Brazil: Back to a more conventional economic cycle?

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ECONOMIST ARMINIO FRAGA NETO knows the nuances of the financial system nationally and internationally, as both market participant and policy maker. After six years in New York managing the investment fund of financier George Soros and serving as vice-president of Salomon Brothers, Fraga headed the Central Bank of Brazil in the second term of President Fernando Henrique Cardoso. He is a founding partner of Gavea Investments, an asset management firm with a net worth of R$13 billion, and chairman of the board of the Stock Exchange, Commodities & Futures of São Paulo (BM&F Bovespa). He points out the need for government to increase investment, especially in infrastructure, calls for more rational and less emotional debate on the reduction of bank spreads, and speaks of the fall of domestic interest rates as a factor to induce growth and alignment between Brazil and the global parameters. “Chile has had a long-term real interest rate of about 2%. Although we are an economy that does not save much, we must go along the same path.

**The Brazilian Economy**—A principal problem Brazil faces today is low economic growth, lower than the other BRICS and even some Latin American countries. Why is this so?

*Arminio Fraga*—It is important to separate long-term growth factors, which are linked to investment, productivity, and education, from cyclical factors. The long-term factors are always present. As for cyclical ones, for the last five years, they have been the result of the American and European crises.

We must also consider that the domestic economic cycle in Brazil has normalized. The economy had been growing above its potential, unemployment had been declining, credit went through a period of accelerated expansion . . . , and inflation went up . . . forcing the central bank to react. Soon after came the global crisis, which led the central bank to reverse its policy, but it had already signaled that we would live a more conventional cycle, partly because Brazil does not yet have the problem of excessive debt seen in most of the world. Regarding 2% growth in 2012, you must be very cautious [reading this number] . . . . How exactly Brazil is growing
on average is always difficult to measure. Perhaps it is around 3.5% or 4%. However, Brazil’s potential growth rate is higher . . . I see with hope the comprehensive debate in this country about growth beyond the cyclical aspect. It underlines the importance of having a more efficient government.

How do you assess the Rousseff administration approach to the efficiency of public management?

President Rousseff has made it clear that this is a priority . . . Of course the government still has to deal with a difficult political environment, a government supported by a party coalition with more than 30 ministries. There is a long way to go in this area, but at least the debate is in the air and is growing.

Another important aspect relates to education . . . Today, for public opinion, education is second only to employment . . . This is a significant change. It also gives hope that families will call for better schools. I have a positive view of Brazil. I know there are many challenges ahead, we are suffering a bit with the current situation—but we should take advantage of the moment and seek solutions.

In a recent report on Brazil, the International Monetary Fund was optimistic about growth but warned of the lack of savings and investment and high household debt. What did you think of the report?

Overall, it seemed well balanced. With regard to investment, it is somewhat natural that in recent years consumption has led domestic demand. There was repressed demand, and access to credit, better income distribution, and poverty reduction played an important role in meeting it. However, the supply side is lacking. This disparity is most visible today almost everywhere in infrastructure: airports, ports, railways, highways, energy, and sewage. It has become a national emergency. The government invests very little because it was designed to transfer income, not to invest, and it has difficulties in mobilizing private capital. . . . In my view, some very positive things are happening in this area, including the fall in interest rates. Currently, the long-term interest rate is about 4.5% a year. That is still high, but well below the 6% or 7% of the not-so-distant past. Another important fact is the change in the government’s attitude about partnerships, granting concessions, and so on.

Brazilian industry has suffered from the crisis. Is this a temporary situation or does it arise from structural changes in industry?

I think it is more structural than cyclical. One part has to do with the so-called Brazil cost, which includes aspects such as taxes and red tape, as well as the infrastructure problems already mentioned. Another part is related to an almost global trend where industry has an ever-smaller weight in GDP.
... But I do not minimize the problem; it is relevant. I think that the answers [for this problem] should be more comprehensive—it is very rare to see a well-based industry response. Usually, what happens is the product of lobbying and ends up being an income transfer: the resources come from somewhere and are finite; benefitting a particular industry means burdening others in some way. There is no magic.

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Do the falling profits of the three largest private banks in the country indicate a risk to the health of the banking system? Overall, our financial system is going well. Brazil, given its history, should never fall into the illusion that a fully free but highly leveraged financial system is good. There is still much discussion about the fact that the banking spread is very high, but this is due to many causes. Some will improve over time, with increasing competition and transparency; others, like the tax on financial transactions, the IOF, depend on the government. The IOF is one of the worst taxes; it is a wedge that affects both savings and investment. Undeniably, the world today has an enormous antipathy toward the financial system. Part of that, in my view, is deserved... there was much folly and irresponsibility, with [financial institutions] leveraging 60, 80, and 100 times their equity. It is therefore natural that the pendulum is going against the banks, but I fear that there is an exaggeration, because the economy needs a healthy and efficient financial system. I support reducing banking spreads, but I think it has to be done comprehensively, without turning banks into villains. We must rigorously examine the real causes of these spreads.

Turning to the international scenario, the crisis in Europe has dragged on for months without signs of a solution. What can we expect? Europe is experiencing a very serious and deep crisis. With the advent of monetary union, which was incomplete, suddenly European nations saw the chance to borrow money very cheaply, which led to a large increase in debt, of not only governments but also businesses, families, and banks. One day the music stopped. Now, these countries have to deal with large debts and very low growth. In the past, if a crisis happened in one of the five economies now in the spotlight, it would generally be resolved by depreciating the exchange rate. ... However, because they no longer have their own currencies, the cost of adjustment is greater... It seems that Greece will restructure its debt again, but it is not yet clear whether it will leave the euro. As to the others, I am sure they would like to stay, even though the lack of a floating exchange rate entails a huge sacrifice and requires administration of political pressure. On the other hand, it is not that simple to deepen the monetary union. Germany and France may not want or may be unable to assume this burden. Other countries have difficulties in making the necessary adjustments and do
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How immune is Brazil to the crisis?

Although Brazil does not have a very open economy, it will certainly be affected. As I stressed earlier, in recent years the country enjoyed a long period of falling unemployment, rising debts, and improving export prices. Export prices may become less favorable. That somewhat reduces our room to maneuver and can last several years, but it is cyclical. Uncomfortable, but it does not kill.