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How far is the Brazilian sustainable economic growth?

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Macroeconomic stability since 1994

1. Reforms started in the Cardoso government in 1994 lead to price stability, but were unable to restore sustainable economic growth.
2. Lula's government was a positive surprise, in the sense of maintaining: a) fiscal discipline; b) the floating exchange rate regime and; c) giving the Central Bank *de facto* independence. Contrary to Cardoso's government, it benefited from an extremely favorable international economic environment, that allowed GDP to grow by 5.0%, but such is not a sustainable rate.

What about economic growth?

1. Brazil is a late-comer in the process of economic growth. Growth is not shaping-up as vigorous as in China or India, and the reform process resembles more Chile's path.
2. The largest progress is occurring in the field of macroeconomic stability. There is a mature democracy, and the country is progressing in reforms and in the creation of institutions guaranteeing the smooth functioning of markets, the working of regulatory agencies, the gradual improvement in the judicial system. There is also some improvement in the microeconomic reforms agenda.

Macroeconomic Stability

1. Although since the monetary reform of 1994 inflation is under control, the present economic policy regime started only in 1999, with: a) fiscal discipline and primary fiscal surplus targets aiming at a reduction of the debt/GDP ratio; b) floating exchange rate; and c) inflation targeting.
2. The corrections and adjustments under the present regime have been large, and it has not yet produce visible results improving economic growth.

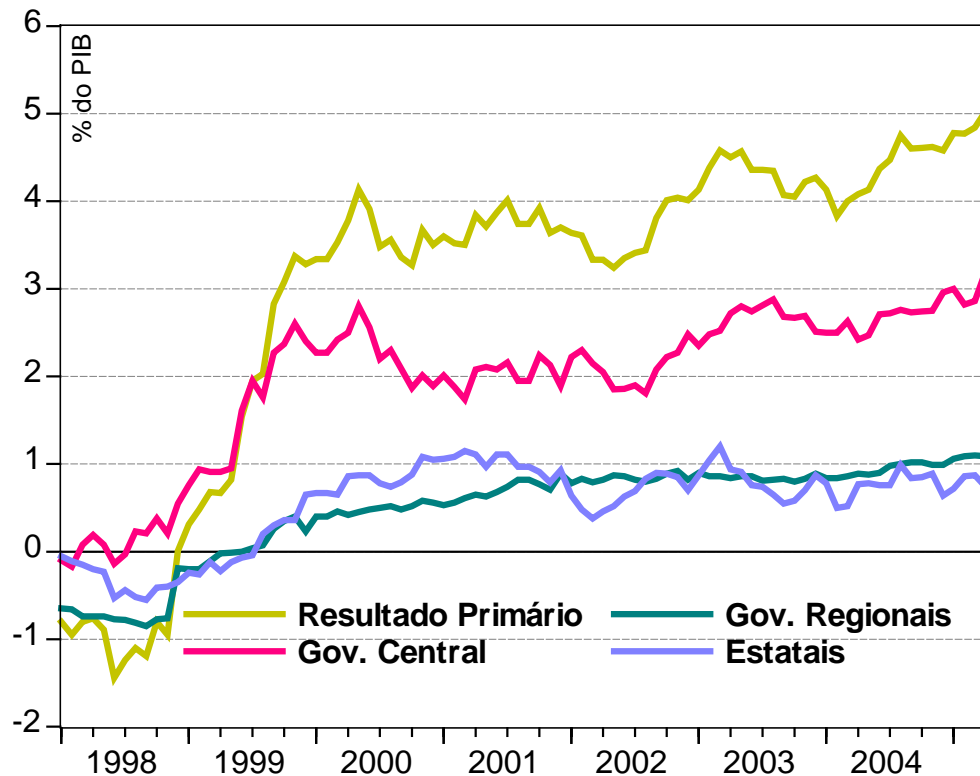
The 3 main characteristics of the present macroeconomic regime

1. Interrelation between the debt dynamics and the real exchange rate: the requirement of large primary fiscal surplus targets
2. Exchange rate volatility: its effects on inflation and on international trade
3. Inflation Targeting and the limits for monetary policy flexibility: the trade-off between flexibility and credibility

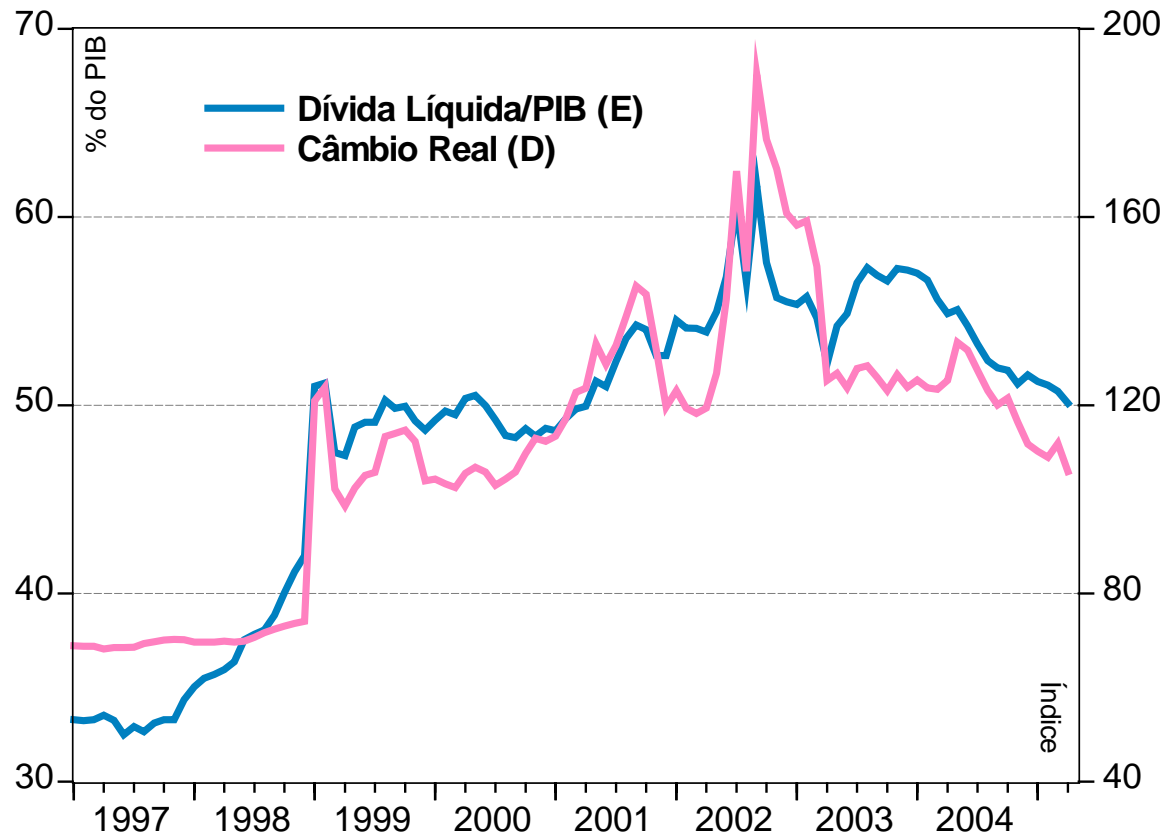
Fiscal Policy and the Public Debt Dynamics

1. The public debt is large, and has a large proportion linked to the exchange rate.
2. As a consequence its public debt dynamics is still dependent upon the real exchange rate (such dependence is declining, as we will see later), which is volatile because:
 - Capital flows are volatile, and are partly dependent upon the fears of the public debt sustainability;
 - The real exchange rate is volatile because the economy is not enough opened to international trade.
3. The fears of the public debt sustainability were at the basis of the 2002 crisis.

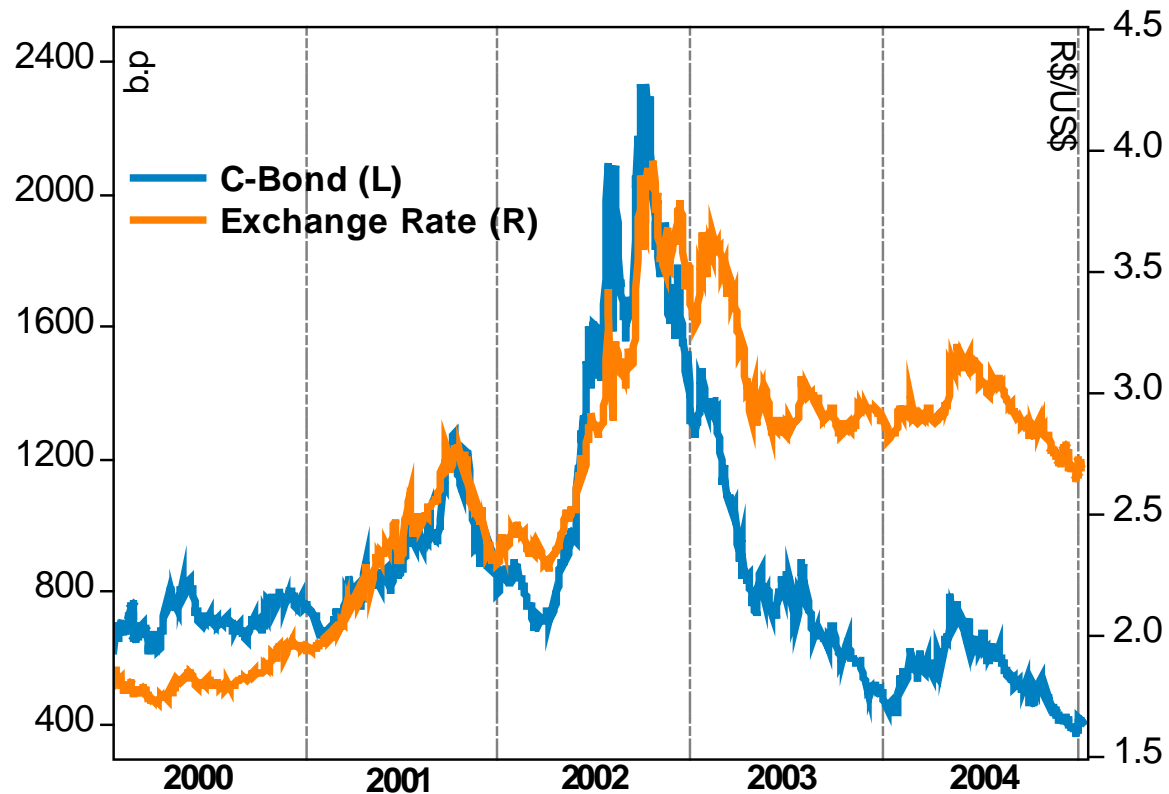
Since 1999 the primary fiscal surplus targets have been reached. Control was imposed on States and Municipalities, and a Fiscal Responsibility Law was approved and enforced.



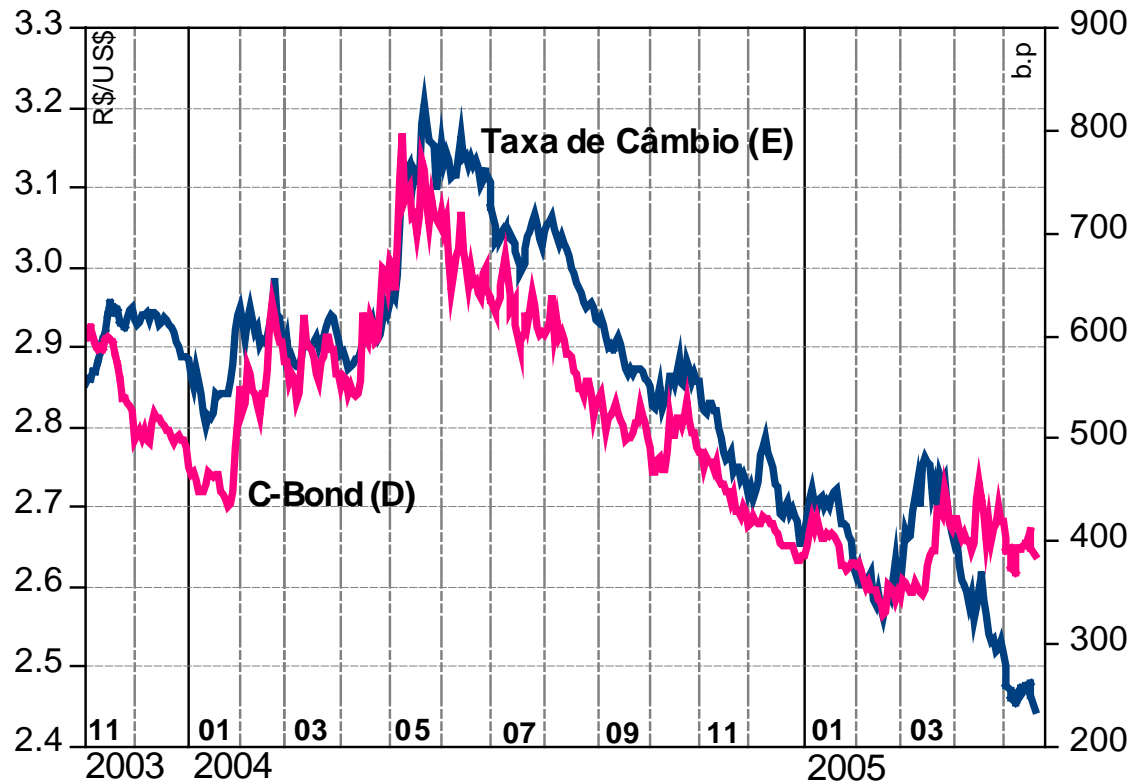
Since 2003 the net debt in proportion to GDP is declining. The public debt dynamics is dependent upon the real exchange rate



Nominal exchange rate, and capital flows: there is a positive correlation since the beginning of the floating exchange rate regime, in 1999



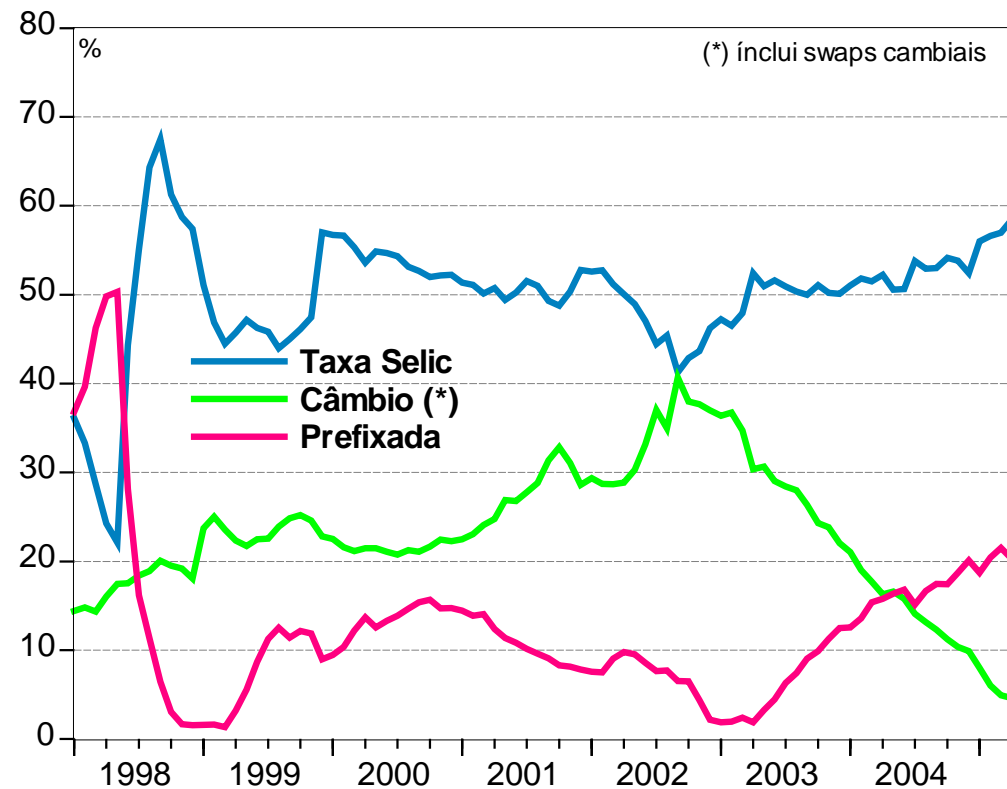
...that is maintained also more recently



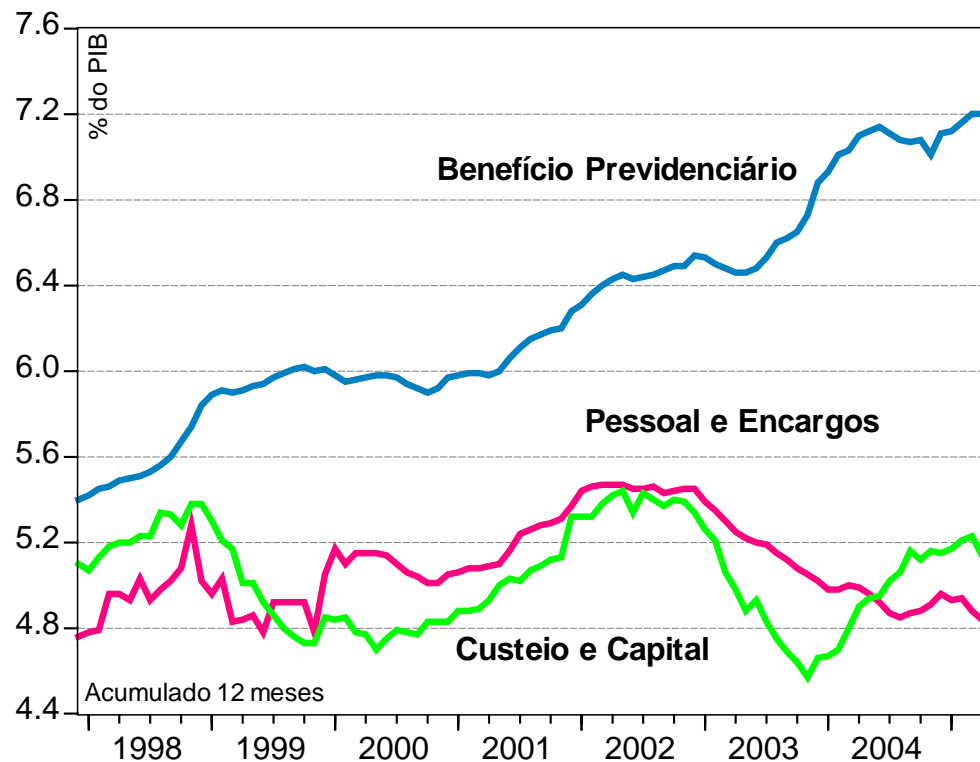
The link between debt dynamics and capital flows

1. The demand for Brazilian bonds shifts with changes of perceived risks concerning the public debt sustainability.
2. A rise in such risk reduces the demand for Brazilian bonds provoking two effects: a) in the secondary market it reduces bonds prices and increases risk premiums; b) but it also reduces the demand for newly issued bonds, leading to a shrinkage of capital flows and the exchange rate depreciation.
3. The nominal exchange rate depreciation leads to the real exchange rate depreciation, increasing the debt/GDP ratio, and unless the primary fiscal surplus is increased to guarantee the debt sustainability, the risk premiums also increases.

More recently the composition of the domestic debt is improving, with the reduction of its dollar-linked proportion



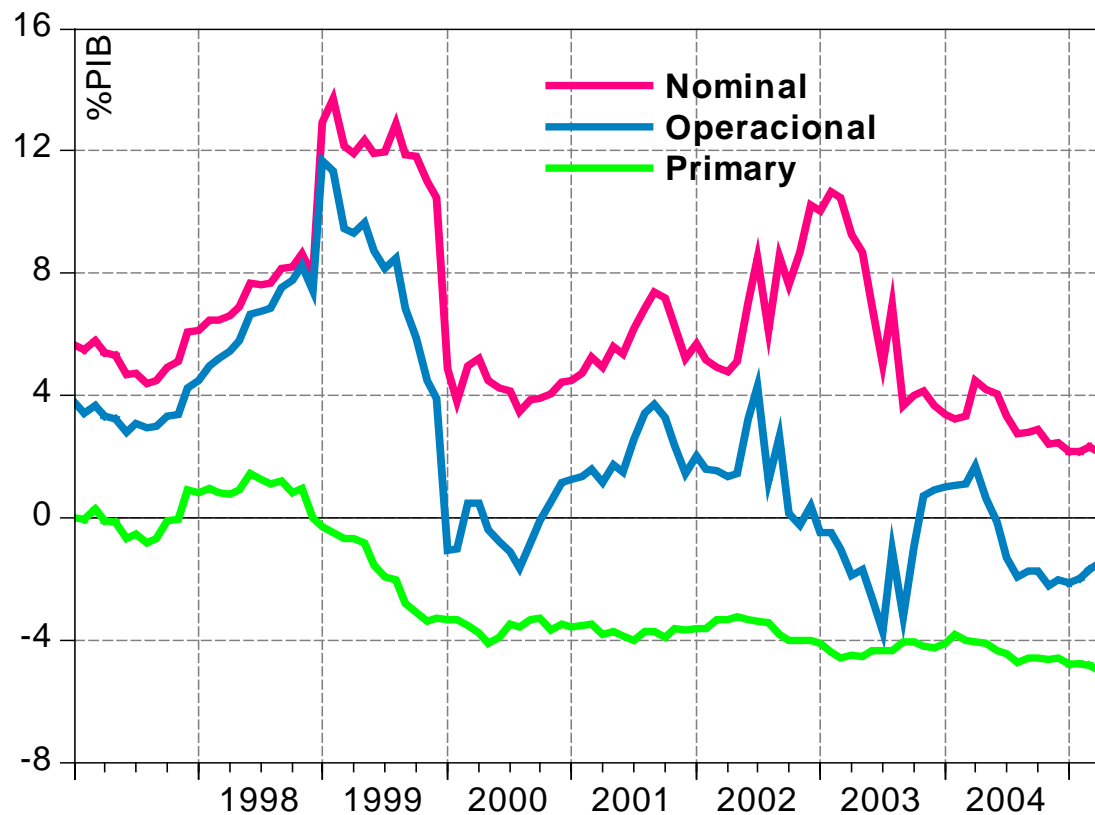
Expenditures are high, and its discretionary component is small, but the government is controlling expenditures. There is still a problem with the social security benefits.



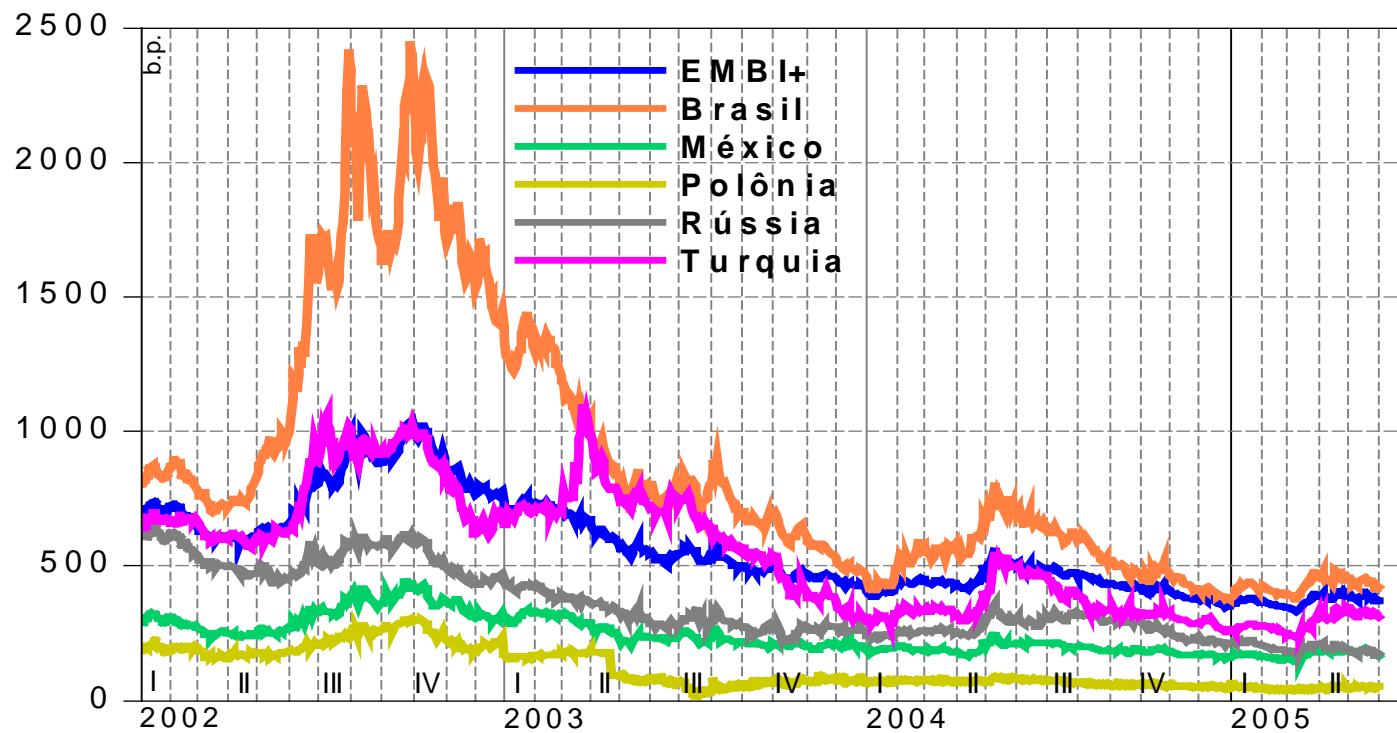
Consequences:

1. PSBR declined, and is presently comparable to those occurring in countries with good fiscal performance.
2. Public savings have increased, contributing to match the dissaving generated by the current account surplus.
3. Brazil risk has declined, contributing to reduce the effective international interest rate.

PSBR, Operational and Primary Balances



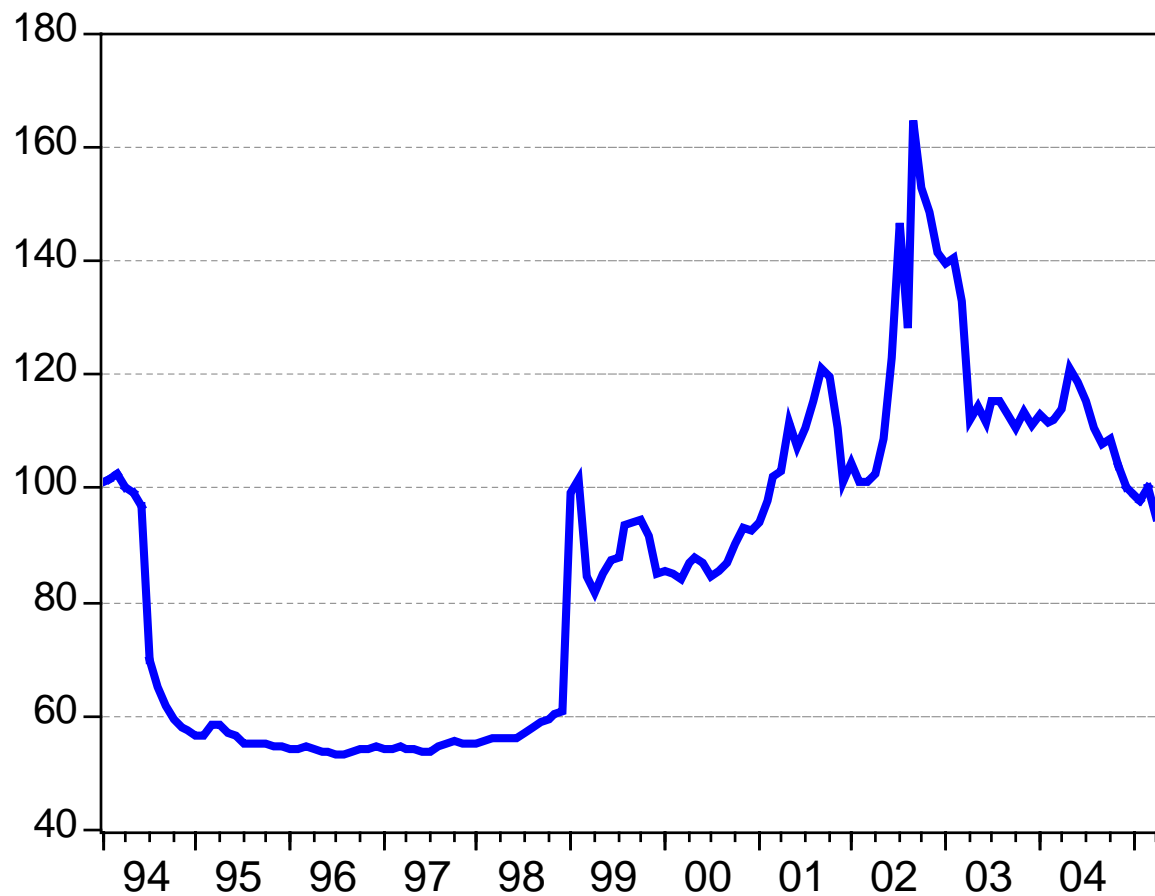
Risk premiums declined, and if Brazil's beta is large, they are converging to the international average



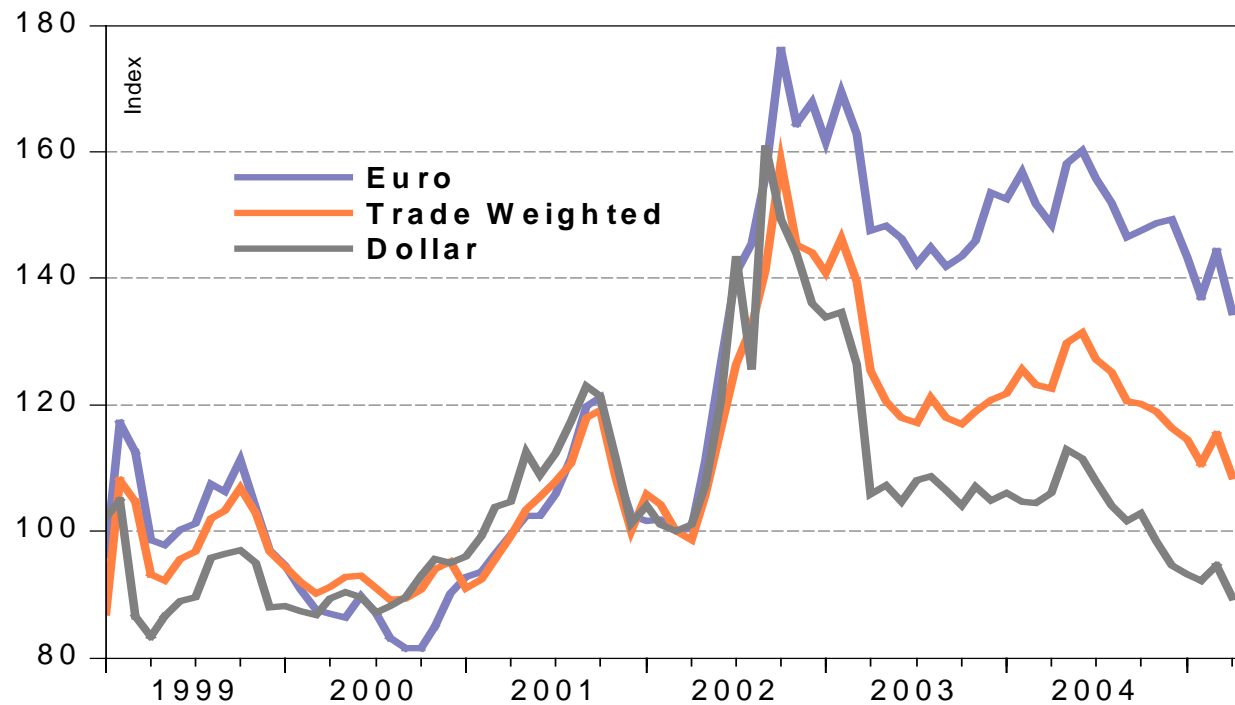
Real Exchange Rate and the Balance of Payments

1. Before 1999 the exchange rate operated as a nominal anchor, and the real exchange rate appreciated, leading to an unsustainable current account deficit.
2. Since 1999 the current account turned into a surplus, international reserves increased, and exports resumed a growth rate larger than total world exports growth rate.

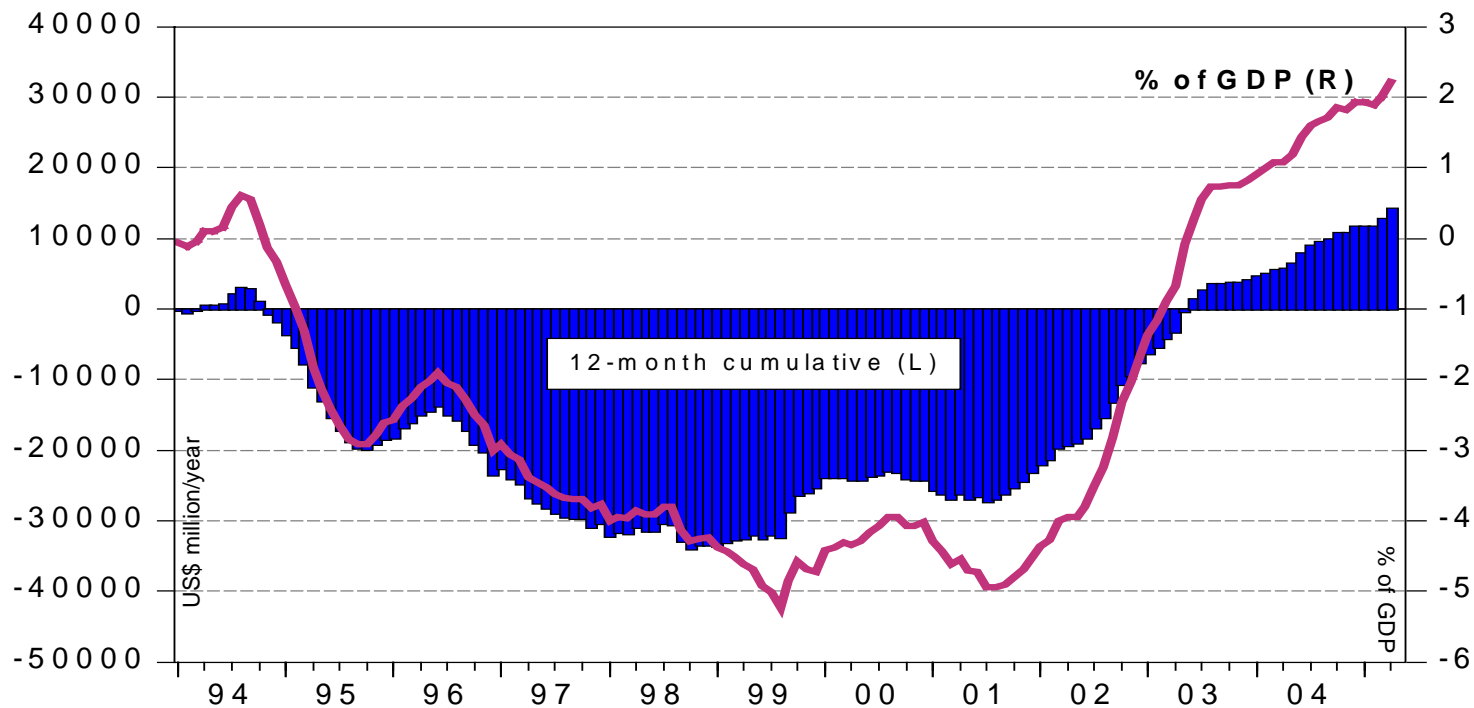
The real exchange rate underwent a major depreciation since the 1999.



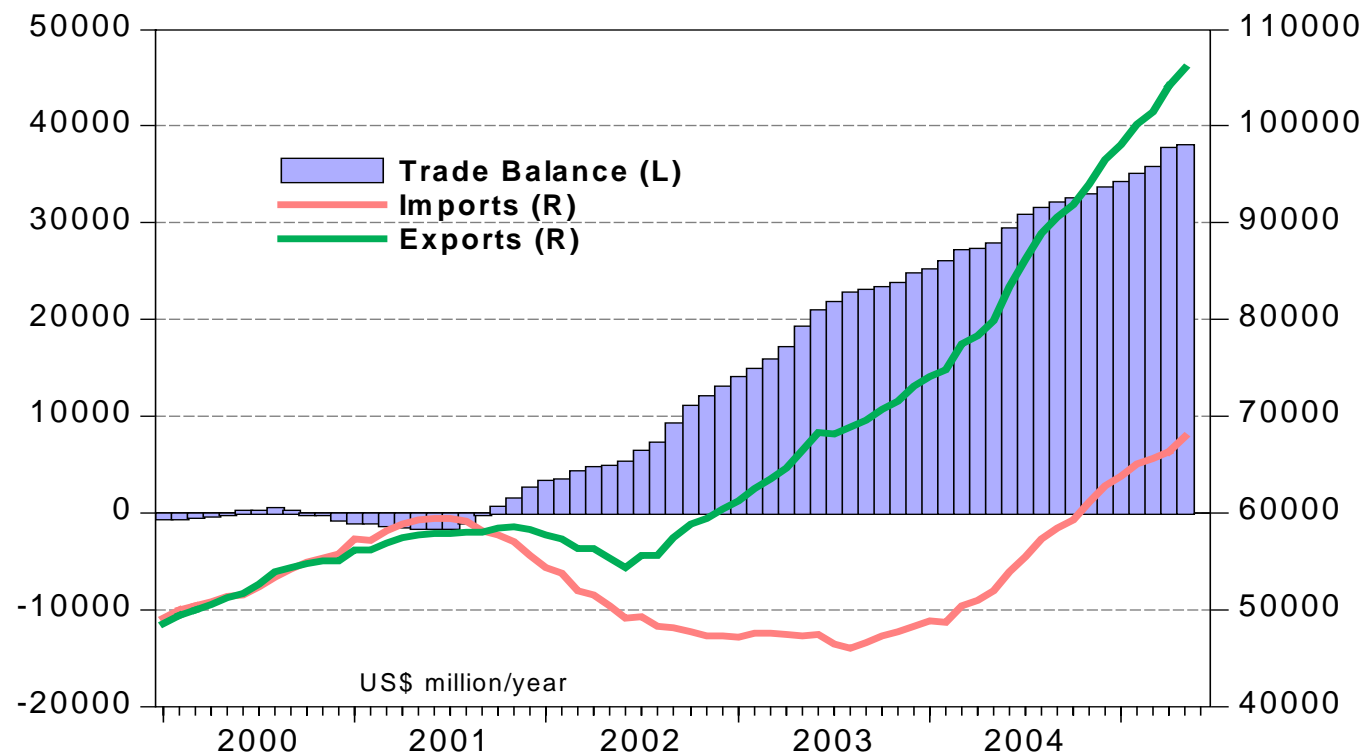
...and such fluctuations were particularly high since 2002. The country has a diversified regional pattern of trade, and the dollar depreciation minimized the effects of the strengthening of the real.



The large depreciation was required to eliminate the unsustainable current account deficit, that is presently a surplus of some 2% of GDP



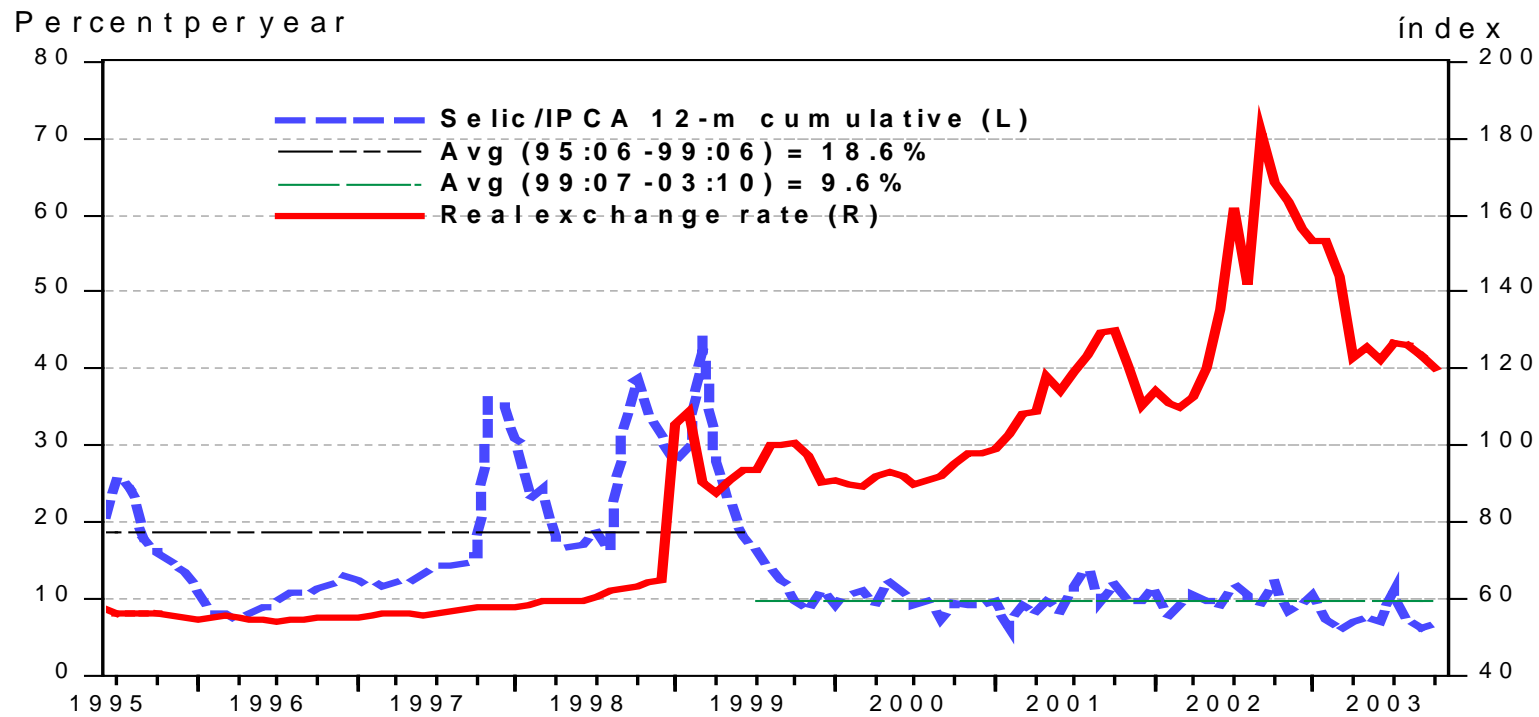
Such turn-around was brought by a rate of exports growth larger than the growth of total world exports, leading to more than US\$ 30 billion trade surplus



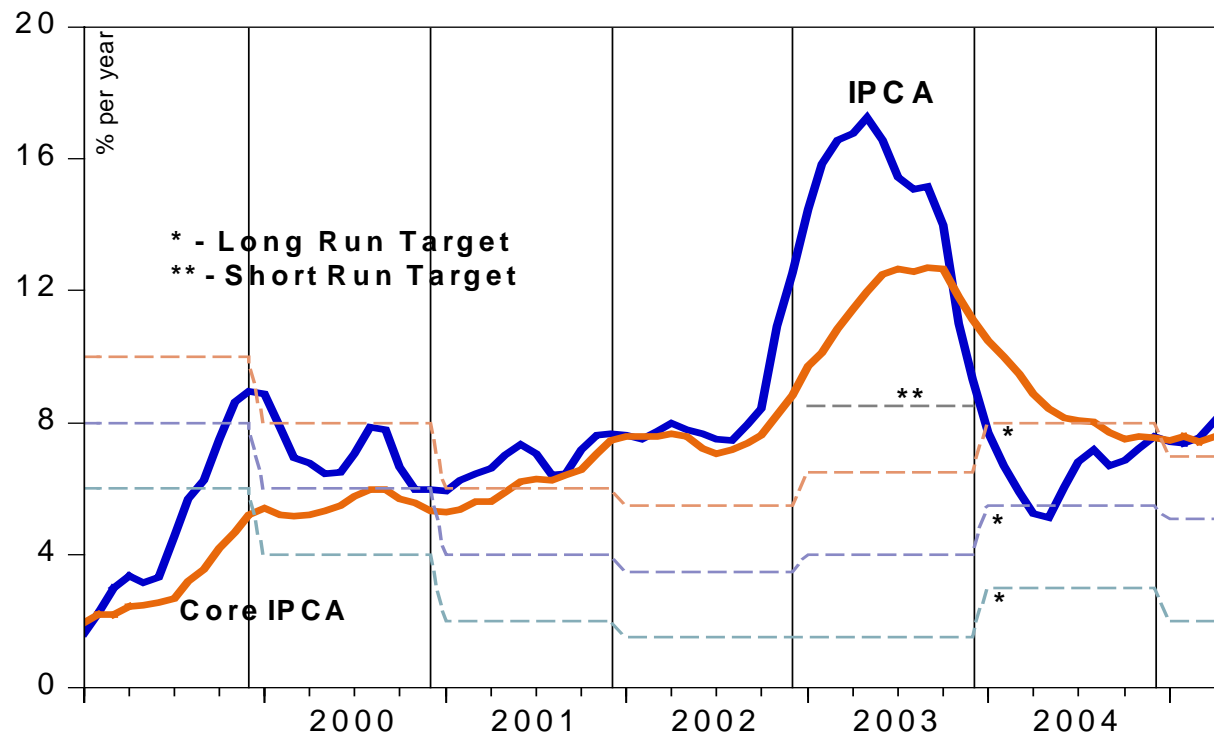
Inflation and Monetary Policy

1. The inflation targeting regime has functioned well, but several shocks tend to increase inflation, requiring some flexibility in monetary policy. Examples of shocks are: a) the exchange rate depreciation; b) increases in tax rates; c) changes in international prices of commodities. Expectations are very sensitive to such shocks.
2. Credibility requires a firm commitment to the inflation target, and the volatility in output provoked by the monetary tightening required to dissipate the inflationary effects of such shocks requires some flexibility. There is a thin line separating how much flexibility can be used, and how much would undermine credibility.

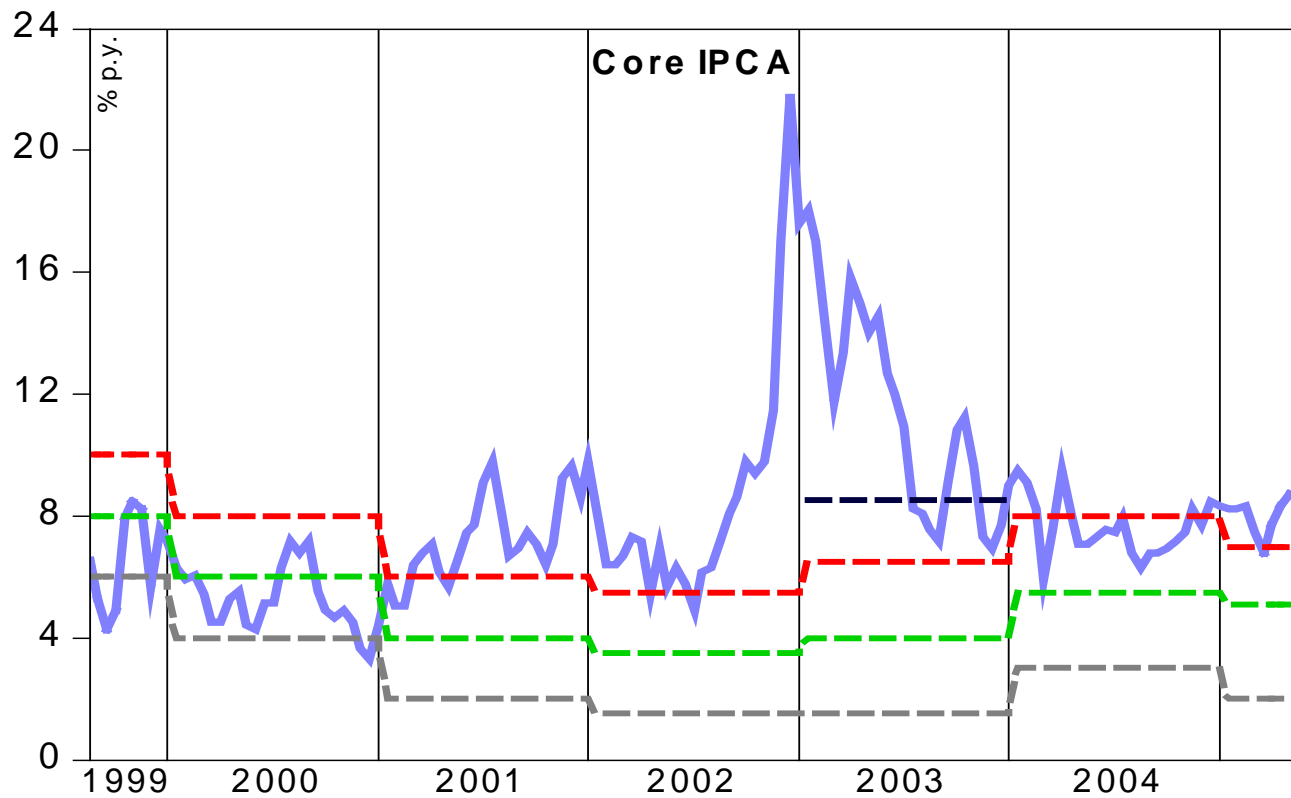
Before the 1994 monetary reform, the real interest rate absorbed external shocks, and after the floating exchange rate such shocks were absorbed by the real exchange rate, with important consequences on the level of activity. But even though interest rates are high.



The 2002 exchange rate depreciation brought inflation well above target. The target bands have to be large



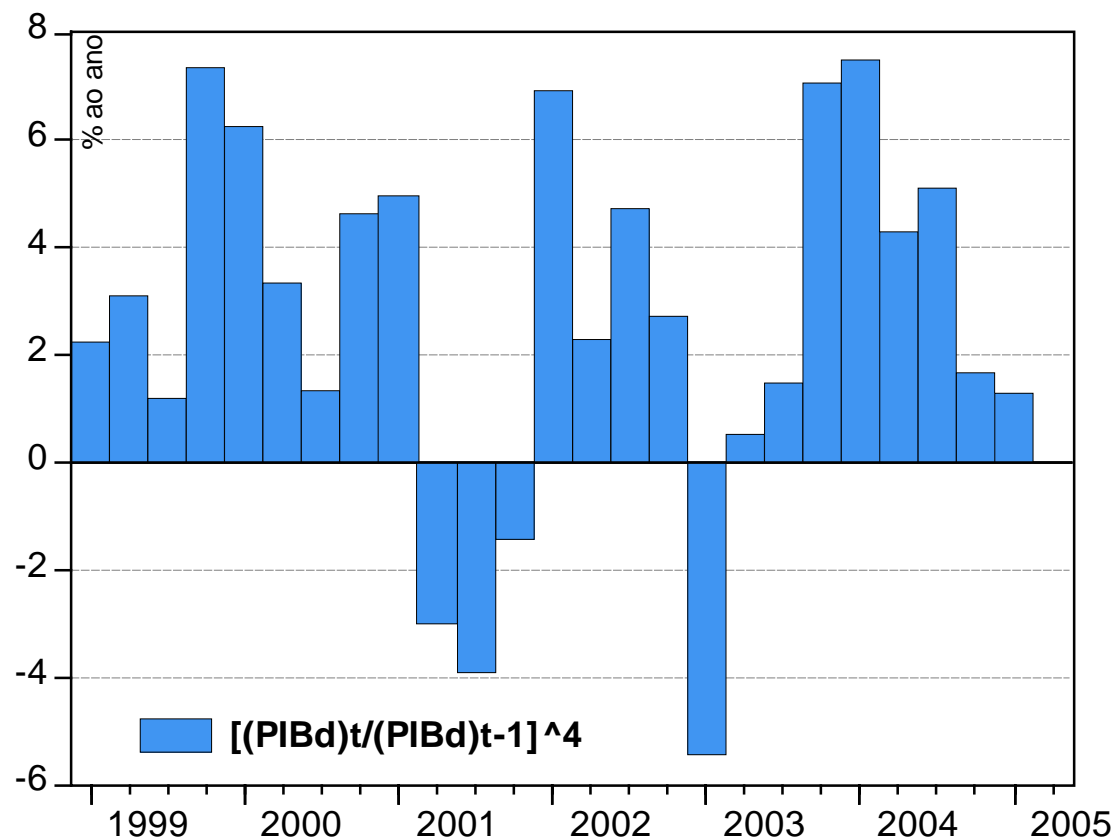
Presently the annualized core inflation rates are fluctuating around the upper limit of the interval for the inflation target



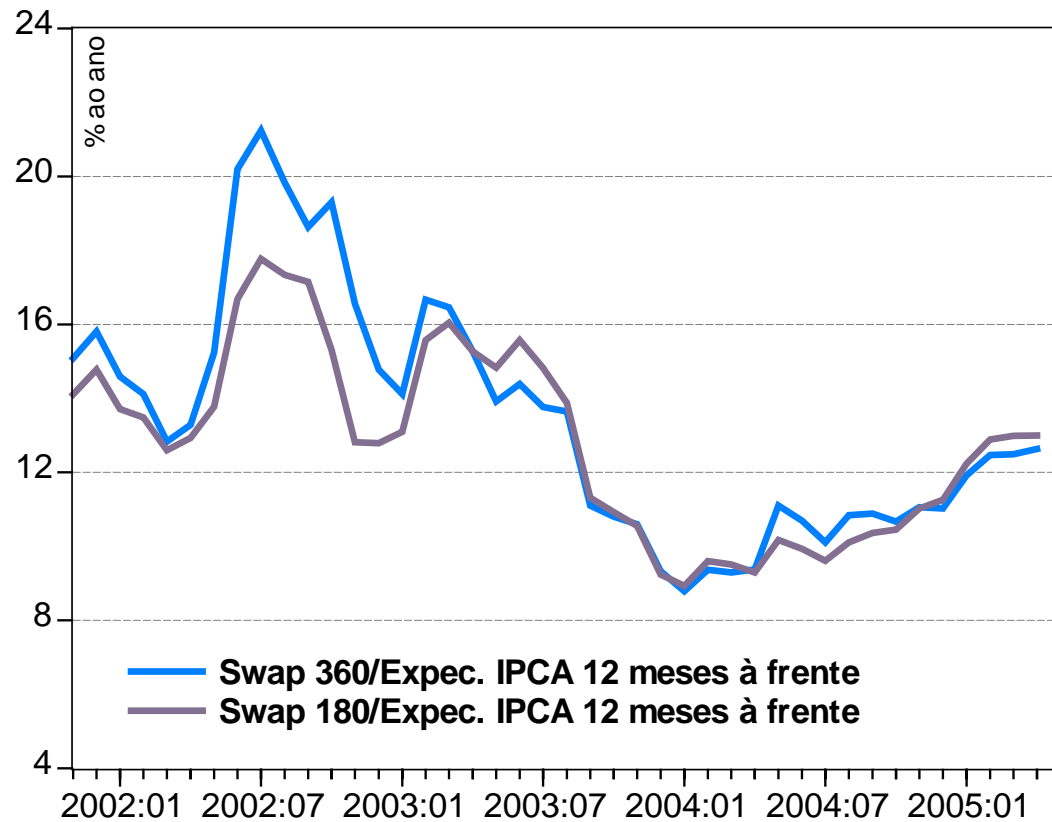
Economic Growth

1. The 2004 rate of economic growth was larger than sustainable. It was permitted by the large margin of unused installed capacity, and by the fast growth of exports.
2. In 2005 growth will decelerate

Quarterly annualized rates of GDP variation



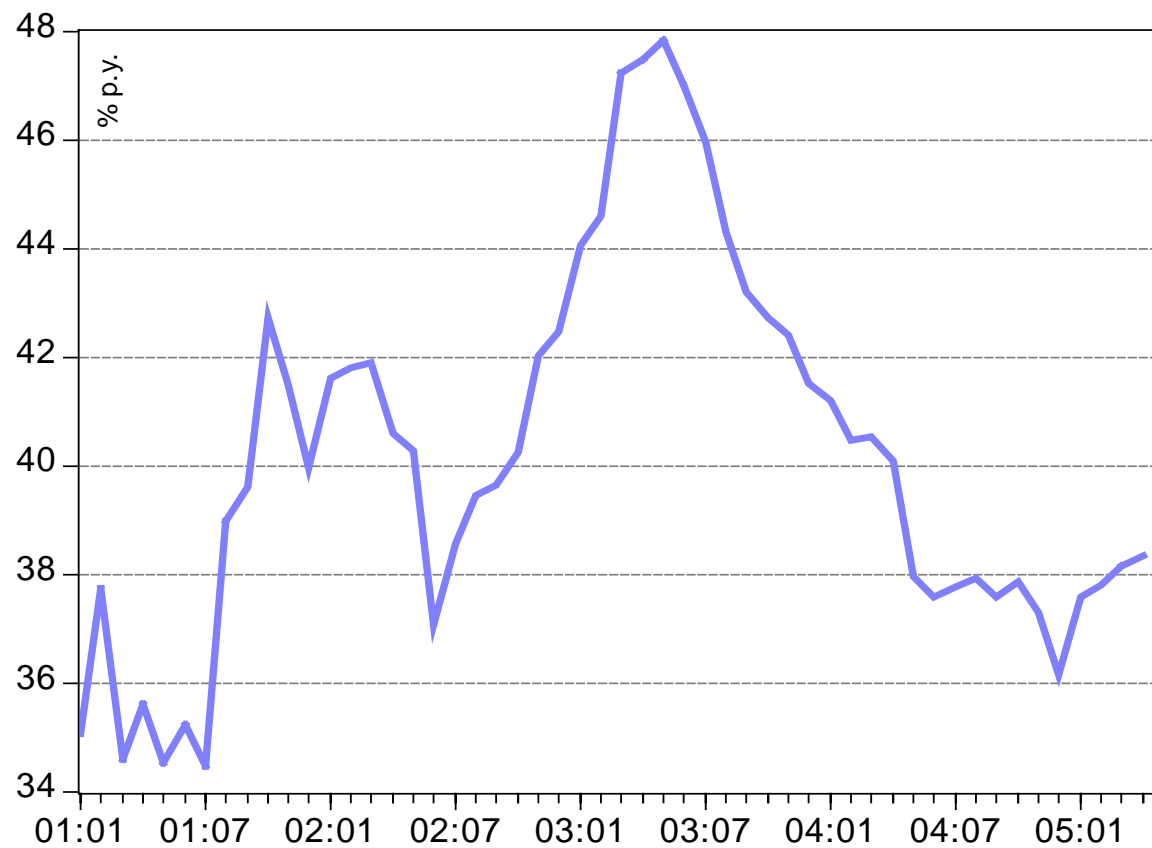
Such deceleration is partly due to the high real interest rates



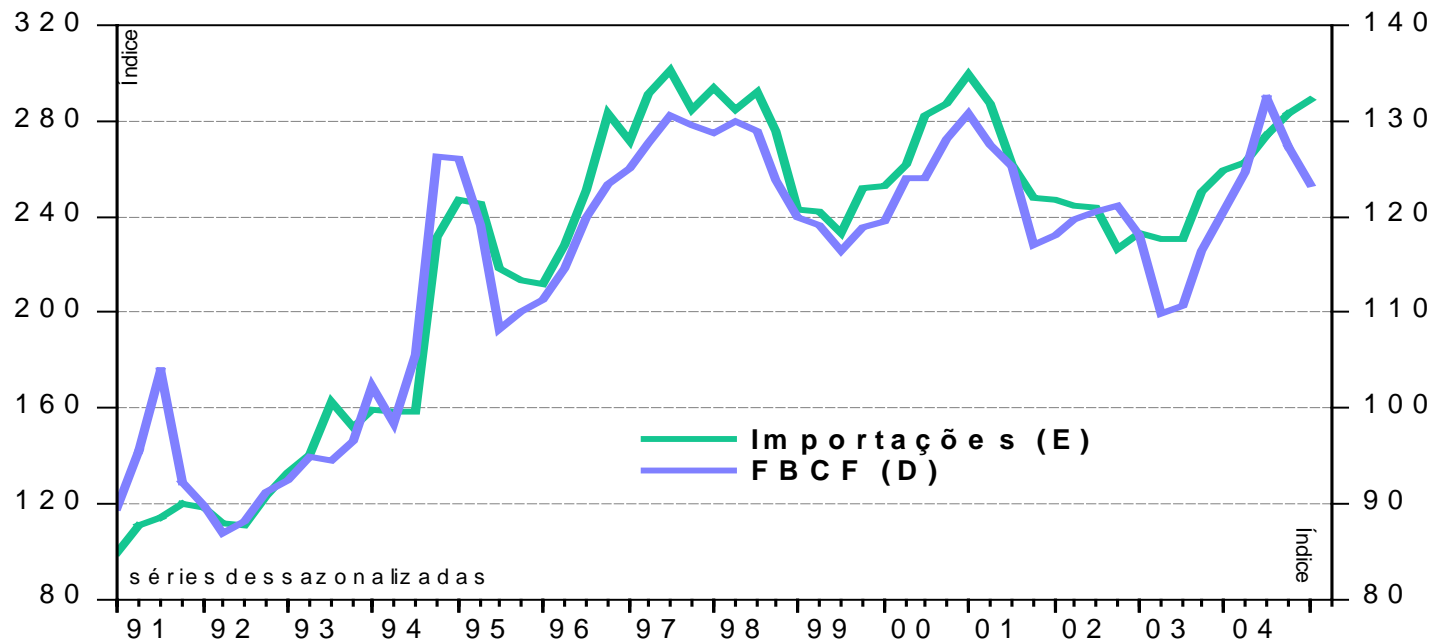
Interest rates and banking spreads

1. A lot of attention is devoted to the high real basic interest rate. It is high fundamentally because even with improved economic fundamentals, such fundamentals are not yet solid enough. The public debt has to decline further, and to allow a reduction in total tax burden. The total trade (exports and imports) have to increase further. Legal independence, rather than only *de facto* independence has to be granted to the Central Bank.
2. But as important as such high rates, are the high banking spreads, and the shallow degree of bank lending to the private sector. The reduction of the public debt and the improvement of the judicial system are key to reduce such spreads.

Banking Spreads



But the high real interest rates are not the only factor impeding the rise in investments. They are heavily dependent upon on imports, implying that the real exchange rate depreciation increases the cost of capital



The other factor is certainly the real interest rate: recently investments declined even in face of the real strengthening. Such reaction is mostly due to the high real interest rate.

