

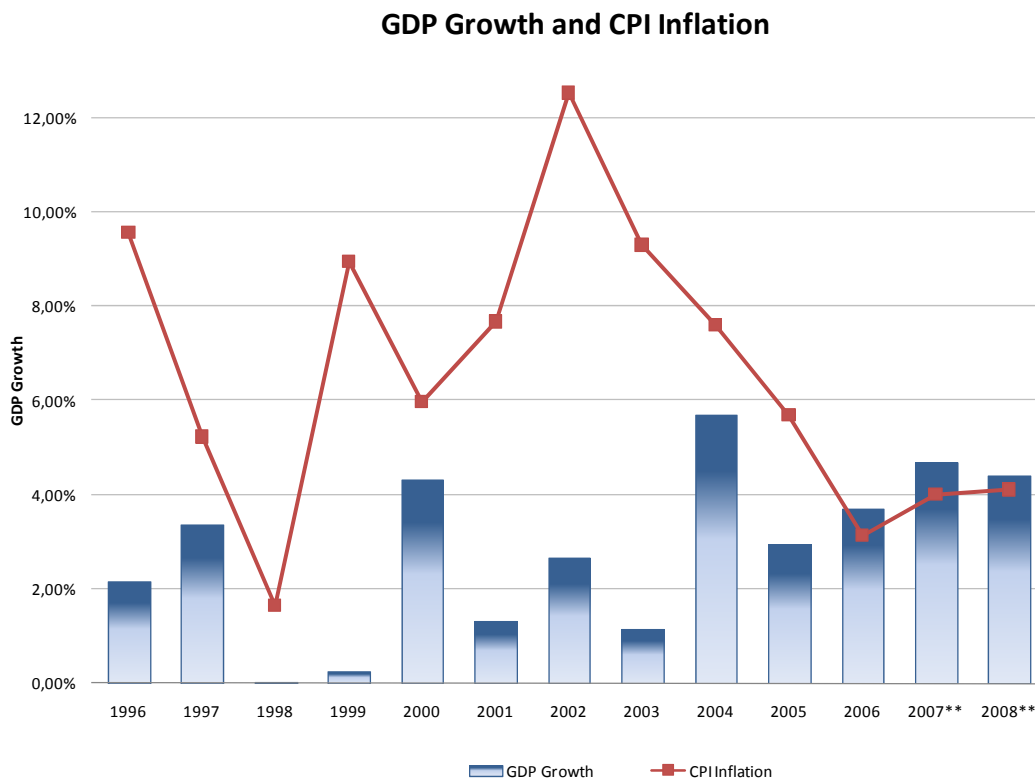
Brazil: Resilience in the face of global uncertainty¹

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Márcio Garcia (PUC-Rio)

This year, at the LACEA/LAMES meetings (Bogota, Oct 4-6), I participated in two sessions. The first one dealt with policy reactions to the sudden stops of the nineties and, in the case of Brazil, of 2002. In the same evening, Nouriel Roubini invited me to discuss the effects of the current subprime mess on the Brazilian economy. The comparison between the economic fundamentals in 2002 and 2007 is shocking.

Brazil never had it so good. Demand for Brazilian exports have been skyrocketing for years, turning the 2002 sudden stop in an almost unrecognizable past, and allowing the persistence of (mostly) sensible economic policies to bloom. The most drastic changes happened with external variables, as foreign debt, trade and current account balances, or export to debt service ratio. However, the most important macroeconomic change was the one shown in the attached chart. For the first time in several decades, the former hyperinflationary Brazilian economy will post reasonable real GDP growth rates systematically above inflation rates. That is, no doubt, a great achievement.



¹ I thank Laura Macedo and Pedro Maia for superb research assistance. Some of the ideas used in this text were taken from presentations made by Ilan Goldfajn, Affonso Pastore and Paulo Leme at the seminar "Brasil e a Turbulência Mundial", held on September 14 by the Department of Economics, PUC-Rio (www.econ.puc-rio.br). Of course, they are not responsible for any misuse of their ideas.

Let me move to the topic of how Brazil may be affected by the subprime mess. First, let me state a few assumptions that are behind the arguments:

- If the US economy slows down, there will be lower US interest rates and US inflation will not be a problem, or
- If the US economy remains strong, US inflation might be a problem, and US interest rates will have to rise in the future, but
- There will be no stagflation, since we are not currently dealing with a supply shock or productivity meltdown.

There are two main possible subprime crisis` channels of transmission to the Brazilian economy:

- 1) **Capital Flows:**
 - Unlike in 1994,1997, 1998, 1999, 2001 and 2002, the effects of a reversal in capital flows in both the financial sector and the real economy would be much weaker, because today:
 - The foreign debt is much smaller;
 - There is both a large trade account surplus and a current account surplus;
 - The foreign reserves are above USD 160 billion; and
 - The public debt is no longer linked to the exchange rate. The debt/GDP ratio *falls* in the face of a depreciation of the BRL.
- 2) **World output growth and international trade:**
 - With world output slowdown, demand for Brazilian exports will decline, commodities prices will fall, the terms of trade will worsen, and export growth will also decrease. Brazilian real exchange change will depreciate, and output growth will be negatively affected.

Let me now move to the scenarios of how the subprime mess may affect Brazil.

- Scenarios:
 - 1) **Continued world growth with world inflation:**
 - Brazil will keep its (still) abnormally high real interest rates to meet the inflation target, but output growth will remain strong (compared to recent history).
 - 2) **World slowdown:**

- Since there will no longer be a combination of low demand for Brazilian exports with massive capital flight, there will be room for countercyclical monetary policy (fiscal policy is already expansionary). Output growth will suffer, but not like in previous crises.

Now, the bottom line of how the subprime mess may affect Brazil.

- Although the current crisis will affect Brazil, most likely, the effects will not be as severe as in the recent past. Of course a worldwide depression like during the 1930s would be a different story, but such catastrophic scenario has very low probability.
- Economic policy measures to promote output growth would help to weather the crisis` effects:
 - Reduce the growth rate of primary expenditures, which have been growing at a rate twice as large as GDP growth since the Real Plan, opening room to decrease the tax burden (35% of GDP) and introduce flexibility to conduct countercyclical fiscal policy;
 - Structural reforms (Tax reform, Social Security reform, Labor reform) to increase employment and promote growth;
 - Improve regulation and privatize to be able to increase infrastructure investments in key parts of the economy (electricity, roads, ports).
 - Improve social and infrastructural public expenditures.

My opinion is that, unfortunately, very little of the above measures will be undertaken by the Brazilian government until the end of the current administration (2010). Nevertheless, if world growth continues despite all the global imbalances, Brazil will keep enjoying the good times.