The ripple and the tsunami

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After 12 consecutive quarters of GDP growth, the Brazilian economy went down in the third quarter of 2008, catching everyone by surprise: GDP fell by 3.6% compared with the previous quarter. Nevertheless Brazil grew 5.1% in 2008. For 2009, however, the market outlook is not at all encouraging. GDP growth projections for this year are about 0.5%. Some analysts believe even that is optimistic; they do not dismiss the possibility that Brazil will slip back into recession. What are the economic policy options in such a distressing international environment?

Modern macroeconomic models have two fundamental ingredients — shocks and propagation mechanisms. Shocks bring about changes in the behavior of the economy. Propagation mechanisms carry the changes through time and space.

The tsunami-like shock in the US was the financial crisis in the low-income consumer mortgage market, known as subprime. Those mortgages were securitized, packaged in a variety of forms, and sold to all kinds of financial institutions around the world. As the fall in real estate prices pushed the mortgage default rate up, the value of the securities backed by the mortgages plummeted. The financial institutions that held them were then overleveraged, and the stampede out began. The sale of part of these asset portfolios made prices plunge, destroying a substantial part of world financial wealth.

Though the subprime shock was relatively small compared to other events, such as the drop of share prices on the stock market, the excessive leverage brought about a propagation mechanism of enormous proportions. The subprime ripple thus turned into a tsunami. No one was spared. The heart of the market economy, the credit system, which depends critically on the banks’ health, was affected, with no recovery in sight. For 2009 the International Monetary Fund forecasts that world GDP will decline between 0.5% and 1.0%.

Brazil

The American tsunami swept into the Brazilian economy through the shock in the financial markets (see Table). The country risk rating for Brazil jumped from 250 to over 400 points, which means that Brazilian government bonds had to pay 4% more than US public bonds. The real depreciated abruptly against the US dollar; the dollar gained almost 50% against the real between September 2, 2008, and March 2, 2009. The central bank “Selic” basic rate reversed its rising trend and is now lower.
During the March 11th meeting of the monetary policy committee (Copom), the central bank reduced its base rate to 11.5%. Ibovespa, the São Paulo Stock Exchange index, fell from 54,000 points in early September 2008 to 36,000 points in early March this year and has since hovered around 40,000 points. The real interest rate on public bonds indexed to the IPCA price index, which was rising, started to fall late last year. Ultimately it went from 9.1% on September 2, 2008, to 6.4% on March 2, 2009.

The substantial depreciation of the national currency against the dollar caught some nonfinancial enterprises unprepared and caused major losses for businesses that were speculating with the currency. Those exporting businesses should have restricted themselves to protecting themselves against US dollar variations without going into high-risk deals by keeping open positions, either buying or selling, in the term or futures markets for US dollar. Not everyone learned from the mistakes of nonfinancial businesses in other countries that previously speculated in the exchange market and, from not properly pricing the risk, many have as a consequence gone bankrupt.

Some analysts have condemned the central bank for the appreciation of the real before the crisis. Nevertheless, the central bank’s policy of aggressively buying foreign currency to increase international reserves was unable to prevent the appreciation. The interest rate certainly contributed to the appreciation, but it was not decisive. The fiscal policy of increased government spending was a factor. The high level of liquidity in world financial markets before the crisis, and the successful continuation of macroeconomic policies inherited from the Fernando Henrique Cardoso administration made Brazil quite attractive to foreign capital. As it flowed in, the real appreciat-

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The crisis is a good opportunity to correct endemic problems. In Brazil, the bank spread is an anomaly. The old refrain that the central bank was solely responsible for the appreciation before the crisis does not withstand rational analysis.

It is not unusual to find someone in the media claiming that the devaluation of the real was excessive, and that the government should move to set the right price for the currency. But there has always been a foreign exchange crisis whenever the Brazilian government tried to fix the exchange rate. In just the last century, a crisis occurred in every decade after 1950. The current flexible foreign exchange system has shown that the exchange rate absorbs external shocks. The price that must be paid is the high volatility of the exchange rate, with the rate rising beyond (overshooting) or falling below (undershooting) its equilibrium level. These facts have been documented in a number of countries besides Brazil.

If that is the cost, what is the benefit of a flexible exchange rate? With a fixed exchange rate system, Brazil would have had an outflow of reserves that would have forced the central bank to raise the interest rate, which in turn would have worsened the employment and income situation. The flexible exchange rate allows the central bank to lower the interest rate to stimulate employment and income.

With a flexible exchange rate system, does the central bank need to maintain foreign reserves? In the fixed system, it is obliged to keep reserves because it buys and sells the currency at a predefined price. With a flexible system, on the other hand, the price of a foreign currency is determined by the market. In this situation, the central bank should intervene in the foreign exchange market only in two situations: to reduce the volatility of the exchange rate, and to prick a bubble. The first is a trivial task. The second, however, is extremely complex: because the exchange rate is the price of a financial asset, a bubble may occur — but in economic theory there are no tests to detect bubbles.

When the central bank judges that the exchange rate does not reflect the fundamentals that determine the price, it may try to alter the price by carrying out purchase or sale transactions. If that fails, the best option is to let the market follow its course. Does the central bank of Brazil require US$200 billion in international reserves for this type of intervention? Those who advocate this level of reserves argue that, if its coffers were not packed with dollars, Brazil would be in dire straits. Granted, the central bank profited substantially from the rise of the exchange rate because it was carrying out purchase operations with this currency. But there is no need to build up such enormous reserves in a flexible system. The exchange rate can do the job, as has been seen more than once during the current external shock. Leaving aside the eventual capital gains resulting from the external shock, US$200 billion in the central bank, when the borrowing rate is higher than the investment rate, imposes an unnecessary cost on the poor in Brazilian society who do not have a roof over their heads but have dollars to spend.

The international crisis also arrived in Brazil through credit. Traditionally, large Brazilian companies had easy access to foreign credit. When that credit became scarce or even disappeared, the obvious alternative was to seek domestic credit. When they did that, the large companies
crowded out small- and medium-sized enterprises, which are now having difficulties getting working capital. Meanwhile, small- and medium-sized banks began to have difficulties raising capital to finance lending, and the government was called on to come to their rescue before they were forced to close shop. In this environment, many banks became more selective, adopting the natural aversion to risk that is characteristic of sound banking management and putting the brakes on their loan portfolios. The result of increased demand for domestic credit combined with the higher risk perceived by bankers is a wider spread.

**Options**

There are two major differences between Brazil and the US in the current crisis: The Brazilian financial system is sound, and there is room for applying the conventional monetary policy of reducing the interest rate. In the US, salvaging the financial system calls for unconventional measures, and a more effective policy is yet to come. Because the interbank market interest rate in the US, the Fed funds rate, has dropped to practically zero, there is no way it can be reduced further. The Federal Reserve has thus been increasing its monetary base by a variety of means, including purchasing financial assets, whether private or public, to restore the normal functioning of the credit market.

The Brazilian central bank has been the scapegoat for politicians, union leaders, workers — even economists. Some are calling for the heads of the bank’s governor and director. Others consider all its directors incompetent. But how has the central bank actually performed in the Lula administration? Given the regime of inflation targets, the central bank has been assigned a specific objective: to meet the inflation target. The figures show that it has done a fairly good job meeting the targets.

What the central bank can be criticized for is its fine-tuning of monetary policy. Twice in the past, in September 2004 and April 2008, it was forced to interrupt the process of interest rate reduction and revert to a rate increase. If we apply a plane metaphor, the central bank did not manage a soft landing and had to take off again. Otherwise, the inflation target would have been missed. On both occasions, the real interest rates were inconsistent with the inflation target. Those who criticize the central bank claim to be experienced pilots able to land visually regardless of weather conditions. But the social responsibility of those managing monetary policy requires extreme caution; otherwise, instead of landing smoothly, the plane may crash. The experience of those two events illustrates that there are limits to how far the central bank can reduce interest rates. It must leave voluntarism to the critics.

The other option for Brazil is fiscal policy, a portion of which is actually built into the system. When real growth falls, so do tax revenues, and at the same time certain government expenditures, such as unemployment subsidies, increase. The autonomous part of fiscal policy may be managed by increasing public investment in labor-intensive projects. The crisis is a good opportunity to correct endemic problems. In Brazil the bank spread is an anomaly. After almost 15 years of stabilization, nothing has been done to correct the disparity between deposit rates and lending rates. The financial crisis abroad and the shock it brought into our economy clearly underscore the importance of credit in the efficient running of a modern economy.