four other relatively favorable moments— in terms of political and economic tranquility—of the last 100 years, namely:

(i) The late 1920's: a period marked by robust economic growth with consistent trade surpluses (while dependent on coffee exports) and consolidation of a democratic political regime, just prior to the Great Depression and, for Brazil, a balance of payments crisis only to be overcome towards the end of World War II;

(ii) The late 1970's: a time of even stronger economic growth with trade surpluses (while too exposed to oil imports) and with inflation ("stabilized" via indexation) at 40% per year, just prior to the Iran crisis which triggered a sharp escalation of oil prices and interest rates globally and, for Brazil, another balance of payments crisis only to be overcome in the early 1990's with the Brady Plan;

(ii) 1996-1997: almost two years of solid economic growth with low inflation (under 6%/annum), with the effects of the Mexican crisis, which erupted soon after the introduction of the Real in July 1994, overcome. However, the country still carried significant foreign indebtedness and incurred trade and fiscal deficits. This was just prior to the Asian (mid-1997) and Russian (late 1998) crises and, another balance of payments crisis for Brazil, which this time was more readily supplanted by the combination of a maxi-devaluation (January 1999) and adherence to a macroeconomic regime (still in effect) combining a floating exchange rate, a target inflation rate and a target primary fiscal surplus;

(iv) The first semester of 2002: a period of solid trade surplus (around 2% of GDP), inflation under control (at 8% per annum), a base (SELIC) interest rate at 16% (and expected to decline), and a relatively stable exchange rate (at R$ 2.2 per U.S. dollar). Global financial markets, however, had one eye on the deterioration of the situation in Argentina (evolving from a sovereign default to an increasingly likely debt repudiation) and the other on the delicate political transition to occur in Brazil. Growing concerns about the possibility of a significant departure by a new government from the macroeconomic policy in place caused a major confidence crisis and, beginning in June, a substantial reversal of capital flows. This time even short term trade finance lines were cut by international banks. Within five months the Real had suffered an 80% devaluation (from R$ 2.2/US$ in May to R$ 3.9/US$ in October), the base interest rate had to be hiked back up to 25%, and growth prospects, at least temporarily, compromised.

By mid-2007 the world was experiencing its sixth year of solid economic growth, in good measure due to strong and continued demand for consumption in the U.S. and increased supply of consumer goods at relatively stable prices by developing economies (led by China and India). For Brazil, this meant significantly better prices for export commodities and consistently higher trade surpluses month after month, allowing for a solid path towards the zeroing of the country's net foreign indebtedness. It also implied that 2007 could turn out to be the second year of GDP growth in excess of 4% for the country in this millennium and led to projections, by Wall Street and Brazilian banks, of sustained and robust economic growth with continued gradual reduction of interest rates in Reais. But net public sector indebtedness remained too high (over 40% of GDP) for its carrying cost (8% in real terms) and aggregate investment remained too low (20% of GDP).

My fear for the medium term was that Brazil's slow march towards "turning the corner" could be interrupted by a global economic slowdown to be caused by higher interest rates in the U.S. (inflationary pressures were then already evident) and reduction of the rhythm and increased costs of production in China (due to lower global demand plus increasing environmental pressures). But the crisis— the so-called subprime meltdown— came sooner, as a result of the rupture of the U.S. real estate price bubble which had been fostered for so long by a lax U.S. monetary policy, particularly between December 2001 and November 2004, during which period the Fed funds rate was maintained below 2% per annum, actually 1% between July 2003 and July 2004.

Very low interest rates in a society so much in love with leverage led to explosive growth in the demand for credit (against "perceived" wealth) by individuals and in the supply of credit (based on over optimistic risk modeling) by banks. Real estate prices, which had gone up on average some 3% per annum between 1990 and 2000, went up on average around 9% per annum between 2000 and 2006 (over 10% per annum after 2004). Subprime lending, defined as 100% mortgage financings at subsidized adjustable rates in the early years (to be reset later), became increasingly popular. Capital markets creativity, lax regulatory supervision, less than adequate credit ratings and generalized greed conspired to bring about additional levels of poorly priced financial instruments.

At its roots, the subprime meltdown crisis was not very different from other financial crises we have seen around the world. Rather, it can be seen as history repeating itself: the perception of sustained economic stability and growth leading to excessive optimism by lenders and borrowers, an economic slowdown, severe balance sheet problems for banks, the risk of a major recession, and a government sponsored bailout of the financial sector. What made this crisis unique— and particularly dangerous—is that it was nurtured over a long period of time in the country with the largest economy, the most creative financial market and the world's most credible and widely accepted currency.

Competent people in government and in the private sector now acknowledge that risks incurred were much higher than risks measured. Lessons apparently have been learned and, in due time, a revised global regulatory framework should emerge to impose greater transparency by stricter supervision of, and higher capital requirements for, financial institutions according to the specific risks they take. But the losses of private sector financial institutions have been colossal and the support required from the government, provided initially by the Fed (through overall liquidity support and collateralized lending to banks and investment banks), has been massive and continuous; and explicitly by the U.S. Treasury with the nationalizations of Fannie Mae and Freddie Mac (US$ 100 billion for each in credit facilities at 10% interest per annum in exchange for 80% equity stakes) and AIG (US $ 85 billion, also at 10% interest, in exchange for 80% equity stake).

Still, much more was yet to come. On October 3 the U.S. Congress passed the Trouble Asset Relief Program (TARP) legislation. Under TARP Congress authorized the U.S. Treasury to acquire up to US$ 700 billion in primarily but not necessarily mortgage credit risk to help clean the balance sheet of private sector banks in an attempt to restore life to U.S. credit markets. In order to speed up action while seeking to mitigate final cost to taxpayers, the U.S. Treasury was authorized by the TARP legislation to take preferred equity positions in the financial institutions receiving assistance. By October 10, the U.S. Treasury's authorized potential credit exposure to the financial sector bailout stood at approximately US$ 1 trillion, some 7% of the country's GDP.

U.S. low interest rates and recurring large trade and fiscal deficits also stimulated feverish economic activity around the world, allowing for extraordinary trade surpluses, particularly for oil exporting countries and leading emerging market economies.

Credit tightness in the U.S. arising from the subprime meltdown has spilled over internationally, initially having greater impact on the economies with greater linkages to the U.S. financial markets. Central banks around the globe have been forced to act– in many cases, like that of the main European countries, with explicit potential Treasury involvement— to provide assistance to their respective financial systems, including the possibility of governments taking equity stakes in home banks. In an attempt to avert the triggering of a global recession, a joint .5% coordinated interest rate cut was put in effect in early October by the U.S. and leading European central banks and continued cooperation among these central banks to provide liquidity to the market, particularly in U.S. dollars, has been agreed upon.

Which takes us back to Brazil.

Tightening of U.S. dollar funding and reversal of capital flows has caused an immediate and significant devaluation of the Real, from R$1.8/US$ in late September to R$2.3/US$ by October 10. But at this level the Real is simply back to where it was in early 2002, when the global boom was still at its early stages and, as indicated above, the country marched comfortably towards a trade surplus of 2% of GDP. And Brazil, presently a net creditor in US dollars, is today much more protected against the destabilizing effects of capital flight than ever before.

There have been very significant losses in market value of the leading publicly traded

Brazilian banks (on average, approximately 50% in US dollars between January 1 and October 10). But the financial system appears to be in good health. Still fresh in the minds of Brazilian bankers and regulators are the lessons from the banking crisis of 1995 (which led to the PROER and PROES rescue plans, at significant cost to taxpayers) and the capital flight/foreign exchange crisis of 2002, which severed U.S. dollar funding and caused credit and mark-to-market losses to banks but did not require government assistance to the financial system, by then much more robust. Capital requirements, disclosure and provisioning rules imposed by the Central Bank on the Brazilian banks are strict and have been, now for over a decade, very tightly monitored. In addition, most of the country's leading insurance companies and investment banks are controlled by these closely supervised banks. It is, therefore, quite unlikely that a failure by a major financial institution could result. And because monetary policy has been austere, liquidity assistance (particularly to smaller banks, as per the measures announced in October) can be provided without severely compromising inflation targets.

Still, a major economic slowdown seems unavoidable. And, unfortunately, no material qualitative progress has been made by Brazil over the past several years on the structural front. Final design and agreement on fiscal reform (towards taxation of income and/or consumption and not of production), on labor reform (towards reduction of the indirect costs of employment and increased incentive to formal employment) and on social security reform (towards stronger incentives to voluntary savings by workers while preserving acquired rights from past contributions) remain at large. These are conditions precedent for the establishment of an environment where the conjunction of competent fiscal and monetary policies could finally transform heroically pursued primary fiscal surpluses each year into a reliable perspective of a balanced nominal budget for the medium term— the change of gear necessary for the country's turning of the corner.

Only then, with the capability to issue Treasury bonds at fixed nominal rates of no more than 10% in Reais with tenors of at least 10 years, could Brazil finally cease to depend exclusively on the compulsory savings of the National Bank of Development System (BNDES) for the medium term financing in domestic currency of the investment in infrastructure (such as the R$ 15 billion approved in May for hydroelectric power plants in the Rio Madeira), ownership restructurings (such as the R$ 2.5 billion approved last August to finance share purchases among controlling shareholders of Oi Telecom, prior to this company's acquisition of Brasil Telecom), plus all the crucial investment in Reais by Brazilian companies in serious competition against their rivals in China, India and other countries where long term financing in domestic currency at less than 10% per annum exists.

Many percentage points of GDP growth have been left on the table as a result of Brazil's incapacity to complete the set of actions necessary to guarantee long term economic stability. Several precious additional points of GDP will continue to be forever lost if the country accepts the current status quo of "inflation under control" and "acceptable rate of growth given the international crises," instead of seeking maximum economic efficiency with social justice. But, as I suggested in the article for *Foco, Economia e Negocios* over a year ago, reaching this dream requires a degree of conviction and political commitment that the Brazilian society may perceive as important but does not treat as urgent and, as a result, sits watching as it fades into the horizon.

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