

BRAZIL IN THE FINANCIAL CRISIS: DECOUPLING OR HARD LANDING?



**MARCOS
POPLAWSKI
RIBEIRO**
Economist
CEPII
visiting researcher
University of
Amsterdam

Si le Brésil a été fortement touché par les crises précédentes, la crise mondiale actuelle aura peut-être des conséquences plus modérées. Mais ceci ne signifie pas que le Brésil sera épargné, loin s'en faut. Parmi les effets déjà visibles de la crise, il faut retenir l'accélération de la concentration du système bancaire brésilien. Les banques Itau et Unibanco ont ainsi annoncé en novembre leur rapprochement pour créer le plus grand groupe financier d'Amérique Latine. Il n'en reste pas moins que l'impact de la crise dépendra des actions du gouvernement et des actions entreprises pour soutenir la demande intérieure.

Much has been said about how similar or different the current global financial crisis is compared to previous crises. Surely, a remarkable difference between the current crisis and previous ones relates to its impacts on the Brazilian economy and even on the role of Brazil in the crisis. In former crises of the 1970s, 1980s, and 1990s, as anecdotally captured by the famous expression, "when the US sneezed, Brazil got a cold..." This South American country would be one of the first to be strongly hit (if not the originator of the turmoil) with disastrous consequences to its economy and society.

This time things are slightly different. Brazil, albeit also hardly affected, has been so far more resilient to the crisis than many developed nations. Prior to the capitulation of Lehman Brothers and the subse-

quent crash in global stock markets (Black September), some economists even claimed a potential decoupling of that country from the developed world with respect to the economic consequences of the crisis. Such optimism can be personified by the Brazilian President, Lula da Silva, who until very recently maintained that the impact of the "tsunami" of the global financial crisis in his country would be no more than some small waves ("marola").

Indeed, despite of some Brazilian economists diagnosing Lula da Silva with Pollyanna Syndrome (the over optimistic little girl...), little consensus exists about the medium-term effects of the crisis in Brazil. Will Brazilian economy really decouple, land softly, or face a hard landing? This article contributes to the debate by presenting some of the already noticeable effects of the crisis in Brazil as well

as the government measures so far implemented to tackle them.

Recent Brazilian growth model at a glance

In recent years Brazilian economy has obtained steady and positive GDP growth rates. From 1999 – year of the speculative attack that led Brazil to float its currency (the Real) – to 2007, the average GDP growth rate has been around 3.2.¹ Although this average rate is low compared to those of other BRICs (China, India, and Russia), for more than two decades the country has not experience such extended period of stable and continuous growth. Moreover, the implementation of a rigorous inflation target regime combined with a relative fiscal discipline in recent years have allowed the country to conciliate GDP growth with low inflation, another chronic problem in earlier decades.

Lower inflation rates have permitted a partial reduction in interest rates (see Chart 1),² which, in turn, set in motion a significant credit expansion in the country. This credit boom allied to well-succeed social programs implemented Lula da Silva, increased the purchasing power of the poorest groups of Brazilian society. The consequent rise in household consumption

1. This rate has been higher more recently. In 2007 the Brazilian growth rate was approximately 5.42% and for 2008, the forecasts point to values between 4.5% and 5%.
2. Notice, however, that the Brazilian real interest rate equal to 7.5%, the 13.75% target lending rate minus annual inflation of 6.25%, is still the second highest of the world. Turkey has the world's highest real interest rate at 7.55%.

together with the increase in investments and public spending explain in large part the recent GDP growth and the still strong internal demand in Brazil. The external demand for Brazilian products, in particular for its commodities, and the increase of their international price are the other main determinants of the recent growth in GDP.³

Therefore, the understanding of how the financial crisis has impacted Brazil so far is crucial to analyze its impacts on medium-term growth. That is because the main growth channels in that country, namely the increase in credit and external demand for Brazilian commodities, are both highly sensitive to the current financial crisis. We start this analysis by presenting the financial impacts of the crisis and then moving to its economic effects.

The crash in the Brazilian stock market

In 2007 the Brazilian stock market, Bovespa, had the biggest gain in value from all world stock markets. That situation, however, quickly deteriorated with the worsening of the financial crisis (see Chart 2). From May 2008 (when the 66-stock Bovespa Index reached its peak) to November 2008 that index lost practically half of its value. Only Moscow's stock exchange index fell more in the same period. In October alone, the Bovespa index, in large part formed by shares from producers of energy and raw materials, lost a quarter of its value as commodities had their biggest monthly drop in 52 years.⁴ In the same month, investors from abroad sold R\$ (Reals) 4.69 billion (US\$ 2.23 billion) more shares than they bought in Latin America's largest stock market.

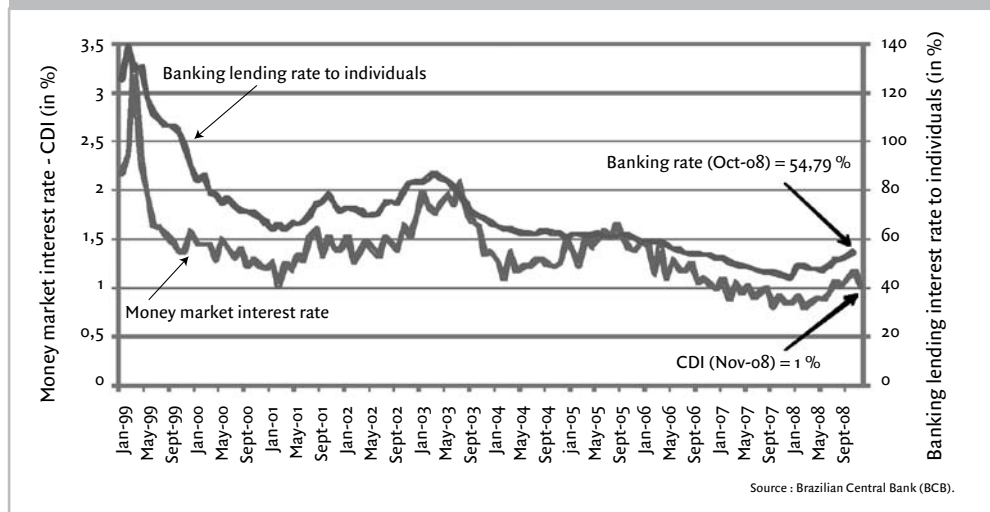
Capital Flight and Systemic Sudden Stop

In parallel, Brazil, as most of the emerging markets, is facing massive capital outflows and a syste-

3. The external sector (exports and imports) currently represents 30.9% of the Brazilian GDP.

4. In October, the Reuters/Jefferies CRB Index of 19 raw materials plunged 22%. Crude oil plummeted by a third, the most ever.

1. Money market rate vs banking lending to individuals



mic sudden stop. Calvo, Izquierdo and Mejía (2008) defines a “Systemic Sudden Stop” as episodes of capital account reversals and sharp increases in aggregate spreads with a systemic – and, hence, largely exogenous – origin.⁵

The intensity of the sudden outflow of portfolio capital is clearly identified in Chart 3. After two years attracting huge amounts of foreign capital via portfolio and direct investments, more than US\$ 8.2 billion left the country last October alone. Brazilian hedge funds, for example, saw a record R\$ 14.3 billion (US\$ 6.7 billion) in withdrawals last October. Redemptions brought total outflows this year to R\$ 48.9 billion, shrinking the industry by 16%, according to data released by the National Association of Investment Banks.⁶ Such a hasty run to the exit was mainly triggered by external reasons, such as the cover of losses and margin calls elsewhere, foreign banks preserving liquidity, or simply as a response to the systemically heightened risk aversion.⁷ Nevertheless, they also point to an

increase in the uncertainty of foreign investors about the short-term future of the Brazilian economy.

The credit freezing

The systemic sudden stop has been accompanied by a sudden freeze in all credit lines (including trade credit). Domestic credit conditions deteriorated as a peculiar form of the credit freeze happening at the core-advanced economies. Notwithstanding the small proportion of foreign sources in the total of both banking and non-banking funding, a spurt of uncertainty regarding local corporate health both at banking and non-banking sectors was sparked after the sudden drought of foreign finance and local-currency devaluation. News of an unexpected vulnerability to exchange-rate depreciation by corporations and smaller banks due to exposure through derivatives immediately led to a local version of doubts about hidden “toxic assets” and financially fragile balance sheets.

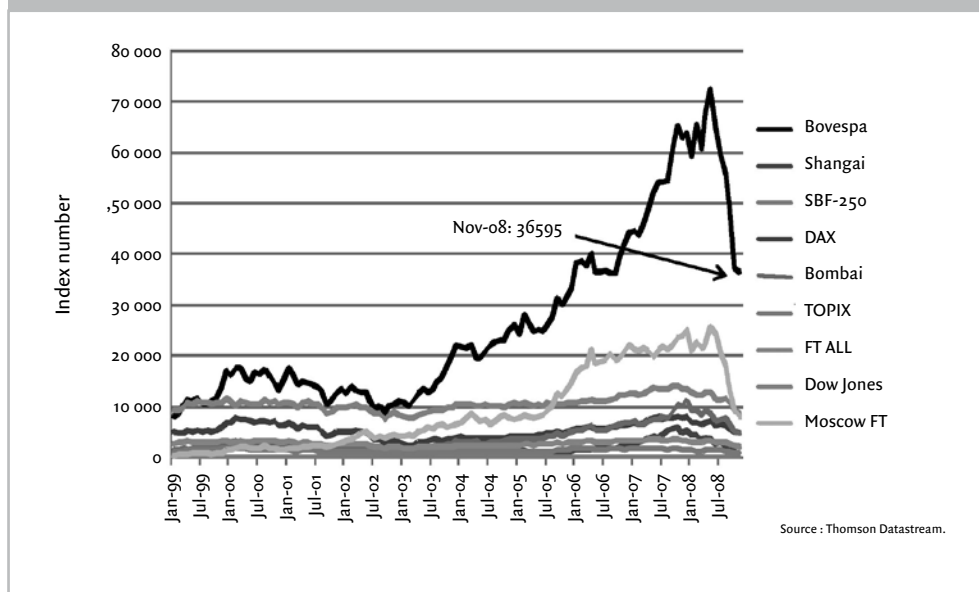
Given its impact on consumption and growth, this lack of external and internal credit is perhaps the main problem that Brazilian economy faces after the crisis. For example, according to the Minister of Finance, Guido Mantega, the state-controlled oil company, Petroleo Brasileiro SA (Petrobras), is being forced to step up local borrowing and local companies in general have not being able to meet 25% to 30% of their financing needs. This illiquidity of the system may also

5. Calvo, G., Izquierdo, A., Mejia, L. F., Systemic sudden stops: the relevance of balance-sheet effects and financial integration. NBER Working Paper 14026, May 2008.

6. This rate of withdrawals is similar to hedge funds globally, even though the worst-performing Brazil funds lost a third as much on average as their overseas rivals.

7. Canuto, O., Emerging Markets and the Systemic Sudden Stop. Boletim de Informações da FIPE, November 2008.

2. Main world stock market indexes



lead to insolvent institutions, leading, therefore, to an increase in the exigencies of guarantee and reciprocity by financial institutions.

The depreciation of the Brazilian exchange rate

After reaching its highest value in nine years in early August, Brazil's Real has dropped 29% against the dollar in the past three months. Only in October, Brazil's Real dropped 12%. Table 1 illustrates this point showing the six-month variation of the exchange rates of six important countries/region. The depreciation of the real was the largest among the six currencies investigated.⁸

Nevertheless, this depreciation can be positive to Brazil given the increase in competitiveness of its domestic products. Moreover, the Brazilian public sector had availed itself of the current-account surpluses and foreign-capital bonanza of the last few years to reduce its foreign debt and retire dollar-denominated domestic debt,

8. One can additionally show that the Real has the worst performance in the last six months among the 16 major world currencies. Moreover, the dollar is only the third currency for which Brazilian Real lost value. The Japanese Yen and the Chinese Yuan have appreciated more than the Dollar against the Brazilian Real in the last six months (approximately 33% and 29% respectively). These were also the only two currencies that gained value against the dollar in that period.

up to the point of acquiring a negative dollar-exposure in its accounts. Hence, the recent depreciation has even contributed to a shrinking public debt-to-GDP ratio. Still, the depreciation can create a higher pressure in terms of domestic prices (inflation), but the fall of commodities and industrial prices can compensate such negative effect on domestic prices.

Consolidation of the banking sector

The financial crisis has also sped up a consolidation process in the Brazilian banking sector. In the beginning of November the Brazilian banks Itau and Unibanco announced their merger in a stock transaction valued approximately at R\$ 26.5 billion (US\$12.5 billion), creating the biggest Latin America financial group and the sixth largest bank in the Americas.

The operation was mainly motivated by the acquisition in October 2007 of the Brazilian branch of the bank ABN-Amro (Banco Real) by the Spanish bank Santander. The entry of such big player in the Brazilian market led both banks to look for possibilities to increase efficiency and competitiveness, giving start to the negotiations of the merger. Nevertheless, the current crisis cannot be excluded as one of the reasons for the merger due to the previous link between Unibanco and AIG, one of the American

financial groups mostly affected by the collapse of Lehman-Brother last September. The Unibanco-Itau merger was quickly followed by another merger between the federal bank Banco do Brasil and the Sao Paulo state bank Nossa Caixa, in a operation estimated in R\$ 5.38 billion. This operation was a response to the one between the two private groups and aimed to bring Banco do Brasil back to the post of biggest bank in the Brazilian system. Further, Banco do Brasil has also decided to buy a significant share (US\$ 3.2 billion) of Votorantim bank (the seventh largest commercial bank in Brazil).

These operations evince, therefore, that the process of consolidation in the Brazilian banking system is just in the beginning and that, even though not contaminated by American toxic assets, more room for restructuring in the Brazilian sector exists.⁹

Current economic impacts of the crisis

In recent months, the risks of the crisis to the Brazilian economy have increased considerably. While domestic consumption and production have been strong during the last several quarters,¹⁰ several analysts expect it to slow down due to higher interest rates and higher inflation. This deceleration is likely to be particularly pronounced in the interest-rate-sensitive sectors, especially durables and capital goods. Recent figures for industrial production and business confidence have already surprised on the downside. Output went down by 1.7% and the index of business confidence fell abruptly in October from September (see Chart 3).

At the same time, exports are going to start dwindling in the coming quar-

9. It is important to notice that from June 2007 to June 2008 domestic credit expanded at a 28.8% rate. However, while the five largest private banks increased their lending in 50.6%, in the rest of the banking system that rate was only 18.2% (less than a half). This suggests some difficulties in the small Brazilian financial institutions.

10. During the second quarter of this year the Brazilian economy grew by 6.1% compared to the same period a year earlier after posting a 5.9% rate during the first quarter. Domestic consumption and gross fixed investment were the keys for second quarter growth. Personal consumption expenditures posted a growth of 6.7% year on year while gross fixed investment did so by an impressive 16.2%.

ters as the biggest consumers of Brazilian goods see their own economies go down the path of recession. A fall in the sales of meat and wheat is already observed. Protectionism might also increase in the buyer's country due to the internal pressures to generate jobs and increase income. Brazilian agricultural inputs will also increase given that they are quoted in dollars. However, the prices of fertilizers are going down given the huge existent stocks and the difficult to obtain credit right now.

Unemployment shall also play a role. Job creation, which has been running at about 200,000 new jobs per month this year, also fell to 39,000 in October. In manufacturing industry, where about 50,000 jobs have been created each month, 7,000 jobs were lost in October. Joblessness is currently near an all-time low (7.6%). The expansion of credit was an important force behind labor creation as companies and workers joined the formal economy to gain access to credit, increasing labor productivity. Hence, the abrupt slowdown of credit expansion will likely drive unemployment higher.

The Brazilian response to the crisis

Regarding the monetary authority, its response has been twofold, on both foreign exchange and domestic credit fronts. From October 20 to November 28, the Brazilian Central Bank (BCB) realized four actions in the foreign exchange markets irrigating the credit market with US\$ 5.5 billion (2.75% of international reserves); combined with derivative sales of US\$ 25.8 billion through currency swaps. Additionally, temporary dollar liquidity has been provided through repo agreements both at the spot market (US\$ 4.8 billion) and abroad (US\$ 3.3 billion). Those interventions received a confidence boost given by the inclusion of the BCB in the US Federal Reserve's network of currency swap lines, which amplifies BCB's ammunition to provide liquidity to the market. The swap line has been authorized through April 30, 2009. It will be a new short-term lending facility aimed to help emerging markets with sound policies get through crisis. The new IMF credit line can

Variation of the US\$ in relation to other world currencies

Country/Region	Brazil	China	Europe	India	Japan	Russia	UK
Currency	Real	Yuan	Euro	Rupee	Yen	Rouble	Pound
Value of 1 US\$ in 31.05.2008	1,71	6,97	0,64	42,13	104,35	23,73	0,51
Value of 1 US\$ in 28.11.2008	2,27	6,83	0,79	49,15	96,87	27,32	0,65
Variation	32,72 %	-2,06 %	23,44 %	16,66 %	-7,17 %	15,14 %	28,05 %

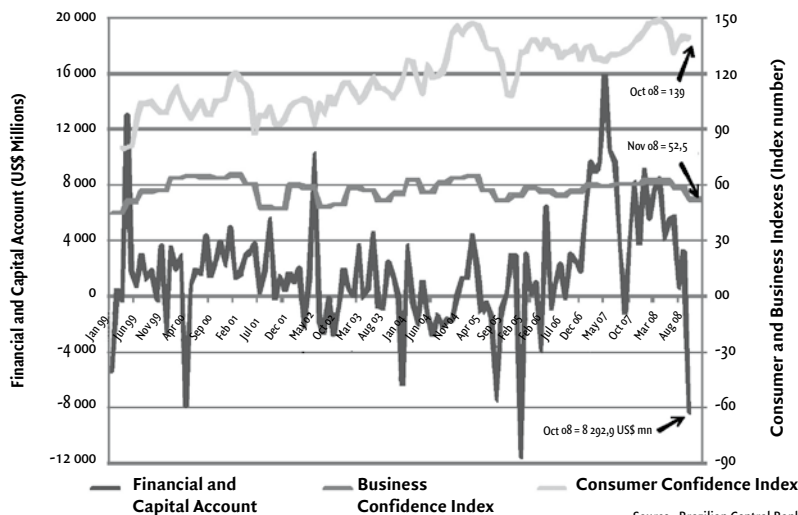
also reach five times each country's quota (up to US\$ 23 billion in case of Brazil). These swap lines could help to normalize the level of the exchange rate, even though the BCB has itself lots of reserves (US\$ 200 billion) and it is already providing ample liquidity to the market.

At the domestic credit side, besides extending its rediscount policies, the BCB has eased on its long-held stiff reserve requirements, in a series of moves that according to estimates may end up liberating an amount of liquidity potentially superior to 5.7% of GDP and 5.6% of total bank assets (or up to R\$ 100 billion). It has also expanded the list of securities it will accept to free up reserve requirements on term deposits. Up to November 14th 2008, 70% of the total reserve requirement on time deposits must be done in cash, without any remuneration

(to stimulate large banks to acquire assets from small/medium ones). Moreover, financial institutions can have their assets acquired by others banks without the necessity of any collateral, if they are not part of the same financial group. Trade credit lines have also returned to a level equivalent to half of the one prior to mid-September

From the government side, the main response to the crisis has been the creation of the provisional measure bill (MP443), which eases the constrains for two public banks – Caixa Economica Federal (CEF) and Banco do Brasil – to acquire capital of private financial institutions. The MP also creates an investment bank under CEF to acquire capital not just in the financial, but other sectors as well. The government has also announced the extinction of the financial transac-

3. Financial and capital account vs consumer and business confidence indexes



Source : Brazilian Central Bank (BCB)

Box 1. Brazilian Car industry

Sales of new cars and trucks in Brazil slumped 11% in October, and 25.7% in November from October, according to Anfavea, the auto manufacturers' association. Production fell even more sharply, by 34.4%, as automakers adjusted to a collapse in consumer sentiment following the onset of the global credit crisis (see Chart 3). Exports also fell, by 23.1%. The slowdown follows three years of torrid growth in Brazil's auto market, which has benefited

from a credit boom that helped fuel a surge in consumption. Most car sales have been financed on installment plans of six years or more, often financed by banks set up as subsidiaries of auto manufacturers. But funding for those banks – who depend on interbank lending – has collapsed along with the global credit crisis. In addition, the slowdown in the mining industry is causing a negative bias on the rail business, due to potential weaker

demand from the two Brazilian giant companies Vale and MRS for new railcars. To help it ride out the current financial crisis, the Sao Paulo state government said on November it would extend an R\$ 4 billion (US\$ 1.8 billion) credit line to the automotive industry. The federal government has also instructed Banco do Brasil to make an available a total of R\$ 4 billion so that vehicle financing units can increase lending and spur sales.

tion tax (IOF – 1.5% flat) for foreign investments in local bonds market and rising funds abroad in order to increase liquidity in the credit market. Moreover, state-owned banks have increased their share in the provision of domestic credit, allowing the possibility of delays in the loan payments. The government intends, in addition, to resort to public-sector majority-owned banks to fill in the blanks in the cases of credit to agriculture, automobiles, construction and others, as well as to acquire partnership shares in Brazilian-based companies. It also plans to lend Brazil's national development bank more than US\$ 2 billion to finance exporters, who have been hard hit by slowing demand for commodities and tightening international credit markets.

Conclusion: Brazil in a soft landing path

Even though in a better shape than in previous crises, Brazil faces its most challenging circumstances for years. Until recently this country had been relatively unscathed by the global economic crisis, but the outlook has quickly worsened in the past month.

The performance of the economy in the medium term will depend crucially of the role of the government. The Brazilian government still retains an arsenal of monetary, foreign reserves, and fiscal and quasi-fiscal instruments to be used if domestic demand decelerates too deeply. This is a major

upside derived from policies of positive public primary surpluses, inflation targeting and reserve accumulation that were followed prior and along the now-ended period of favorable external environment.

So far, the preemptive and timely behavior of Brazilian authorities, mainly the ones announced by the BCB on reserve requirements, suggests that they will be able to reduce the impact of the international shock on domestic economy. Yet, the fast pace in which measures have been announced opens doors for the approval of some bad measures as well. For instance, using public banks to acquire capital of private corporations may be one of them. The MPP433 gives a lot of discretion to public banks to acquire smaller financial institutions and companies from any sector. It is important to remind that the privatization process of the nineties brought several productivity gains to the Brazilian economy and the return to statization is not the correct solution for the crisis.¹¹

Moreover, additional policies should be rapidly pursued. The credit expansion is one of the pillars of the upsurge of the Brazilian economy and therefore, deserves special attention in this

moment. The system has to be irrigated with abundant sources of liquidity, favoring in particular smaller institutions. The BCB should also reduce temporarily the interest rate, even if inflation exceeds a bit the target for some months. Lower interest rates would lead to a domestic economic activity reacceleration, a revitalization of the domestic investment cycle, and a rotation out of fixed income funds into equities.

If most of these measures are taken, no further downward revisions to global growth occur, and the high levels of risk aversion ease; Brazil should be entering 2010 in a clear recovery mode. That would represent an important achievement for the country, since it would imply a soft landing of its economy in the face of a global financial crisis. The first time this would happen in decades of financial crises.

A key assumption underlying this view, however, is that fiscal policy will remain consistent with supporting macro stability. The concern here could follow an expectation that President Lula's record-high popularity would suffer as the economy slows, providing motivation for picking up public spending due to the presidential election in 2010. Nevertheless, the strong Brazilian institutional fiscal framework (Fiscal Responsibility Law) and the deeper local debt markets readily reflecting excess spending help to keep fiscal profligacy constrained.

Finally, in the medium-term, the crisis demands other efforts to reduce the dependency of the Brazilian economy from commodities prices, of external financing and of credit demand stimulus. The policies for a sustainable growth are known: the implementation of structural reforms, in particular, tax reform, labor reform, law reform, political reform and product reform. The reduction in public spending, particularly in public employment, is also important to guarantee fiscal sustainability. Further, the government should also provide greater stimulus for internal entrepreneurship activities and keep its level of spending in education and investments (in particular in the fields of science and technology) to increase potential growth in Brazil. ■

11. See, for example, Eid Jr., W., and Poplawski Ribeiro, M., 2004. "Fatos e Lendas da Privatização," [Facts and Legends about the Privatization]. In Wood Jr., T. (org.), "Gestão Empresarial: Finanças - volume 1" (chapter 6). São Paulo: Editora Vivaldi, in portuguese.