The BRAZILIAN ECONOMY

Economy, politics and policy issues • APRIL 2009 • vol. 1 • nº 3
FGV Publication of Getulio Vargas Foundation and George Washington University

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IBRE's letter

Bank spreads in Brazil: Not all weapons have been used

Today in Brazil nothing causes as much uneasiness and generates more criticism than the extremely high spreads charged by banks, whether private or state-owned. Factors other than bank profits may explain the magnitude of the spread. A study by the Brazilian central bank shows that factors affecting the spread can be broken down into: 37.4% due to defaults; 13.5% to administration costs; 3.6% to banks' required reserves; 18.1% to taxes and fees; and 27% due to other reasons not explained. The current economic crisis could be an opportunity to correct this persistent problem.

Interview with Niall Ferguson

The Harvard professor says the crisis marks the end of easy credit for consumption and undercapitalized banks. He believes that a global bailout will be very difficult because of political obstacles. He argues that US Keynesian policy will not be very effective and will cause volatility in financial markets. For him the crisis is essentially a problem of excessive debt. To solve it requires a major restructuring of household mortgages and banks.

The ripple and the tsunami

The Brazilian economy plunged in the last quarter of 2008. What are the economic policy options in this scenario of international crisis? Professor Fernando de Holanda Barbosa discusses some alternatives.

The interest base rate: How low can it fall?

The fall in international interest rates to nearly zero is not promoting the recovery. Economist Alberto Furuguem looks into how far Brazilian interest rates can be reduced.

Book review

Sardenberg's new book is an exciting discussion of different facets of the Brazilian economy and the world's. He makes a passionate defense of capitalism in times of crisis. He then draws attention to institutional advancement in Brazil and the continuity of consistent economic policies for almost two decades, despite the radical transition from the Fernando Henrique Cardoso administration to Lula's Workers Party administration.

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Economy, politics, and policy issues
A publication of the Brazilian Institute of Economics and the Institute of Brazilian Issues.
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The effects of the economic crisis triggered in the United States are the theme of this issue. The main differences between our country and the US as we deal with the crisis are two: the Brazilian financial system is healthy, and it has room for a conventional policy of reducing the interest rate. In the US, repair of the financial system has required unconventional measures, and a more effective policy is yet to come: The interest rate of the interbank market, the Fed funds rate, has reached the bottom — there is no way to reduce it further.

The crisis is, however, an opportunity to correct some persistent problems of Brazilian economic policy. For instance, in Brazil bank spreads are an anomaly. After almost 15 years of stabilization, little has been done to correct the disparity between bank deposit and lending rates.

Niall Ferguson, professor of history at Harvard who specializes in financial history, says that the current financial crisis marks the end of both easy credit for consumption and undercapitalized banks. It will also be the end of the Asian growth model based on exports, because the American consumption engine is dead. He believes that for political reasons a global bailout will be very difficult. He also argues that US Keynesian policy will not be very effective and will cause volatility in financial markets. For him the crisis is essentially a problem of excessive debt. Solving it will require a major restructuring of both household mortgages and banks.

Bank spreads in Brazil: Not all weapons have been used

As Brazil continues its long march toward becoming a "normal" country from a macroeconomic and financial perspective, overcoming challenges like hyperinflation, external vulnerability, enormous budget deficits, and a double-digit interest rate (which probably reflects all of the above), the remaining distortions become increasingly more evident. Today in Brazil nothing causes as much uneasiness or generates more criticism than the extremely high spreads charged by banks operating in the country. This is true for both private and state-owned banks.

Obviously, before naming a culprit, a rigorous analysis of the various components of bank spreads is necessary. Factors other than bank profits explain the magnitude of the spread. For example, default risk affects the size of spread. Legal and institutional risks make financial agents nervous about whether the client can repay the credit as agreed. This is no doubt one reason for the high default rate in Brazil. Another factor fueling default is the poor performance of the economy, which may cause unemployment, with consequent failures to repay amounts owed to banks.

Other elements also influence the size of the spread, such as taxation of financial transactions, banks' required reserves, and the administrative costs associated with lending. Leaven and Majnoni (2003),[1] Demirgüç-Kunt, Leaven, and Levine (2004),[2] and Alencar, Leite, and Ferreira (2007)[3] offer a detailed analysis of the variables that influence spreads.

Raising funds

Before looking specifically into spreads, it may be useful to briefly examine the evolution of the cost of raising funds for banks operating in Brazil. To a great extent the term structure of the interest rate is determined by the Selic base interest rate (the central bank policy rate), which has been gradually decreasing (with some ups and downs) since the Real Plan was launched.[4] The worldwide financial crisis, combined with the relatively favorable Brazilian economy, has opened up the possibility of reducing the Selic rate to a single digit before the end of 2009, according to the predictions of many financial institutions. The one-year real interest rate, for instance,

has been declining and should reach 4% in the short to medium term. During most of Fernando Henrique Cardoso's second term and throughout the administration of Luiz Inácio Lula da Silva, the real interest rate has fluctuated between 9% and 13%.

This revolution in the raising of funds, however, has not affected the spread at the same pace, though until the bankruptcy of Lehman Brothers last September it was also falling. The reduction of the spread started in December 2005 but it has moved much more slowly than the fall in the cost of raising funds. Indeed, for individuals the reduction of the spread was slightly more significant than for businesses — from about 43 percentage points to 32 between December 2005 and December 2007. This development, however, is for the most part due to the dissemination of consigned credit, in which payments are debited directly out of borrowers' paychecks or pensions. This type of credit to a large extent affects only public service employees and pensioners, a relatively small group within the society — and only the purchase of durable consumer goods. Over the same period, the average spread for businesses fell from about 14 percentage points to 12, and the general spread fell from 29 percentage points to 22.

Leaven and Majnoni (2003),[5] making an international comparison, suggest that the spread in Brazil is indeed high, ranking second in a sample of 72 countries. On the other hand, after making certain methodological adjustments and taking into account the high cost of raising funds in each country, Nakane and Costa (2005)[6] show a better picture: Brazil ranks 11th on a list of the worst 33 countries. Regardless of these findings and the difficulties associated with establishing comparisons, however, any Brazilian citizen or businessman going into a bank to borrow expects to be charged much higher rates than the Selic base rate. That is why the high spreads have become one of the most sensitive issues on the political and economic agenda.

The Brazilian central bank's *Report on Banking Economy and Credit* breaks down the spread in 2007 into its major elements as follows: 37.4% due to defaults; 13.5% due to administration costs; 3.6% due to banks' required reserves; 18.1% due to taxes and fees; and 27% due to reasons not explained, possibly related to banks' profits and implicit subsidies resulting from earmarked credit at subsidized interest rates .

Agendas

The debate on reducing the spread in Brazil centers on three major agendas. The first is the political and institutional agenda, comprising legal and tax issues, such as the government policy of earmarking credit to some sectors. The second covers macroeconomic issues, factors like exchange rate volatility, the base interest rate, and banks' required reserves, as well as the GDP growth rate, which affects bank risk and therefore influences the spread. The third agenda is related to microeconomic issues: market structure and competition among banks.

Factors other than bank profits explain the spread: default risk, taxation of financial transactions, banks' required reserves, and the administrative costs

Successive administrations in Brazil have addressed all three agendas at a moderate pace and subject to the interruptions and setbacks typical of the country's institutional development. Exchange rate volatility is today much less than in the past. While it is true that since last September volatility has increased in response to the hard test of the world financial crisis, the Brazilian real has followed a much

less dramatic course than currencies in other emerging countries.

The real interest rate is falling steeply. Even though the spread is being reduced more slowly, it is obvious that the influence on it of a falling real interest rate can only be positive. GDP growth depends clearly on the recovery of the global economy; most analysts, however, place Brazil among the countries that will more quickly recover to a reasonable level of expansion (though not at the rate we had been seeing going into the third quarter of 2008), perhaps as early as next year.

Regarding effective loan guarantees, there have been some achievements in recent years with the introduction of the new Bankruptcy Law, the establishment of consigned credit, the development of the car leasing market, and the reform of real estate credit. Lenders have improved their ability to timely access collateral (automobiles and real estate) in case of default. There has also been a significant expansion in the maturity of car loans.

The global crisis has permitted the reduction of the banks' required reserves, which combined with the fall in the Selic base rate strengthened the government's battery of measures to revive the economy

The global crisis has permitted reduction of the banks' required reserves, which combined with the fall in the Selic base rate strengthened the government's battery of measures to revive the economy. It is conceivable that there will be further rounds of cuts in reserve requirements, which are still high, and taxes on credit as part of an effort to prevent a more severe and protracted recession. There is room for this to happen.

Clearly, there is still an intent to reduce the spread. Nevertheless, it is an increasingly disturbing problem for Brazilian society. The slow and irregular rhythm of the fall in the spread is not sufficient to abate the perception of both consumers and businesses that the credit system is fundamentally unfair. To finance consumption and investment, they have to accept costs unparalleled in the rest of the world. It is therefore worth investigating what else can be done to speed the Brazilian convergence to lower spreads — particularly with regard to competition among banks.

Banks' clients

A centralized register disclosing information on the credit quality of clients is a mechanism that would greatly contribute to reducing the problem of information asymmetry, and improving competition in the banking sector, and consequently helping to reduce spreads. Banks process information and know their client profile. A manager's information on the credit quality of clients is perhaps the best asset of a bank network, something a foreign institution planning to enter the Brazilian market is ready to pay a high price for.

The problem is that when banks already established in the country are faced with new competition, they can — based on the information they already have about clients — offer better terms than competing institutions to keep their best clients, letting the not-so-good clients migrate to the new banks. Newcomer banks thus suffer from adverse selection in terms of the clients they can attract, which reduces their capacity to make profits and

compete. The register on the credit quality of clients helps to offset that situation because it makes credit ratings public to those wishing to examine it.

The argument against the register, which has been slow in getting approval from Congress, is that it is discriminatory, since clients not wishing to subscribe to the system will most likely be those of the worst quality. This, however, is an old national difficulty: in trying to protect the most vulnerable we end up harming the vast majority of citizens who have their credit history in good order and would like to access credit at lower cost.

Unconventional weapon

The government does have one good weapon at hand in its effort to reduce spreads at a speed that neither compromises economic and financial logic nor harms social sensitivity. It is possible to use the Federal Savings Bank, Caixa Econômica Federal, which is almost 100% state-owned, to establish profitability parameters in the banking sector. Caixa's lending policy could follow a reference rate of return established by the government, which should obviously safeguard the financial health of the institution. Using that profitability parameter, Caixa would offer interest rates with spreads corresponding to that target.

Because Caixa has a significant share of total bank credit, such a strategy would obviously result in competition forces pushing spreads downward. It would also limit the returns to the banking sector without directly interfering with its functioning, as would inadequate measures, such as interest rate ceilings. Involving Caixa in the effort to reduce spreads in Brazil may seem a daring idea. However, boldness combined with rationality may sometimes be the best answer to distortions that are difficult to correct through conventional means. ■

A centralized register disclosing information on credit quality of clients is a mechanism that would greatly contribute to reduce the problem of information asymmetry and improve competition in the banking sector, and consequently help to reduce spreads

[1]Leaven, L. and Majnoni, G. (2003), Does Judicial Efficiency Lower the Cost of Credit? World Bank Policy Research Working Paper 3159.

[2]Demirgüç-Kunt, A., Leaven, L. and Levine, R. (2004), Market Structure, Institutions and the Cost of Financial Intermediation. *Journal of Money, Credit and Banking*, 36, 593-622.

[3]Alencar, L., Leite, D. and Ferreira, S. (2007), Spread Bancário: um estudo cross-country. *Relatório de Economia Bancária e Crédito*, Banco Central do Brasil.

[4]The Real Plan was introduced in 1994 and successfully eliminated hyperinflation.

[5]Leaven, L. and Majnoni, G. (2003), Does Judicial Efficiency Lower the Cost of Credit? World Bank Policy Research Working Paper 3159.

[6]Nakane, M. and Costa, A. C. (2005), Spread Bancário: Os Problemas da Comparação Internacional. *Relatório de Economia Bancária e Crédito*, Banco Central.

The perfect storm: Lack of international cooperation and flawed policies will prolong the recession



Niall Ferguson

Laurence A. Tisch Professor of History at Harvard University and William Ziegler Professor of Business Administration at Harvard Business School

Pinheiro Ronci, from Cambridge, Massachusetts, USA

Niall Ferguson, professor of history at Harvard, is a recognized expert in financial history. For Ferguson, the current financial crisis will be the end of easy credit for consumption and of undercapitalized banks. It will also be the end of the Asian growth model based on exports, because American consumption is over: "We will certainly have a protracted period of very low growth." He believes that political obstacles will make a global bailout plan very difficult. He expects to see a surge of defaults in several countries. Ferguson argues that the Keynesian policy of the US will not be effective but will cause volatility in financial markets. For him the crisis is essentially a problem of excessive debt; to solve it requires a major restructuring of not just mortgages but also banks. Insolvent banks should be nationalized to have a positive impact on confidence.

***The Brazilian Economy*: In your recent book, *The Ascent of Money*, you point out that financial systems deliver immense benefits but they are inherently crisis-prone, and this has to do partly with human emotional volatility. However, a question that begs an answer is why central banks that have long institutional memories have not been able to create incentives to limit the damage done by foolish human nature.**

Niall Ferguson: I think there are two answers to this question. One is that we have stopped reading Walter Bagehot [1] Bagehot's *Lombard Street* provides a wonderful account of how central banks should deal with speculative excesses and liquidity crises in a financial market. His view was that an insolvent bank should not be helped, but banks having merely a liquidity problem should be lent generously, at a penalty rate. I think the theory of central banking has suffered a serious deformation in the last 10 years.

I would single out the Jackson Hole Conference of 1999,[2] in which a series of papers were presented arguing it was not the business of central banks to anticipate or prevent asset bubbles but merely to mop up after the bubbles had burst. The corollary of this view was that central banks should target or closely monitor consumer price inflation. This idea that you could somehow turn monetary policy into a very simple game in which you anchor expectations by targeting a particular inflation rate was adopted in

Photo: Hoover Institution

various degrees by central banks around the world, and I think it was a gross oversimplification of what central banks are supposed to do. Why should consumer price inflation be more important than asset price inflation? Why does the price of a house not concern a central bank, but the price of a computer does? That was a big mistake, because it meant central banks, particularly the Federal Reserve Bank (the Fed), stopped caring about the dangers of asset price bubbles.

Here is the second problem: Regulators did not pay enough attention to bank balance sheets or turned a blind eye to their excessively leveraged character. When you come to think of it, that was the big vulnerability.

Banks were downloading their risk off their balance sheets. Now they are forced to bring the risks back onto the balance sheets.
And the leverage is now exploding. Banks were following the same off-balance-sheet-vehicles techniques that were pioneered by the Enron Corporation — hardly a model for good accounting practices. Particularly in Europe even more than in the US, but certainly in Wall Street, leverage (the ratio between borrowed funds and equity) kept going up. Now if your leverage is 25 to 1, assets do not need to go down terribly far to have a bank's lending capacity wiped out. That seems to have escaped regulators in the US as well as in Europe.

It seems unbelievable that so many people got it wrong.
I think it was overconfidence in the theory of efficient markets and the theory of monetary policy. In 2002 Ben Bernanke published *The Great Moderation*, arguing that effectively central banks had solved the problem of economic volatility by clever improvements in monetary policy. With hindsight that was incredible hubris. Even at the time, I did not believe it, and I wrote skeptically about the death of volatility. The notion that volatility somehow was experiencing a decline because of improved monetary policy always struck me as complete nonsense.

In your view, is the current crisis the end of global financial markets as we know them?
It is certainly the end of the age of excessive debt. It is not possible to base consumption growth on debt growth for a long time. It is also the end of the Basel II vision of bank regulation with a very generous measure of capital adequacy. We will have to adopt something much stricter, as some countries have done — as Canada did. It is certainly the end of the Asian export-led growth model. The collapse of exports Asian economies are suffering is spectacular, and since these economies rely heavily on exports, economic growth is falling. That is the most alarming development. Whether all this means the global financial system is going to collapse we do not yet know, but it is certainly going to contract.

Beyond the current financial mess, your point on Asian export-led growth underlines a more fundamental problem facing the world economy. How do we rebalance global demand and support global growth? As Americans try to restructure their debts, they will be forced to save more, and Asians are apparently now willing to consume more.

Getting the IMF and the G20 to agree on a global bailout is going to be really difficult. The political obstacles to a global bailout are really quite big. A much more likely scenario is going to be an outbreak of sovereign defaults

This will certainly prolong the recession.

It is a global paradox of thrift. If it seems likely that US households continue to raise the savings rate from 0 to 5% of GDP very fast (it may even rise to 10% of GDP), then the engine of world economy growth has just stalled, because it was essentially fuelled by American consumption, and that is over. There has been a fundamental shift in the American psychology: you can detect it and you can see it in the statistics. I do not think we will have a Great Depression, but we will certainly have a protracted period of very low growth.

American policies are sucking all international capital into the US. The effect of that on currencies depreciating against the dollar and on almost any asset market except the US bond market is really quite dramatic

So although I do not believe the global financial system is dead in the way it was in the early 1930s, when by 1933 the entire system had basically frozen. What is going to happen is that planet finance, as I call it, is going to shrink. It is going to be a lot smaller and it is going to be dominated by public institutions, whether national governments, national central banks, or the International Monetary Fund. That is going to be the big transition. We are also heading toward some big defaults in Eastern Europe, and it is not clear whether there are resources to bail them out. It is big, actually bigger by some measures than the Latin American debt crisis or the Asian crisis of previous decades.

But getting the IMF and the G20 to agree on a global bailout is going to be really difficult. And actually we don't have much time, the G20 meeting is going to be on April 2nd. Ukraine could have collapsed by that time.

Perhaps under pressure the G20 could pull its act together.

That has been what happened in the US. There has been a policy response whenever things have taken a further step down. The Lehman bankruptcy forced the Troubled Asset Relief Program, the TARP bill, to be passed and AIG to be bailed out. But I doubt it is going to work quite so easily at the international level because the crisis is very asymmetric. It is not evenly distributed. Some countries are getting much more pain than others. The US is not taking most of the pain by any means, and in some ways it is better placed than anybody else to ride it out because of the "safe-haven" status of the dollar and the fact that the Fed, the Treasury, and the Federal Insurance Deposit Corporation (FDIC) can respond with enormous stimulus to the crisis.

The problem with the G20, I foresee, is that at some point people are going to say, and I bet the Russians will be the first, you Americans started this crisis, it is your fault, but we in the rest of the world are suffering more, what are you going to do about it? And President Obama is going to reply that Americans have their hands pretty full dealing with their own economy. That is when cooperation to fight the global crisis will break down. Imagine if the US administration goes to Congress and says that in addition to the US$1.7 trillion budget, it has to rescue Ukraine. The Republicans will have a field day. So the political obstacles to a global bailout are really quite big. A much more likely scenario is going to be an outbreak of sovereign defaults.

You have been critical of the delusion that creating more debt and spending can solve

a crisis that resulted from excessive debt in the first place. Why is a Keynesian approach of government profligacy not likely to take us out of the crisis?

I am a great admirer of Keynes, but I am not a believer in a crude application of a caricature of Keynes' General Theory of Unemployment, which is what is currently going on. We are already making an enormous monetary effort. The Fed has already done a large amount and will do more to inject liquidity. I do not think Fed monetary policy has failed, I think it is succeeding. The big question is what happens if you compound a problem of excess leverage with an explosion of public debt. If the US budget is right, the debt-to-GDP ratio will rise from 70% to 100% in less than 10 years. Although having that additional government expenditure financed by borrowing may in some measure compensate for reduced consumer demand, the expenditure multiplier is almost certainly very small, so it is not going to have a tremendously positive impact, and there are lots of negative side effects.

For example, American policies are sucking all international capital into the US. It is really extraordinary, and the effect of that on currencies depreciating against the dollar and on almost any asset market except the US bond market is really quite dramatic. So I think we have to think about the crisis globally. When you think of it as a global problem, Keynesian solutions do not actually make a lot of sense. Governments all over the world simultaneously flooding bond markets with their bonds is clearly a no-win situation. Investors would prefer the US safe haven to other sovereign bonds.

We need one big restructuring, in which bondholders of insolvent institutions will receive equity. Some of the insolvent institutions will just have to be taken under government administration

This could create a lot of volatility.

It's the volatility I'm worried about. We're already seeing it because people are thinking, wait a minute, the US is a safe haven but the US deficit is 12% of GDP and its debt-to-GDP ratio is going to double. What should I do? What am I more worried about? Should I be worried about everybody else defaulting, or should I be worried about the US dollar depreciating sharply?

US expansionary policies are going the same way Brazil and Argentina went in the 1980s.

This is the big intellectual challenge. For years economists like Ken Rogoff have been warning us about the US dollar. One thing economic theory tells us is that at some point huge external current account deficits will weaken the dollar, but it hasn't happened because the financial crisis had the opposite effect: It strengthened the dollar as people desperately tried to scramble for dollar liquidity and also for a safe haven. This tension between worrying about the potentially inflationary downside to American expansionary policy and worrying about everything else being more dangerous than US assets is going to create a tug of war between expectations and cause a lot of volatility. Because of this sort of thing the current US policy approach makes the crisis worse.

It seems to me that if you think the crisis is fundamentally a problem of excessive debt, the policy is more straightforward than that. You don't need an enormous expansion of the public deficit if households are behaving this way because they are underwater — basically

their debts are in excess of the value of their properties. Then you have to address that issue directly, and everything else is going to be a Band-aid. Similarly, if banks are essentially paralyzed by excessive leverage, you cannot drip-feed them bailouts. That is not solving the problem. We need one great big restructuring, in which bondholders of insolvent institutions will receive equity. Some of the insolvent institutions will just have to be taken under government administration. I do not see a problem with that. That is much more likely to change the game, send a positive signal to households and financial markets, and make credit flow again through the economy than just an explosion of public debt predicated on a flawed Keynesian policy.

How would you rate the Obama administration with regard with addressing the banking crisis and the real estate downturn?

The economic team is supposed to include the smartest people on the planet. Larry Summers is very smart. I wonder if in the end there is a kind of intellectual gridlock, where the mindset of the Harvard economists, which turns out to be Keynesian during a crisis, bumps up against the mindset of the US Congress, where the Democratic Party is overwhelmingly dominant, to produce a suboptimal policy mix. The stimulus package is a mistake because it looks like essentially Obama said to Congress, you decide what we spend the money on. That is not the rational way to decide the bill to get the optimal effect.

As Robert Samuelson pointed out, Obama's package is too focused on political goals and projects and will do little to boost domestic demand because a large part of public investment spending will take place in 2011 or latter.

In a way the stimulus package became sort of a dog's breakfast, a kind of mess of competing political priorities. The other big issue I think is that Treasury Secretary Timothy Geithner was part of the previous administration, and there is therefore real continuity in the way in which the banking crisis has been dealt with. Geithner's most significant action has been to say that the Fed should make more use of the term asset-backed securities loan facility (TALF). In fact, this is much more important than the stimulus bill. It is much more money and is targeted at the asset-backed securities market, which Bernanke wants to revive. That is real continuity in policy, and the decision has been clearly taken to postpone the nationalization of insolvent banks. I consider this policy highly questionable. So we are stuck on a course of improvisation that dates back all the way to 2007. We have not had a real paradigm shift in thinking about the banking crisis.

I guess what the Obama administration fears most is that they might do something that has even bigger unintended consequences than Paulson's decision to let Lehman fail. They fear that if they say something that suggests bank nationalization, there will be a meltdown of the stock market. The only way you can pull off bank nationalization is if you do it dramatically, overnight, without warning. You do not achieve that psychological shift in confidence without a more dramatic step. That is a key point. At the end, it all comes down to dealing with the problem of excessive debt.

You have to bring the debt down to a sustainable level that you can pay.

The lesson of emerging markets is that when debt restructuring happens, it is all very unfortunate and painful but it is amazing how quickly people get over it once they see the country is on a sustainable path again. The

degree to which sovereign defaults had not been punished by increases in risk premium is one of the striking findings of financial history. Right now people's nightmare scenario is that there will be a vast number of foreclosures and Lehman's bankruptcy will repeat itself with Citigroup and Bank of America. This nightmare scenario could be eliminated by simply imposing a general debt restructuring.

In the case of the US during the Great Depression, the Home Owners Loan Corporation was set up to restructure mortgages and it was relatively successful.

Yes, that was one of the important things the New Deal did. The New Deal really did transform mortgages into long-term financial instruments. Before that only short-term loans were available to buy houses. This illustrates why it is worth looking at financial history, because you suddenly realize, Gosh, this was something they tried and it worked, and we could do the same.

You and some economists have argued in favor of giving support to households to restructure their mortgages. Does the US Treasury housing rescue plan address the problem?

The current Treasury policy takes a large group of people who have Fannie Mae and Freddie Mac mortgages and hopes that lenders will give people lower interest payments, and it subsidizes that by reducing interest payments further. But that does not address the issue of negative equity at all, and it is negative equity that makes people walk away and causes foreclosures. So it seems to me that the Obama administration is missing a fundamental analytical point here. I think it will become painfully apparent in the course of this year that this is not working, and a change in the economic team is possible.

Is Paul Volcker involved in the policy making?

He plays the role of figurehead, he is not involved in the decision making, and I was told he is not very happy about that. He would have handled the crisis very differently. I interviewed him for my book *The Ascent of Money* a year ago. He made clear to me the extent to which he thinks we need structural reforms of the financial system rather than just fresh injections of cash to keep banks in operation. If you had appointed him as Treasury Secretary the impact on confidence would have been psychologically huge.

Fresh injections of cash are dangerous because you keep dead banks going, making it very difficult to recover confidence.

That is my point. You have to deal with insolvent banks because they are standing in the way of financial recovery. They are also standing in the way of new banks. We need new banks well-capitalized to have credit flowing again through the economy. Let Canadian banks come into the US. Basically what we are doing is taking taxpayers' money and putting it on the line for bank equity and bondholders. I do not think that is justified in a systemic banking crisis. It is not achieving enough results to justify these huge risks that have been taken on the taxpayers' money.

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[1]English journalist, closely associated with the English institutionalist-historicist tradition, He stressed the need for more institutional content, especially cultural and social factors. He was one of the first economists to discuss the concept of the business cycle, and developed a distinct theory of central banking.

[2]Conference organized by Federal Reserve Bank of Kansas.

The ripple and the tsunami

Fernando de Holanda Barbosa

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-

There is no need to build up enormous reserves in a flexible exchange rate system. The exchange rate can do the job

How the global shock affected Brazil's financial markets

	EMBI-Brazil Bond Index (basis points)	US dollar /Real exchange rate (sale closing)	Central Bank "Selic" base rate (% yearly)	São Paulo Stock Exchange Ibovespa (index closing)	Treasury Bonds 08/15/2010 (% yearly)
02/09/2008	248	1.6602	12.92	54,404	9.1022
01/10/2008	333	1.9213	13.66	49,798	9.2486
03/11/2008	445	2.1818	13.65	38,249	10.0269
01/12/2008	526	2.3565	13.65	34,740	9.3340
02/01/2009	403	2.3298	13.67	40,244	7.8615
02/02/2009	420	2.3475	12.66	38,666	6.7340
02/03/2009	451	2.4121	12.66	36,234	6.3999

The crisis is a good opportunity to correct endemic problems. In Brazil, the bank spread is an anomaly

ed. 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.

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The interest base rate: How low can it fall?

Alberto Furuguem

During the March 10th meeting of its Monetary Policy Committee (COPOM), the central bank reduced its annual policy interest rate from 12.75% to 11.25%. According to the press, on the eve of the COPOM meeting President Lula is said to have summoned Governor of the Central Bank Henrique Meirelles and Finance Minister Guido Mantega to the Presidential Palace to tell them that a reduction of 1.5 percent points of the policy rate would be the minimum acceptable.

Whether or not this political pressure was actually applied, the fact is that the COPOM could have had good reason to perform a more modest cut of the policy rate because inflation as measured by the National Statistics Bureau (IBGE) was about 6% (that is, at the upper target limit) for the 12-month period closing in February. The COPOM could have thus justifiably acted more conservatively at its March meeting. On the other hand, there is nothing wrong with the decision to reduce the base rate by 1.5 points in a completely abnormal period for the world economy, and for Brazil. Central bank real policy interest rates are negative in most developed economies and close to zero in most emerging countries. Yet inflation is falling in the face of the recession, triggering fears less of inflation than of deflation, which could lead to a depression.

Even though the COPOM cut the policy interest rate significantly in March, the usual criticism was heard from the business community, which advocated an even more dramatic cut; criticism was also voiced by politicians, among others the Governor of São Paulo, José Serra, for whom the measure came "better extremely late than never." Some economists claimed that there was room for an even bigger reduction. What the critics almost always underscored was that, in spite of the significant March rate cut, the real policy interest rate (policy rate less inflation) in Brazil is still the highest on the planet: 6.5% yearly.

Flawed idea

The idea that Brazil has the highest interest rates in the world tends to lead some to believe that interest rates here are "wrong." They truly believe that interest rates could be much lower were it not for the central bank's stubbornness (this is the recognized opinion of Vice President José Alencar). What most fail to take into account is that Brazil has found it much tougher to bring down inflation than most other countries. Despite high interest rates, inflation in Brazil is moving only very sluggishly toward the targets set for it.

It happens that because Brazil has adopted inflation targeting, the central bank has institutional responsibility for meeting the target (IBGE's IPCA price index) the government sets. With a central inflation target for 2009 of 4.5% and 12-month inflation at 6% in February, the COPOM under normal circumstances could have reason not to speed up the reduction in interest rates, though in the end it happened, apparently (but not necessarily) in response to pressure from the president and a large segment of public opinion.

In this critical phase for the world economy, characterized by widespread recession, Governor Meirelles himself could have considered it fit and prudent to adopt a less conservative stance. It was quite plausible to expect that a reduction of 1.5 percentage points would jeopardize neither inflation control nor attainment of the inflation target for 2009, especially because the world recession may in fact lead inflation to fall in most developed and emerging countries, including Brazil.

It seems only fair to point out that it is generally comfortable for those outside the central bank to claim that the rates may fall without jeopardizing inflation control. Just about everyone wants both low interest rates and controlled inflation, but the central bank alone must meet the inflation target. For a central bank director, a more daring reduction in interest rates would only be comfortable if inflation were below the target. It is not; rather, it is well above it. For that reason the accelerated interest rate cut in March may not have been a comfortable decision for the central bank directors, even though they approved it by consensus.

While it is true that real interest rates in Brazil are the highest in the world, it is also true that Brazilian inflation has been relatively harder to curb. Considering interest rates for the last 15 years, inflation under normal conditions should be closer to zero than to 6%, and GDP growth should have been negative long before the outset of the international financial crisis.

Persistent inflation

Thus, the obligatory question is: Why does inflation persist in Brazil in spite of high interest rates? In other words, why has inflation in Brazil not dropped as rapidly, in response to falling international commodity prices, as it has in other countries?

There are a few easily identified factors that help explain why inflation resists falling in Brazil: The most obvious is the price indexation (even after the de-indexation introduced by the Real Plan) caused by contractual (telephone, energy, road tolls); cultural (rent, private contracts in general, wages); and political (real increase in minimum wages, tax increases, etc.) factors. In most other countries, prices are usually more flexible downward. Because they are not flexible in Brazil, the central bank tends to be relatively more demanding about meeting the inflation target because it is more difficult to curb inflation once it rises.

Fiscal policy is of little help most of the time. Both current public expenditure and the tax burden have risen significantly

The proposal to reduce taxes on financial transactions could also help to reduce the interest rates paid by borrowers

over the past 15 years. The political decisions surrounding the minimum wage helped increase the pressure on business costs and public spending. We are not discussing the merit of the policy of increasing the real minimum wage, which, with inflation controlled, has been a major factor in increasing the real earnings of the poor and has helped promote the highly desirable reduction of social inequality. However, the resulting increase in public spending is a given for monetary policy makers. For society, then, the bill comes in the form of a more restrictive monetary policy to keep inflation within desirable limits.

It is also a fact that in Brazil — as in most other countries — almost the only tool available to fight inflation has been setting central bank policy interest rates. In Brazil, the need to raise interest rates to meet inflation targets has been a harsh reality, based on the evidence of inflation patterns rather than on the whims of central bank management.

Would it really happen that even under very strong pressure to push interest rates down, the central bank would

keep the rates high simply because it so wished? That makes no sense whatsoever. The central bank has a mission (to meet inflation targets) and must deal with the variables — indexation, inflationary culture, increase in public spending, tax hikes, minimum wage increase, etc. — as they are given.

Unique to Brazil

Though the high interest rates have been necessary to keep inflation to the levels defined by the government, they did not prevent GDP growth of 5% in 2008. That is, by the way, a peculiarity of the Brazilian economy in recent years: the economy grows despite such high interest rates. There might be a justifiable argument that lower interest rates might have promoted higher growth. Of course, inflation might have also been much higher. The government, correctly in our opinion, has not consented to higher inflation.

It thus seems neither fair nor correct to assign Brazilian monetary policy any responsibility for the current recession. The major cause of recession since the last quarter of 2008 is the world recession. That is obvious.

As long as the world recession deepens and drags on, inflation should continue falling in Brazil, as elsewhere. The fall in interest rates, which elsewhere are close to nominal zero, and even negative in most cases, has not managed to foster a speedy recovery. In Brazil both nominal and real interest rates may continue declining as long as inflation also falls.

Abroad, interest rates are far below the equilibrium rate, but that problem for Brazil cannot be addressed until the current recession is over. Fiscal deficits may also reach astronomical levels in 2009 in most developed countries, according to projections by *The Economist*: 11.1% of GDP in the US, 5.4% in Japan, 11.3% in the United Kingdom, and 4.6% in the euro zone. Again, this is a problem to be solved later. The urgent task now is to deal with the economic crisis.

The real interest rate in Brazil, although still very high compared with rates internationally, may already be below the equilibrium rate, according to some economists. If inflation continues to fall to the central inflation target of 4.5%, there is no reason for the Brazilian central bank to cut its base rate like other central banks. Interest rates may fall temporarily to levels below what would be considered sustainable equilibrium. When the world economy recovers, interest rates will return to equilibrium both in Brazil and abroad.

Equilibrium

Measures to reduce the feedback of past inflation into current inflation could indeed help to bring the real equilibrium interest rate toward more normal international levels. Negotiated de-indexation of contracts (in effect in the privatized utility sector) could be a great help. Abandoning the inflationary culture will take longer — a large number of Brazilians still have indexation in their minds as a consequence of long years of high inflation and widespread indexation of the economy. The proposal to reduce taxes on financial transactions could also help to reduce the interest rates paid by borrowers.

We must consider, in conclusion, that positive and relatively high real interest rates and a solid financial system could represent a trump card for the Brazilian economy in times of international crisis. Brazil might be seen as an attractive destination for international financial investment. In this case, higher external current account deficits would be easier to finance. In a world where capital is scarce and credit more restricted, that would be an advantage not to be ignored. However, Brazil as a preferential destination for foreign investors is a conjecture yet to be validated. So far, what we have seen is money running toward the epicenter of the crisis, the US. Even though the interest on US Treasury bonds is very low, they are still regarded as the least risky investment option. ■

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A defense of capitalism in a time of crisis



Neoliberal, Não. Liberal: Para entender o Brasil de hoje e de amanhã (Neoliberal, No. Liberal: Understanding the Brazil of Today and Tomorrow). Carlos Alberto Sardenberg. Editora Globo, 168 pages, R$28 (US $14).

Carlos Geraldo Langoni

Sardenberg's new book is an exciting study of different facets of the economies of Brazil and the world. The methodological background is the debate between free market and state intervention. He explains clearly that after the Chinese economic revolution and the fall of the Berlin Wall, the ideological divide — capitalism "versus" socialism — lost relevance.

Sardenberg is a highly regarded journalist and columnist. He is not afraid to say that the organization of production and consumption based on competition and free choice is undoubtedly superior to centralized planning led by an omnipresent State and a suffocating bureaucracy.

The severe global crisis does not seem to intimidate him. There are no doubts that distortions and inefficiencies in the operation of the market may generate bubbles and can even destabilize the financial system. Nothing, however, he says, points to the imminent end of capitalism. Modern and dependable regulatory frameworks and even occasional and transitory government interventions to correct market distortions are not new in economic history.

The balance of globalization is still largely favorable not only in terms of wealth creation but also in its social aspects: poverty reduction and better distribution of income.

With his bright style and at the same time rigorous foundations, Sardenberg presents a broad view of issues so that we Brazilians can better understand where we are and where we are going. With elegance and grace he addresses the importance of consistent economic policies, the main components of which are control of public accounts and price stability anchored in an independent central bank. He also explains the pragmatism of the Chinese change from socialism to capitalism while keeping its authoritarian political system, which is controlled by a party that is increasingly more technocratic and less "Communist."

Of particular interest to the American public, Sardenberg draws attention to the institutional advancement produced by the continuity of Brazil's economic policy for almost two decades, despite the radical transition from the administration of Fernando Henrique Cardoso to that of Lula's Workers' Party. This strategic decision explains the reduction of Brazil's vulnerability, the conquest of the investment grade from international rating agencies, and the jump in growth, which has been interrupted only recently by the external financial cataclysm. The book also contains a profound and creative analysis of the relationship between growth and income distribution, demolishing myths along the way.

Finally, Sardenberg makes a plain and nonideological assessment of Brazilian privatization, emphasizing its logic directly associated with the bankruptcy of state entrepreneurs and the economic and social benefits.

Neoliberal, No. Liberal is a stimulating book, and very current. Sardenberg's intense participation in a variety of media allows him to decipher masterfully for the general public issues previously restricted to the hermetic language of academic economists. Certainly for the American public, the book is an excellent introduction to the Brazil of today.

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