The Brazilian Economy — At the IMF annual meeting in September Managing Director Christine Lagarde said that IMF reserves may not be sufficient to help European countries in crisis. How do you see the IMF situation?

Paulo Nogueira Batista Jr. — It is not clear whether the IMF needs more lending capacity — it depends on the international economy and member country demands. In the Joint Communique issued during the IMF annual meeting in September, the BRICS (Brazil, Russia, India, China, and South Africa) expressed cautious willingness to provide additional resources in a time of crisis when the need is demonstrated, but also expressed concern about the slow pace of reforms to redistribute decision-making power within the institution. Quota and voice reforms in 2008 benefited some emerging countries, including Brazil, and there is agreement for a further review of quotas.
by January 2014. But this issue exposes the imbalance in IMF decision-making power. The BRICS communiqué therefore reinforces the understanding that reforms must continue, so that the IMF becomes more representative of today’s world rather than a world long past in which great powers on both sides of the North Atlantic had much greater relative weight than they have today.

In an interview with *The Brazilian Economy*, former Minister Delfim Netto asserted that the European Economic Community was the victim of a “self-deception” in requiring that no member countries could have fiscal deficits exceeding 3% of GDP or domestic debt greater than 60% of GDP. Were the targets indeed utopian?

Yes. The rigid definition of the targets primarily reflects the thinking of northern Europeans, mainly Germany. These simple rigid rules do not deal with the complexity of reality. Over the past 10 years, even before the current crisis, one of the countries that did not meet these requirements was Germany, pressed by extraordinary circumstances. So if Germany itself violated the targets, the credibility of the system was already compromised.

A key aspect of the European Union project, which has now become much more evident, was a monetary union with a common central bank but without fiscal and policy union. The Germans and other northern Europeans have tried to make up for the lack of union with strict fiscal policy rules. When times were good, the imbalance was not evident, but with the crisis it became very visible. What’s worse, the mistake of the past is repeating itself now, with increased penalties on countries that fail to meet fiscal targets, in much more difficult economic circumstances.

Some economists have argued that if the stronger countries in the euro area do not adopt expansionary fiscal and monetary policies, attempts to rescue the ailing economies will fail, producing a general recession. Do you agree?

I agree in part because the question transcends Europe. In the euro area, expansionary policies were already in use in 2008. In general, after Lehman Brothers collapsed, developed countries, even with IMF support and encouragement, were led to practice countercyclical fiscal and monetary policies to avoid a great depression. It worked then because there was a coordinated effort not only from developed countries but in emerging economies like China and Brazil, which also adopted expansionary fiscal and monetary policies. However, though a major depression may have been averted, the crisis has

*The BRIC communiqué reinforces the understanding that reforms must continue, so that the IMF becomes more representative of today’s world rather than a world long past.*

October 2011 • The Brazilian Economy
The Brazilian Economy

never been fully resolved. Now, with the resurging crisis since mid-2011, developed countries have much less fiscal and monetary ammunition than they had before … today’s fiscal deficits and public debt are much higher in almost all these economies. Monetary policy has been used extensively; basic interest rates are approaching zero in nominal terms and negative in real terms.

I agree with the thesis in that countries that still have some fiscal room, such as Germany and the United States, should adopt expansionary policies, as proposed recently by President Obama, or at least soften contractionary policy, phasing it out over time. As for monetary policy, the European Central Bank (ECB) still has a little more leeway than other central banks issuing currency with international liquidity, such as the Federal Reserve, the Bank of England, and the Bank of Japan, that were already adopting more expansionary monetary policies. But countries that are under market pressure, such as Greece, Ireland, Portugal, Italy, and Spain, have no alternative but to adopt contractionary fiscal policies, despite the risk of recession.

Will the European Financial Stabilization Fund (EFSF) suffice and will it be operational in time to address the debt crisis in the euro area?

I think there is still a strong commitment of the European elites to the design of monetary unification, which is part of the euro. One problem of the euro governance system is that many decisions require the unanimous approval of 17 member country parliaments, which makes the process very slow considering the crisis and the speed of market reaction. Since the EFSF decision was announced on July 21, for almost three months the situation has been changing daily. EFSF resources may no longer be sufficient to address the sovereign debt crisis of some countries, and that will threaten the single currency itself because it overburdens the ECB. The German Minister of Finance has stated that restructuring of Greek private debt may have to be revised because the concessions of creditors were very limited, overburdening Greece and requiring more adjustments by European governments, the ECB, and the IMF. An important issue, too, is how the EFSF will be implemented, whether there will be scope to leverage resources and increase its firepower, because it would be unthinkable to return to parliaments to ask for more resources.

What is the role of Germany in the region’s recovery?

Germany is central due to its economic and political weight. Because the country has great influence, even hegemony, in the ECB, it may favor a more flexible monetary policy. Or Germany could take advantage of its fiscal space and introduce...
It is important that [Brazil’s] policy of cutting interest rates is accompanied by great fiscal discipline.

The Brazilian Economy

It is important that Brazil’s policy of cutting interest rates is accompanied by great fiscal discipline.

In developed countries like the United States and Japan, public debt has shot up and there are structural fiscal problems resulting from aging populations, increasing expenditures on social security and health, and large social security systems. The economic crisis of 2008 thus exacerbated an already problematic situation. The IMF has therefore recommended that countries that still have space and intend to adopt expansionary fiscal policies to avoid recession do so, but while signaling measures they intend to take immediately to reduce their deficits in the medium and long term. If Germany and other northern European countries do not adopt more flexible or moderately expansionary fiscal policies, they might at least consider slowing the pace of fiscal consolidation. But it is likely that, if they do so, they will do it quietly to avoid questions about the consistency of their policies.

Finally, I think that Germany could provide a new direction for the European Union, which could either go back to the adoption of national monetary policies and support for some vulnerable countries, or make substantial progress in fiscal and political harmonization to strengthen the monetary union. The current middle way is highly vulnerable.

It is a very difficult situation because there is little solidarity among European citizens of different countries. I was in Germany just before the euro was adopted and the Germans wanted to retain their own currency. The euro was an initiative of European elites. For Germany, joining the proposal was a strategic decision in order to break the resistance of other countries, especially France, to German reunification.

Is there a real risk of the euro or the European Union collapsing? What would be the consequences for the world?

Yes, there is a risk to the euro. There is a risk that countries heavily affected by the crisis — Greece is the most notorious case — will at some point no longer be interested in the euro. It would be a very difficult decision to return to a national currency, but if the situation is not resolved in a reasonable time, some countries may leave the euro or the project itself may be revised. In my opinion, this is not the most likely outcome. I believe there is still a strong commitment of European elites to monetary unification.

Possible developments are difficult to predict. If something is reasonably planned, there will be one result; if there is collapse and chaos, it will be highly destabilizing. The most recent example I can think of is Argentina, which during the Menem administration had almost a monetary union with the United States. Its exit from dollarization was
extraordinarily difficult but ultimately was conducted effectively. The euro case is different, however, because it is a monetary union on an unprecedented scale.

You usually place the United States at the epicenter of the crisis, along with euro-area countries. But companies and U.S. banks are well-capitalized, and despite the severe fiscal situation, U.S. Treasury bonds still appeal to investors. Is the U.S. in a more comfortable situation than Europe?

Yes, for several reasons. One is that America is a unified country, while the European Union is a collection of sovereign nations. I would say the world stage today is to some extent worse than in 2008, just because the epicenter of the crisis is more in Europe than in America. But the American situation obviously is not easy, because the economy is still more or less stagnant, unemployment is very high, and there is a very sharp political division in the country. Despite long and repeated efforts by President Obama to reach bipartisan agreement, the Republican opposition is determined not to accept it. Many in the opposition reveal an extraordinary hostility to the president, and next year’s presidential campaign has already taken to the streets, affecting economic issues. Similarly, several other major countries have elections ahead, which further reduces the scope for governments to make decisions about the crisis.

We have observed street demonstrations in Greece in protest against IMF austerity measures and the Greek government. The situation resembles what happened in Brazil and other Latin American countries in the 1980s, when the people saw IMF as the “enemy” to be fought. Three decades later, does the IMF still have an image problem?

I think so. There is resistance to IMF measures resulting from the practical consequences of Greece’s situation at this time, as there was in Brazil and other Latin American countries then, which even today remain in the collective memory of some countries. But there is one important difference. In Greece, the adjustment involves a troika: the IMF, the ECB, and European governments. In Latin America, the IMF did not have partners. Sometimes it had the U.S. government, which came in with resources, as in Mexico in 1994. So in Greece, the resistance is not only against the IMF but also against the northern Europeans, who have taken positions even more rigid than the IMF has.

The image problem is quite serious in much of Latin America and in East Asia. There is a stigma attached to resorting to the IMF. In part, it is inevitable; it
is the same stigma that attaches to a financial institution that resorts to a central bank discount window. But there has been change since 2008. Today, the IMF has flexible credit lines, without requiring conditionality, that were created in 2009 largely through Brazil’s influence. Another significant change, besides the review of quotas, is that the IMF has become much more important, having financial resources for lending that are remarkably higher since the crisis. This does not solve the image problem but increases the projection and the responsibility of an institution that was marginalized in 2007 and has now become a kind of right arm of the G-20.

How do you assess the decision of Brazil’s central bank to change direction and signal the start of a policy of cutting the benchmark interest rate? Is the inflation target threatened? Even after the latest cut, Brazil’s basic interest rate is one of the highest among major countries. Weighing into the central bank’s decision was the deterioration of the world economy, although some commentators thought the bank was exaggerating [the deterioration]; what happened later showed that the decision was correct. I think the main concern was not to repeat what happened in 2008, when the Federal Reserve raised interest rates just before Lehman Brothers collapsed and then was slow to cut. But it is important that this policy of cutting interest rates is accompanied by great fiscal discipline. Strictly speaking, that would mean a shift to a more favorable mix of macroeconomic policies: moderate interest rates, slightly more depreciated exchange rates, and stronger fiscal policy. Is the inflation target threatened? Not necessarily. The framework operates over time and should be evaluated on the basis of the calendar year rather than continuously; that gives the central bank space to adjust its policies in light of inflation expectations. In its latest forecast, the IMF estimated Brazil’s inflation at slightly below the target ceiling in 2011 and at its center in 2012 — this is a little more favorable than the median market expectations as measured by the central bank inflation survey. The government and the central bank should always be concerned with monitoring inflation, but, if confirmed by the more difficult international outlook and assuming a tight fiscal policy, there is scope for gradually reducing the benchmark interest rate.

What is your assessment of the Rousseff administration? From a broad political perspective the Rousseff administration is the continuation of the Lula administration, but each has its own characteristics. The second
Lula government itself was different from the first. My expectation is that President Rousseff will carry forward the changes that had already been occurring. Lula had an initial phase of caution from 2002 to 2006, playing defense to win the championship. To the extent that the defense worked and the crisis at the outset of his government was overcome, Lula gained confidence and started to move to the attack, especially in the second term, in terms of both economic and foreign policy. With the appointment of Rousseff as chief of staff and Mantega as minister of finance, the Lula government was reoriented in the direction of development policies without abandoning fiscal and monetary stability. This direction remains in the Rousseff administration, as does Lula’s legacy of promoting the affirmation of Brazil in the world with greater independence and autonomy. To follow this direction, however, we must maintain sound economic policies, with fiscal discipline and inflation control, and also sustain growth.

Brazil is currently quite orthodox, but the world is becoming less orthodox, as often happens in times of great crisis. During one period of world history, the dominant view was that markets regulate themselves and governments should play a secondary economic role. The crisis is changing these concepts. The IMF is no longer the same and the U.S., like the Europeans and the Japanese, also has a different attitude. Brazil is not experiencing a crisis as severe as those countries but does need to grow and continue to reduce social inequality. I believe the Rousseff administration will work in this direction.