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New tool to track business cycles in Brazil
The Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation has created the Business Cycle Dating Committee to maintain a reference chronology of business cycles in Brazil. Its first task was to date periods of expansion and recession in the Brazilian economy between January 1980 and March 2009.

Brazil's economic and financial indicators

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Brazil and other emerging economies are once again experiencing some degree of decoupling from the bleak prospects of the developed countries because they have not suffered the real estate bubble or the excessive financial leverage of banks and households that set off the crisis in the developed world. Brazil's partial recovery from the deepest point in the crisis must be celebrated.

This fact has a spin-off: the renewed debate on exchange rate appreciation. If there has in fact been a certain degree of decoupling, a stronger Brazilian currency might be here to stay. As important as decoupling, the appreciated exchange rate is a macroeconomic byproduct of a Brazilian sociopolitical choice — to reduce inequality (promoting higher real wages) — which has been absolutely consistent for the entire 25 years since the country's redemocratization.

One of the most significant aspects of recent developments in the Brazilian banking system after the crisis set off by Lehman Brothers' bankruptcy last September is the expansion of credit by public banks. The governor of the Central Bank, Henrique Meirelles (see the interview in this edition), in a recent address to representatives of the financial sector reported that between September 2008 and February 2009 credit from state-owned banks grew by 15.8% while credit from the large national private banks increased by just 10.8%. Growth of credit from foreign banks, which are more dependent on external funding, was much lower at 3.1%, and credit from small and medium-sized banks actually fell by 6%. During the six-month period total credit grew 6.8%.

This expansion of the public financial sector, together with good performance in other indicators, led the public savings bank, Caixa Economica Federal, to be chosen the Best Financial Conglomerate in the country in the IBRE awards for the best financial institutions. In the retail banking segment Itaú bank was elected the best. Among foreign banks in the specialist category, the Deutsche Bank won, and CR2 Bank was the best among small and medium banks. To achieve these results, the Center for Finance Studies of Fundação Getulio Vargas in São Paulo improved the methodology for awarding the prizes, after consultations with banks and financial analysts.

Exchange rate appreciation again on the agenda

Recently, the notion has gained weight that Brazil and other emerging economies are once again experiencing some degree of decoupling from the bleak prospects of the developed countries. To be sure, this does not mean that emerging economies will emerge unscathed from the global economic slowdown. But this view, suggested in IBRE's last letter — and taken up in a leader in *The Economist* shortly thereafter[1] — is based on the fact that some of the more prominent emerging countries have not suffered the real estate bubble or the excessive financial leverage of banks and households that set off the crisis in the developed world. Moreover, in some of the BRIC countries (Brazil, Russia, India, and China — all emerging economies) there is room for stimulating domestic demand to offset decreasing foreign demand. And in some cases, recovery in one BRIC country entails recovery in another: the best example is the resumption of demand and the evolution of the prices of commodities exported by Brazil early this year after China's performance exceeded expectations.

Brazil's partial recovery from the deepest point in the crisis must be celebrated. But it has a spin-off: renewed debate on some issues that had temporarily been "resolved" by the wave of turbulence. Without doubt one of the major controversies is about exchange rate appreciation, once again under debate after the severe depreciation caused by the outflow of capital toward the safe haven offered by US Treasury bills. If a certain degree of decoupling is correct, a stronger Brazilian currency might be here to stay. Since January projections of the 2009 trade balance have improved

significantly, from US$14.5 billion to US$20 billion (the median of market projections collected by the Central Bank of Brazil). The median projection of the external current account deficit for the year has been cut almost in half since the beginning of December: from US$30 billion to US$17.5 billion, just above 1% of GDP.

On the financial side there are clear signs that Brazil has benefited from the gradual restoration of normal financial conditions in world markets. Brazil's country risk measured by EMBI (the Emerging Markets Bond Index) has fallen below the average for emerging economies, after having been above it. This suggests that the country has moved forward relatively faster than its peers to reduce risk perception. A factor that may have contributed to this improved risk perception is the stability and soundness the national financial sector demonstrated even in the worst of the turbulence. For the first time, at the most severe point in the crisis foreign investors witnessed a decline in the debt-to-GDP ratio — because the Brazilian public sector is a creditor in terms of US dollar position. This has definitely helped crystallize the view that the country has attained a new high point in terms of economic stability. This development contrasts sharply with the debacle in many countries in Eastern Europe that had been considered emerging stars until last September.

The good side of this improved risk profile is that Brazil will be able to live with lower interest rates for a given deficit on current transactions, because domestic rates are determined by internal supply and demand and by the willingness of the rest of the world to finance the country. This is excellent news. It suggests that, when the recovery of economic activity accelerates in 2010, monetary policy need not be as tight as it would have to be if Brazil had a less favorable foreign scenario.

Today, therefore, the situation could be considered satisfactory — were it not for the fact that the exchange rate is starting to appreciate, which many economists believe has negative implications for economic growth.

Brazil and other emerging economies are once again experiencing some degree of decoupling because they have not suffered the real estate bubble or the excessive financial leverage of banks and households that set off the crisis in the developed world

This is a long and complex debate. The view of most critics of appreciation of the national currency is that it hinders growth in industrial production that would bring about positive externalities — the most frequently cited is the introduction of new technology, particularly in export industries, and the generation of dynamic comparative advantages.

With regard to the exchange rate debate, it is important to recognize the seduction

that the "Asian model" exerts on economists in Brazil and other developing countries. They believe the formula for the success of the Eastern Asian countries incorporates one or all of the following elements: export-based growth to a great extent supported by exchange rate depreciation; high savings and investment rates; considerable investment in education and human capital; adoption of industrial policies; emphasis on the absorption of foreign technology; and economic stability.

Despite institutional differences, some economists seem to believe that there is room for Brazil to adopt an economic model similar to the Asian model.

Much as the Asian model rests on factors associated with the liberal recipe book, such as emphasizing education and economic stability, it is also undeniable that it enhances the role played by the state. The debate to determine just which elements of the model account for the exceptional performance in those countries is far from over. But it happens that a large number of developing countries — including Brazil, some countries in Latin America, the Middle East, and India — in the post-war period also adopted measures that foster specific economic sectors and dirigisme. Those attempts for the most part resulted in partial or total failure.

Previous IBRE Letters have discussed the incompatibility of the Asian model with some of the deep determinants of what we might call the "Brazilian model," which has well-defined political, social, and economic roots. Thus, one of the key elements of the depreciated exchange rate in the Eastern Asian countries is their remarkably high savings. This in turn implies an intertemporal choice to trade present for future income. This choice may be translated into many institutional formulas in societies where there are significant incentives for saving, investment, education, and work. A typical example is public social security, which is extremely limited in Asian countries compared with Brazil.

Despite institutional differences, some economists seem to believe that there is room for Brazil to adopt an economic model similar to the Asian model. Some of those countries, with China in the lead, have in the past few decades combined extremely low interest rates with an aggressive policy of reserve accumulation; this has allowed them to keep their real exchange rate relatively depreciated.

It would, however, be unwise to disregard one element that is deeply linked with political, social, and economic choices. This fundamental element is the distribution of income between capital — by means of retention of company profits — and labor. In fact, the balance deteriorates in favor of capital as intervention in the exchange rate market leads to a rise in savings and, as a

consequence, in investment, which are the goals pursued by advocates of the Asian model. This process is linked to the rise in the share of capital in revenue, which broadens retained profits and consequently company savings and investment. The mechanism of regressive revenue distribution stems from the higher relative increase in the prices of goods traded internationally ("tradables") as the national currency depreciates. Relative to salaries, tradables become more expensive, which increases the profitability of capital.

Eduardo Levy-Yeyati and Federico Sturzenegger have suggested that a policy of reserve accumulation may produce a more depreciated exchange rate, which in turn produces a permanent positive impact on growth.[2] An interesting aspect of their article is that the transmission channel between the devalued exchange rate and growth is not foreign trade and industrial activity but rather the higher savings and investment resulting from intervention in the foreign exchange market and reserve accumulation. Thus, the depreciated exchange rate would raise internal savings by increasing the retention of business profits.

The issue of adapting the Asian exchange rate model to Brazil, therefore, might be summed up in a simple question: How is it possible to make a depreciated exchange rate — regressive in terms of income distribution — compatible with a trend of real growth in salaries?

The relationship between the exchange rate and the distribution of revenue assumes further importance when the political perspective is introduced. Dani Rodrik, a supporter of the Asian model, pointed out in 1999 that democracies tend — in relative terms — to pay much higher real salaries than authoritarian regimes.[3] Brazil's appreciating exchange rate is thus a macroeconomic byproduct of its sociopolitical choice to reduce inequality, which has been absolutely consistent throughout the 25 years since the country's redemocratization. The fate of the Asian model in Brazil must therefore depend on an unlikely change in the priorities of our democratic institutions. ■

How is it possible to make a depreciated exchange rate — regressive in terms of income distribution — compatible with a trend of real growth in salaries?

[1] *The Economist*, "Decoupling 2.0," May 23–29, 2009, page 14.

[2] Eduardo Levi-Yeyati and Federico Sturzenegger, 2007, "Fear of Appreciation," World Bank Policy Research Working Paper n. 4387.

[3] Dani Rodrik, 1999, "Democracies Pay Higher Wages," *Quarterly Journal of Economics*, 114(3): 707–738.

"The crisis is serious, but will be overcome."



Henrique Meirelles

Governor, Central Bank of Brazil

Liliana Lavoratti, São Paulo

The Brazilian economy has sound fundamentals, is well-diversified, and has a large and expanding consumer market. This, and not interest rates, is what attracts the foreign investor, explains Henrique Meirelles, Governor of the Central Bank of Brazil. He therefore believes that a drop in the Central Bank's policy rate will not trigger a confidence crisis. Having been at the helm of the monetary authority from the start of the Luis Inácio Lula da Silva presidency, Meirelles has no doubt that Brazil will emerge from the current crisis in better shape than it was when the crisis broke out. "We have reserves, and the Central Bank can offset insufficient foreign credit by extending credit lines to exporters and by implementing anticyclical monetary policy. We have conquered room to maneuver to address the crisis," he stresses. And what does the future hold for Meirelles? "At the moment, … my priority is to work to help Brazil out of the crisis as swiftly as possible. There will be plenty of time to think about the future later."

The Brazilian Economy — This is the last part of the Lula term and of your administration of the Central Bank of Brazil. Is it possible to identify the best and worst moments of your time in command of the monetary authority?

Henrique Meirelles — That is a difficult question to answer. There have been many challenges, difficulties, but also positive moments. In the current crisis there have been some difficult moments, especially because the crisis came from abroad and through several channels. However, without any doubt, the worst point was at the beginning of my term in January 2003, when annual inflation exceeded 20%, our reserves were less than US$20 billion, the country was on the brink of insolvency, and economic activity was contracting. Raising interest rates was the right choice under the circumstances, but it was a very hard decision. At a certain point, the Central Bank had to decide against selling more international reserves, hoping that investors would have confidence in the measures adopted by the government. That was particularly difficult.

The most gratifying event occurred in December 2006, when President Lula paid tribute to me in his year-end speech of thanks to his ministers. Another very gratifying moment was the day Brazil received the investment grade rating from a very respected foreign rating agency.

Photo: Valter Campanato/ABr

You often state that Brazil has become more resilient to international shocks over the past few years. What are the signs of this resilience almost a year since the onset of the international subprime crisis?

Let me emphasize that there are two very different stages to the current international crisis. The first phase started after the collapse of the subprime market in the US, in mid-2007; it mainly hit the developed countries and was characterized by correction of the excesses of the so-called "great moderation" period, with low real interest rates, excessive credit growth and leverage of the banking system, and asset prices inflation. This correction process triggered a severe loss of capital from American and European financial institutions; otherwise, there were no major ruptures in the system.

The second stage of the international crisis started in September 2008, prompted by the bankruptcy of Lehman Brothers. That paralyzed credit around the world and affected economic activity in countries everywhere, including countries that, like Brazil, had been spared up to that point. The scarcity of international credit was the main channel of contagion, compounded by the contraction of international trade and the waning of confidence in both the business community and consumers. So the crisis struck Brazil in its second global phase.

Now, returning to the issue of Brazil's resilience to external shocks, let us compare the situation today with previous crises that hit the country. Unfortunately, Brazil has had to face rather frequent external crises over the past 15 years — Mexico in 1995, Asia in 1997, Russia in 1998, and Argentina in 2001 — and in all of them the pattern of adjustment was similar: a massive loss of reserves, higher interest rates, and fiscal tightening.

Today, the circumstances are different. We have reserves, and the Central Bank can offset insufficient foreign credit by extending credit lines to exporters and by implementing anticyclical monetary policy. We have conquered room to maneuver to address the crisis. The crisis is serious, but it will be overcome, and Brazil will be in better shape than it was when the crisis broke out.

Are you satisfied with the results produced by the measures introduced to improve the availability of credit and stimulate the economy in general? Are there further measures that could be envisaged for the short and medium term?

The Central Bank continuously monitors credit and the economy in general. This is not the time to anticipate new measures. Our assessment is that the measures introduced since last September have been successful, and indeed authorities around the world have acknowledged their timeliness and precision. We have acted with determination to provide liquidity to the credit market using a variety of mechanisms, particularly the reduction of bank reserve requirements, which in Brazil are a prudential instrument to ensure liquidity, as well as incentives to transfer portfolios out of institutions with liquidity problems. Incidentally, no bank has had to resort to the discount window, demonstrating that these initiatives were quite effective. More recently, we have extended deposit insurance for time deposits, a measure that has been crucial for normalizing the credit supply of small and medium-size banks.

Brazil's high foreign reserves have functioned as a sort of insurance against the crisis. Because the Central Bank continues to intervene in the

Any attempt to manipulate the policy rate would push up market rates and would translate into costs to economic activity

exchange market, reserves are increasing. For what purpose?
In fact, foreign reserves have been an important defense against the turmoil, and their pre-crisis level seems to be just right. In the past, some analysts who tried to determine the optimal level of reserves often reached the conclusion that Brazil had already exceeded it. Today, the same analysts recognize that they were mistaken...

Since the beginning of May the Central Bank has once more acquired dollars in the market, taking advantage of the favorable circumstances of foreign inflows into Brazil. It should be noted that the objective of acquisitions of foreign currency by the monetary authority is to take advantage of opportunities; the intervention does not intend to influence the exchange rate but simply to reduce its volatility.

That said, the level of reserves today is higher than before the crisis. That is not a consequence of the Central Bank policy of sales and purchases but is rather the result of investments in assets that in the past few months have appreciated significantly.

The productive sector continues to criticize the government's monetary policy, suggesting that the Central Bank policy rate could be pushed down further. When President Lula's mandate comes to an end in December 2010, the policy rate will be comparatively lower than it was a few years ago, yet it remains one of the highest in the world. Would it be possible to change this before December 2010?
What is decisive for economic activity is not the policy rate but the longer-term market rates, particularly the 360-day term negotiated at the BM&F (the Brazilian Securities, Commodities and Futures Exchange). If we analyze the correlation with economic activity, we see that market rates are much more significant than the Central Bank policy rate. It is also important to recognize that the market rates are not fully linked to the policy rate—they also anticipate monetary policy decisions and the behavior of future inflation. As a matter of fact, if we compare the 360-day rate to inflation expectations, we see that both track each other very closely. Thus, it is not the policy rate but rather expectations about inflation that orient market rates.

What is motivating capital inflows are the opportunities in the real economy. The short-term moves of interest rates are far less important

It is clear that lowering the policy rate by decree is pointless unless expectations about inflation warrant it. Any attempt to manipulate the policy rate would push up market rates and would translate into costs to economic activity, as has happened in Brazil in the past. On the other hand, when we analyze the evolution of interest rates over the past few years — both policy and market rates — we see an indisputable declining trend. For instance, at the end of the 1990s, the policy rate exceeded 40%; at the June Monetary Policy Committee (Copom) meeting it was set at 9.25%. In other words, we can observe a significant structural adjustment over time. The real interest rate shows this declining trend as well; today it is the lowest in the country's recent history.

Economic analysts keep referring to a "crisis of confidence." As interest rates continue to fall, will Brazil still be attractive to foreign capital?

Our economy has sound fundamentals, is well-diversified, and has a large and expanding consumer market. These — not interest rates — are what attracts the foreign investor. Data from both before the crisis and now clearly indicate that most capital inflows are being

invested in productive capacity and in the stock market, which is a way to finance Brazilian corporations. In other words, what is motivating capital inflows are the opportunities in the real economy. The short-term moves of interest rates are far less important.

By implementing measures to rescue their economies since the outset of the financial crisis, the US, the EU countries, and the United Kingdom have witnessed a rapid rise in public debts. How do you see the issue in Brazil?

Brazil is one of the few economies in the world with a balanced fiscal position. The G7 countries in general, and the United States, the United Kingdom, and Japan in particular, project substantial fiscal deficits not only in 2009 but also in 2010. Some estimates indicate that by 2012 the public debt in those economies will be double that in 2007. Even some emerging economies that traditionally recorded a balanced fiscal position, such as Russia and the Gulf countries, forecast significant deficits in 2009. In all those cases, the cost of adjustment to the financial crisis is being transferred to future generations in the form of higher public debt.

In Brazil the circumstances are more favorable. We will maintain a positive primary surplus consistent with the targets established by the government. In 2009 specifically, the fall of the primary surplus is offset by the cut in interest rates, helping to hold the nominal deficit at about 2% of GDP this year and bring it down to 1% or less next year. Those figures are consistent with the falling path of public debt that we have been witnessing since 2002. In other words, Brazil is one of the few economies that will end the year with a net debt-to-GDP ratio lower than it was at the outset of the crisis.

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Recently, President Barack Obama approved measures to control fees and interest rates charged by credit card issuers in an attempt to reduce consumer indebtedness. The Central Bank of Brazil has conducted a study of the credit card market that suggests that the interest rates charged in Brazil are too high. The Chamber of Deputies has opened a debate on changes to the rules governing credit cards with the idea of creating specific rules for this sector. What is your assessment of the credit card market in Brazil?

In Brazil, as in other countries around the world, the relative share of electronic means of payment in retail transactions has increased. Among these, payment cards (credit and debit) show the highest growth. That is good in terms of efficiency, as there is solid empirical evidence that replacing payment in cash and checks with electronic payments reduces transaction costs significantly. Given that preserving the population's confidence in the currency and in the payments system is a major concern, payment cards have deserved the attention of the central banks and other authorities in many countries, including Brazil.

The United States is dealing with a specific issue. The measures approved by President Obama focus on the credit function of the cards, i.e., the part that is financed (after the grace period, during which the card holder pays no interest); this part has a bearing on consumers' decisions about indebtedness.

In the case of Brazil, back in 2006 the Central Bank signed an agreement of technical cooperation with the SDE (Office of Economic Law) of the Ministry of

Justice and with the SEAE (Office of Economic Surveillance) of the Ministry of Finance aimed at coordinating actions to enhance the efficiency of the payment cards industry. This led to the above-mentioned study, which was conducted by the three authorities. The conclusions address the payment (rather than the credit) function of the cards. This highly technical study identified as the main problems related to the card industry: (1) evidence of market power; (2) barriers to entry that prevent competition; (3) lack of transparency regarding type and amounts of fees and interest rates charged; and (4) evidence that the rule prohibiting the business owner from charging different prices according to the method of payment distorts the market and harms the consumer, reducing his bargaining power. Our intention is to continue our efforts to promote better functioning of this activity.

During your tenure as governor of the Central Bank, Brazil managed to settle its foreign debt and today is a creditor of the International Monetary Fund (IMF). The IMF has established a flexible credit line, which Mexico, Poland, and Colombia have already signed up for. What is your view on the changes in the IMF and other international financial institutions in the aftermath of the crisis?

I see as very positive the new Flexible Credit Line (FCL), which was created by the Fund for countries with sound economic fundamentals. It is a credit mechanism without conditionalities, and with rapid approval, for economies facing momentary liquidity problems brought about by external rather than by domestic factors. Fortunately, Brazil has more than US$200 billion in reserves and does not plan to apply for that — or any other — IMF credit line.

In addition to its role of surveillance, the IMF should now play a more decisive role in the development of crisis prevention and early warning tools. The key feature that has made fighting the present financial crisis difficult is the fact that, for decades, the IMF concentrated on preventing crises solely in emerging markets, apparently because of the assumption that advanced economies followed best practices in the management of their domestic financial systems. Things now have changed. What the IMF needs to do now is to be active in all important economies and to develop instruments to detect and prevent crises like the current one, including the need to take full account of the interdependencies and cross-border transactions of the global economy.

In 2002 you were elected to be federal representative for the state of Goiás with an impressive vote count. Do you still conceive the idea of running for a political office? Rumors say that you would like to be governor of Goiás.

At the moment, I am totally concentrated on my work at the Central Bank. My priority is to work to help Brazil out of the crisis as swiftly as possible. There will be plenty of time to think about the future later.

The IMF needs to be active in all important economies and develop instruments to detect and prevent crises like the current one

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Green shoots of US recovery need liquidity to grow

Barry Eichengreen

The phrase of the moment is "green shoots." My most recent Google search on the phrase came back with some 30 million hits (although 30 million is a big number, it's kind of quaint to have a reference to a million rather than a billion or a trillion in a piece about the financial crisis). Yet I am still not a believer in green shoots. Much as green shoots need water to grow into healthy plants, an economy needs liquidity to expand and recover robustly. Even with the stress tests behind it, history suggests that the United States is not going to see normal levels of bank lending and liquidity for some years. The implication is that, even if the US economy bottoms out later this year or (more likely in my view) early next year, the recovery is not going to be vigorous.

Why am I betting on a relatively tepid recovery? Four reasons.

Credit shortage

First, and most important, there will be only weak support from bank lending. We know the outcome of the stress tests was negotiated — and that in particular it understated the risk of losses to bank securities portfolios. Banks will be raising their ratio of capital to assets by earning fees (less competition for the Big Four in the wake of financial-sector consolidation guarantees more fees for banks) and by selling new shares (as Wells Fargo and Morgan Stanley did on the second Friday of May), but also by limiting the growth of their assets. "Limiting the growth of their assets" is of course just code for not lending to the same extent as they normally do in recoveries. Job creation in recoveries typically comes from small firms, and small firms need bank credit to create jobs. They will get less than usual in this recovery.

History supports this conclusion. We know that it typically takes two years from when the authorities intervene in a concerted fashion to when the banks start lending again. This

is the lesson of the Nordic banking crises of the early 1990s and the Japanese banking crisis later in that decade. This is also the lesson of the Great Depression, when bank assets in the United States did not rise for fully five years after the Bank Holiday. Other countries that experienced banking crises in the 1930s learned a similar lesson. More generally, the IMF reminded us in its spring 2009 *World Economic Outlook* that recoveries from downturns marked by financial crises are slower than recoveries from other downturns. One reason is the response — or nonresponse — of the banks.

Insufficient fiscal stimulus

Second, while fiscal stimulus helps, it is not enough. Globally, fiscal stimulus is on the order of 2% of GDP, but the output gap is nearly 6%. The IMF's latest *World Economic Outlook* projects global output to fall by 1.3% in 2009, down from a normal rate of 4½%. The difference between 4½ and -1.3 is nearly 6%. Economists normally assume that the fiscal multiplier is about 1½ — that increasing the fiscal deficit by 2% of GDP increases final spending by 3%. Thus, we are replacing only about half of the global private spending that the crisis has vaporized. This is a second reason why, though we will avoid another Great Depression, we will not see a vigorous recovery.

Unfavorable US policy mix

Third, we in the United States in particular are moving toward a policy mix that is unfavorable for investment and growth. To make myself clear: I am a strong supporter of the use of fiscal stimulus in the current circumstances — but I am also skeptical of the Obama Administration's plans for narrowing the deficit. Its scenario rests on revenues from cap-and-trade greenhouse gases[1] and savings from health care reform, the contributions of which range from the politically problematic to the imaginary.

At the same time, I am convinced that the Fed will do whatever it takes to prevent inflation from revving up once the economy begins to grow. It has the instruments it needs to do so, ranging from encouraging banks to hold more reserves by paying interest on them to issuing Federal Reserve bonds (plans for which were announced in March). After all of its unprecedented recent actions, the Fed will be concerned to reassert its independence by showing that it is serious about price stability. Unfortunately, this combination of big deficits and tight money will mean high interest rates — the worst possible policy mix from the point of view of investment and growth.

Recoveries from downturns marked by financial crises are slower than recoveries from other downturns.

China big ease

Fourth, even if China is doing better, it is still only 7% of the world economy measured at market exchange rates, which is the

China and even the BRICs together are too small to make up for American consumption shortfall

conversion factor relevant for talking about its possible role as a locomotive for the global economy. Although it is clear that the Chinese economy is now recovering, I don't buy the authorities' headline number of 6.1% growth in the first quarter. We know that they can announce any number for GDP growth they wish. Historically, a good proxy for manufacturing production in China is electricity consumption, and electricity consumption was down in the first quarter. In part that reflects the changing composition of production (less aluminum production, for example). But it also suggests that the authorities' headline estimate of GDP growth is exaggerated.

Sluggish American consumption

US consumption is likely to remain relatively weak as US households rebuild their retirement savings. Household savings are currently running at about 4% of household incomes, up from essentially zero before the crisis, and are likely to rise further. China and even the BRICs (the emerging group formed by Brazil, Russia, China, and India) together are too small to make up for American consumption,shortfall, even if they try.

Central bankers like Ben Bernanke display more optimism than I do. But they have a bigger stake: They understand that the state of the economy depends on confidence, and confidence depends on the state of the economy — if they can talk up confidence, they can talk up the economy. Not being a central banker, I can offer the unvarnished truth. I also worry that if they talk up confidence excessively and consumers are ultimately disappointed by the outcome, the exercise can backfire. We shall see.

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[1]In short, the "cap" is a legal limit on the quantity of greenhouse gases that a region can emit each year and "trade" means that companies may swap among themselves the permission – or permits – to emit greenhouse gases.

Government investment spending and the coming election

Murillo de Aragão

Before his term expires President Luiz Inácio Lula da Silva will announce the second Acceleration and Growth Program (PAC) covering 2010–14. "My successor, whoever that may be, will have a series of completed and planned projects; it will be up to him or her to define the priorities," Lula asserted in Campo Grande city last May. The initiative is interesting. The program, however, bears consideration.

Envisaged to centralize the efforts of the Federal government, the program has sensibly included projects to be carried out by state institutions that are recognized as competent, among them Petrobras and Eletrobrás. It also covers projects underway as well as some nonstrategic projects, such as parking at airports. The first PAC was, one must admit, a good initiative that has helped direct governmental action. It transformed the economic stability agenda into an agenda of growth and achievements. So far, so good. However, our bureaucratic, nationalistic, and interventionist instincts may jeopardize the entire program.

As the late Brazilian playwright Nelson Rodrigues would have put it, we have known for ages that the current PAC will play a key role in the 2010 presidential elections. What remains to be seen is whether it will work for or against those who birthed the program. Unlike any other politician today, President Lula knows how to inject a dose of concentrated optimism when he addresses an audience. Having heard and talked with most of the great Brazilian political figures in the past 25 years, I cannot think of one who matches Lula's charisma and communication skills. As a member of the government's Economic and Social Development Council (CDES) since 2007, I have witnessed memorable speeches that have gone unnoticed by the press because the day's agenda was dedicated to some other issue. As I read Lula's words in Campo Grande city about the PAC and its achievements in the railway sector, it becomes obvious that the President is the driving force behind this aspect of his administration. But that is not enough, unfortunately.

Recently, the President's Chief of Staff publicized PAC results by state. For each state, a separate booklet was published covering the projects by sector (logistics, energy, and social/urban area). Each project was given a ranking according to its current status: "contracting phase," "contracted project," "preparatory actions," "public tender," "project on course," and "project completed."

Status

The NGO Contas Abertas (Open Accounts) analyzed the status of 10,914 PAC projects by state, according to the ranking determined by the Chief of Staff. It concluded that after the program's first two years (2007–08) only 3% of the projects (319) had been completed. If we add completed projects to those underway, the total is 2,863 — still only 26% of the total. In other words, 8,051 projects are still pending. The projects where delay is greatest are those associated with social and urban infrastructure, including sanitation and housing projects, of which only 1.3% have been completed. Admittedly, those projects take a long time to execute, which may explain the slow rate of completion in the first two years of the program.

PAC's slow execution rate is a topic of current discussion at the CDES and may now be taken up by the National Congress and end up muddled with the Presidential succession debate. This is an explosive development that might attract the attention of the press and the opposition parties, which would then exploit the issue. Democrat Party (DEM) politicians, for example, have visited the state of Pernambuco to call media attention to the status of the local projects, promising to establish a group to follow up on all stages

After the PAC's first two years (2007–08) only 3% of the projects were completed

of the program. Major media outlets are also working on the issue. In the second half of the year, interest will only increase. There are rumors that Minister Dilma Rousseff might be called to account for the status of PAC.

The main reasons why PAC execution does not take off as President Lula himself would have wished are associated with environmental deadlocks, issues related to the use of indigenous land, court appeals related to public tenders, and halts determined by the Federal Court of Auditors. Considering that the political image of Minister Dilma Rousseff, a likely presidential candidate, is totally bound up with PAC, the slow rate of its execution, unsatisfactory even in the eyes of the administration, is worrying for her. Any progress in PAC implementation would tend to strengthen the possible candidacy of the minister; conversely, a slow rate of implementation would compromise her chances.

To make matters worse, the government's financial expectations are not encouraging. At the end of May the government reduced its projections for revenue by R$60 billion (US$30 billion) for the year, and GDP growth projections were reduced from 2% to 1%. So as it stands now, is the PAC an advantage or a hindrance? I feel it could help. But that will require great efforts. Enormous efforts.

Chairman, Arko Advice Political Research and Analysis; M.A. (political science), Ph.D. (sociology), University of Brazilia

New tool to track business cycles in Brazil

The Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation (FGV) has created the Business Cycle Dating Committee (CODACE) to maintain a reference chronology of business cycles in Brazil. The first task entrusted to the seven CODACE members — all renowned economic experts — was to date periods of expansion and recession in the Brazilian economy between January 1980 and March 2009.

Definition of business cycles by an independent committee lends more efficiency to government economic policies and to allocation of resources by the private sector. It also serves as a reference for scholarly research. CODACE's organization and methodology follows the same model adopted in other countries, particularly that of the US Business Cycle Dating Committee, created in 1978 by the National Bureau of Economic Research (NBER).

The members of CODACE are Affonso Celso Pastore (coordinator; former governor of the Central Bank of Brazil); Dionísio Dias Carneiro (Institute for Economic Policy Studies, Casa das Garças); João Victor Issler (Graduate School of Economics of FGV, EPGE/FGV);

Brazil: Business cycles – Dates and durations

Reference dates		Duration in quarters			
		Contraction	Expansion	Cycles	
Peak	Trough	Peak to trough	Previous trough to this peak	Trough from previous trough	Peak from previous peak
4th Quarter of 1980	1st Quarter of 1983	9	-	-	-
2nd Quarter of 1987	4th Quarter of 1988	6	17	23	26
2nd Quarter of 1989	1st Quarter of 1992	11	2	13	8
1st Quarter of 1995	3rd Quarter of 1995	2	12	14	23
4th Quarter of 1997	1st Quarter of 1999	5	9	14	11
1st Quarter of 2001	4th Quarter of 2001	3	8	11	13
4th Quarter of 2002	2nd Quarter of 2003	2	4	6	7
3rd Quarter of 2008	-	-	21	-	23
Average duration	-	5,4	10,4	13,5	15,9

Sources: Brazilian Institute of Geography and Statistics (IBGE), and Business Cycle Dating Committee.

Marcelle Chauvet (secretary; University of California); Marco Bonomo (Graduate School of Economics of FGV, EPGE/FGV); Paulo Picchetti (São Paulo School of Economics of FGV, EESP/FGV); and Regis Bonelli (Brazilian Institute of Economics, IBRE/FGV).

The dating of Brazilian business cycles that CODACE carried out was based on economic statistics expressed in levels, i.e., each maximum (peak) point of the cycle refers to the end of an expansion period, which was followed by the start of a recession in the next quarter; each local minimum (trough) point refers to the final quarter of a recession, which was followed by the start of economic expansion in the next quarter.

CODACE determined turning points in the Brazilian business cycles according to classic expansion and recession concepts adapted to the unique characteristics of the Brazilian economy. Over the last three decades, compared with the economies of developed countries the Brazilian economy has been more volatile and underwent more exceptional periods, such as hyperinflation surges and economic shocks typical of the late 1980s and early 1990s.

The concept of business cycles was created by Arthur Burns and Wesley Mitchell, both NBER researchers. They defined the business cycle as:

None of the four recessions registered during the period of lowest inflation, after 1994, lasted longer than five quarters

"... expansions occurring at about the same time in many economic activities, followed by similarly general recessions, contractions, and revivals which merge into the expansion phase of the next cycle; this sequence of changes is recurrent

Brazil: Quarterly chronology of business cycles – duration and amplitude *

Contraction				Expansions			
Period	Duration in quarters	Cumulative fall %	Quarterly average growth %	Period	Duration in quarters	Cumulative growth %	Quarterly average growth %
1st Quarter of 1981 to 1st Quarter of 1983	9	-8,5%	-1,0%	2nd Quarter of 1983 to 2nd Quarter of 1987	17	30,0%	1,6%
3rd Quarter of 1987 to 4th Quarter of 1988	6	-4,2%	-0,7%	1st Quarter of 1989 to 2nd Quarter of 1989	2	8,5%	4,2%
3rd Quarter of 1989 to 1st Quarter of 1992	11	-0,9%	-0,1%	2nd Quarter of 1992 to 1st Quarter of 1995	12	19,2%	1,5%
2nd Quarter of 1995 to 3rd Quarter of 1995	2	-2,8%	-1,4%	4th Quarter of 1995 to 4th Quarter of 1997	9	8,2%	0,9%
1st Quarter of 1998 to 1st Quarter of 1999	5	-1,6%	-0,3%	2nd Quarter of 1999 to 1st Quarter of 2001	8	7,3%	0,9%
2nd Quarter of 2001 to 4th Quarter of 2001	3	-1,0%	-0,3%	1st Quarter of 2002 to 4th Quarter of 2002	4	4,9%	1,2%
1st Quarter of 2003 to 2nd Quarter of 2003	2	-1,7%	-0,8%	3rd Quarter of 2003 to 3rd Quarter of 2008	21	29,9%	1,3%
Since 4th Quarter of 2008	-	-3,6%	-	-	-	-	-

Sources: Brazilian Institute of Geography and Statistics (IBGE), and Business Cycle Dating Committee (CODACE/FGV).

* Growth measured as seasonally adjusted quarterly GDP at market prices.

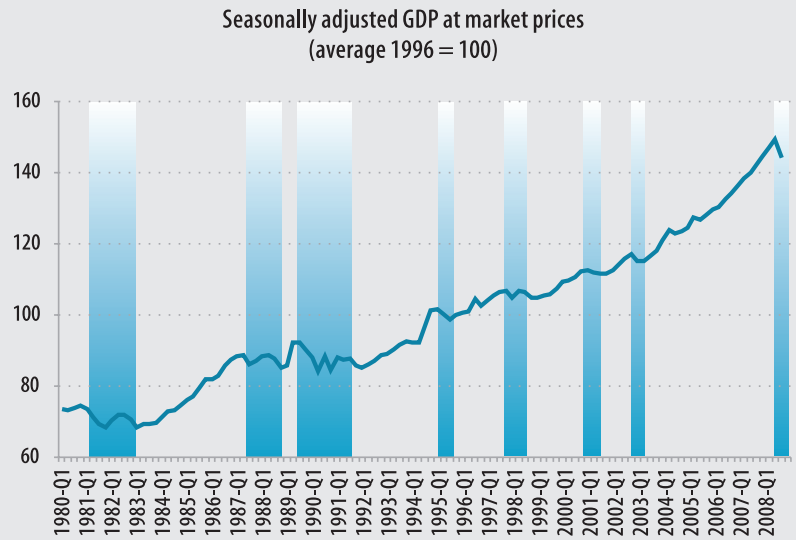
but not periodic; in duration business cycles vary from more than one year to ten or twelve years ..."[1]

Periods of recession

CODACE considers a recession to be a period of substantial decline in economic activity in several sectors of the Brazilian economy lasting for a minimum of two consecutive quarters. The principal variable adopted in the dating exercise is quarterly seasonally adjusted GDP at market prices as calculated by the Brazilian Institute of Geography and Statistics (IBGE). To confirm turning points detected in the quarterly GDP series, the committee resorted to all economic series available, particularly those that better expressed the state of production, sales, employment, and income in the Brazilian economy over the period concerned.

A quarterly interval was adopted for the first exercise of dating business cycles in Brazil because there is a relative lack of continuous monthly statistics of good quality. In addition to monitoring economic activity to be able to date future cyclical events on a quarterly basis, CODACE will also carry out monthly dating for the period between 1980 and 2008 and the dating of cycles before 1980.

Brazil: Quarterly chronology of business cycles, 1980Q1-2008Q4*



*Shaded areas are recession periods.

The chart shows the results of CODACE's quarterly dating of business cycles in Brazil since 1980. Over less than three decades the Brazilian economy underwent seven complete business cycles, lasting on average 13.5 quarters between two troughs and 15.9 quarters between two peaks. The average duration of expansions was 10.4 quarters; recessions lasted on average 5.4 quarters.

The longest expansion phase lasted 21 quarters, between the third quarter in 2003 and the third quarter in 2008; it led to a growth accumulation of 30% as measured by real quarterly GDP. The deepest recession lasted 11 quarters, between the third quarter in 1989 and the first quarter in 1992. None of the four recessions registered during the period of lowest inflation, after 1994, lasted longer than five quarters.

[1]Arthur F. Burns and Wesley C. Mitchell (1946). *Measuring Business Cycles*. New York: National Bureau of Economic Research, page 3.

Consumer confidence

The FGV Consumer Confidence Index (CCI) has increased three months in a row since March. In view of the current international crisis, the evolution of the CCI can be regarded as relatively favorable. The evolution of the indicator reflects the strength of the domestic market — which is being supported by income transfer programs, minimum wage increases and tax exemption measures — and good fundamentals of the economy, most notably low inflation.

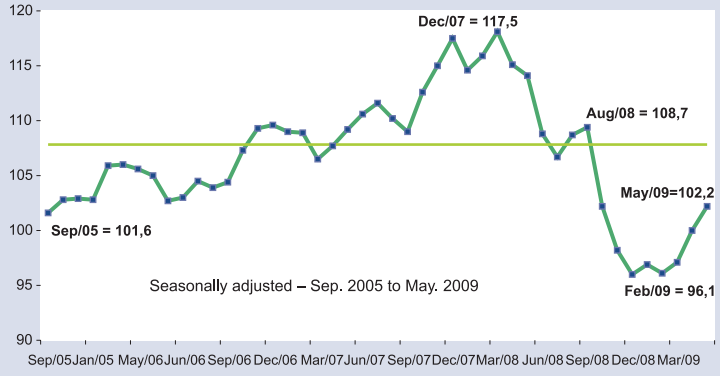
Industry

The FGV confidence index of Brazilian industry dropped sharply last September 2008. Since last December, the sector has recovered gradually. The National Development Bank (BNDES) estimates that the drop in exports accounted for 52% of reduction in industrial production from October 2008 to March 2009. The halt of capital goods industry and shortage of credit for durable goods also contributed for the reduction. Non-durable goods, less dependent on credit, suffered less from the crisis. Sales of durable goods are returning to the level before the outbreak of the crisis because of tax exemptions and monetary loosening.

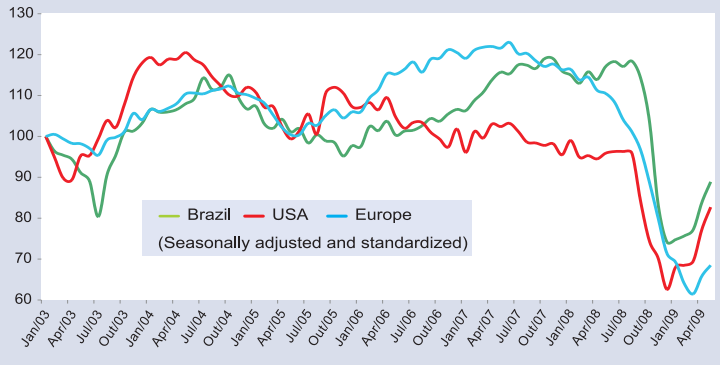
Inflation

12-month inflation measured by the General Price Index (IGP-DI) increased 2.99% in May. Since July 2008 the index has declined by almost 12 percentage points. The trend should continue despite recent monetary loosening. In 2009, monthly inflation rates have been much lower than in 2008, and the recent appreciation of the exchange should help to contain inflation even more. The decline of IGP index indicates both decreasing pass thru costs of inputs and less indexing of services like electricity distribution and residential rents, and as a result anticipates lower consumer prices.

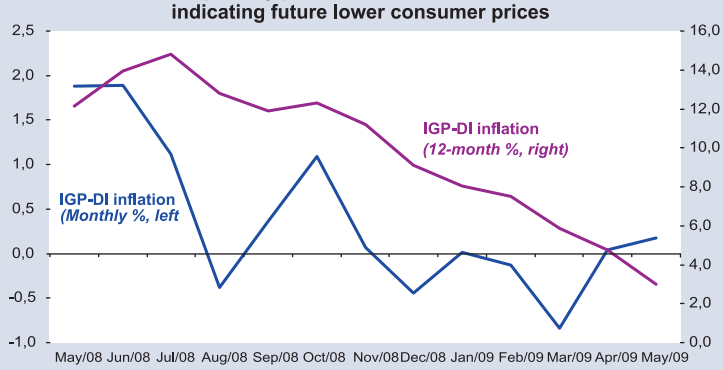
Consumer confidence continues to recover on the strength of domestic market since February



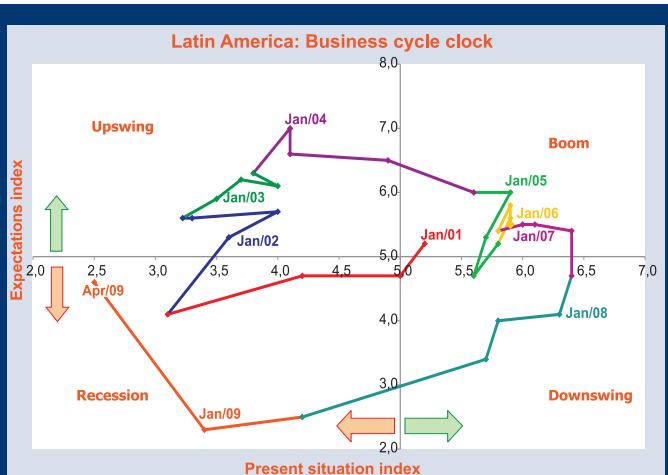
Brazilian industry confidence index has been recovering since last December



Industrial and primary products inflation continues to decline, indicating future lower consumer prices



Latin America: Business cycle clock



Latin America could be leaving recession zone soon

The business cycle clock shows that Latin American region entered the recession zone in October 2008, remaining there until April 2009, although it is close to enter the recovery zone. Brazil entered the recession zone only in January 2009 and in April had already left. The world economy entered into recession in July 2008, remaining in this quadrant until April 2009. The Ifo (Institute for Economic Research, University of Munich) created the business cycle clock, and IBRE (FGV) compiles the business cycle clock for Latin America with information from the Quarterly Economic Survey of Latin America.

For more additional series and methodology contact: Industry and consumer surveys: (55-21) 3799-6764 or sondagem@fgv.br; Price indexes and data bank services: (55-21) 3799-6729 or fgvdados@fgv.br.