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Despite having been brutally affected in the last quarter of 2008 by the global crisis, which will inflict a heavy toll on growth in 2009, Brazil’s economic structure, which is behind the country’s very positive economic performance since 2004, has not been fundamentally destabilized. Brazil is likely to come out of the crisis more rapidly than the rich countries. This could be the start of the second chapter of decoupling.

Interview with Rubens Ricupero

“Brazil will only be spared if the economic crisis and the contraction of world trade do not persist for too long,” says the former finance minister. He maintains that “the G20 is here to stay.” Interviewed by Ernesto Borges.

Savings: Patchwork solutions versus comprehensive reforms

The reduction in the rate of interest that may make savings accounts more attractive investments, opens up the possibility of reform in the financial system, argues Fernando de Holanda Barbosa.

Has the financial crisis corrected the exchange rate in Brazil?
The current severe international financial crisis has not triggered excessive devaluation of the Brazilian currency, observes Márcio Holland.

Insurance: Solid performance and good investment opportunities

The model of the Brazilian insurance market, which long has been criticized for being extremely conservative, suddenly, because of the crisis, has become an example for regulators worldwide. Report Ernesto Borges.

Book review

A new book — edited by Edmar Bacha and Ilan Golfajn — analyzes the impact of the recession on Brazil and shows that the best way to overcome it is to maintain austerity in public spending and control inflation.

Brazil’s economic and financial indicators
For the sixth consecutive year, in April, the Brazilian Institute of Economics (IBRE/FGV) presented awards to the Best and Largest Insurance Groups in the country. After consulting with the major Brazilian insurance companies, last year the Center for Financial Studies at the Getúlio Vargas Foundation in São Paulo developed a new methodology to render the performance of insurance companies more transparent. In addition to nominating the best insurance companies in the fields of health and auto, new awards were created for life insurance and pension plans, property insurance, and sustainability and social responsibility. Furthermore — for the first time — an award was granted to the best insurance group. It went to Bradesco Seguros, which also was given the Sustainability and Social Responsibility Award on the basis of the group’s outstanding performance as measured by the new assessment criteria.

Among the largest groups, HSBC received the award for best insurance company and Mpfre Nossa Caixa Vida e Previdência for the best life and pension insurer. Bradesco Saúde was considered the best in the health segment, and Porto Seguro the best in car insurance. Sul América was named the best property insurance company.

Among smaller insurance companies, Ace was named the best group. Alfa was the winner in the pension and life segment, and Unimed in the health segment. Chubb Brasil was named the best car insurance company. The best in property insurance was Zurich Brasil. The Sustainability and Social Responsibility Award went to Confiança Companhia de Seguros.
Many analysts believe that the enormous turbulence created by the bankruptcy of Lehman Brothers in September 2008 definitely put to rest the thesis of the “decoupling” of emerging economies. That thesis held that a substantial number of emerging economies would better resist the scenario of global slowdown — already apparent before September — than rich countries would. The idea of decoupling gained force starting in 2007 mostly because of the exceptional and simultaneous economic developments witnessed in the main emerging economies, particularly those in the BRIC group (Brazil, Russia, India, and China).

In the weeks immediately after Lehman Brothers collapsed, however, a short circuit in world credit flows struck all economies involved in globalization, without distinction. The annualized growth rate in the last quarter of 2008 of the countries in the OECD (Organization for Economic Cooperation and Development), for example, was dauntingly below normal: They practically all show a drop in GDP that in many cases reaches double digits — think of Ireland (25.7%), Japan (12.2%), Korea (18.8%), Mexico (10.35%), and Turkey (14.3%). In 19 of the 35 OECD countries, GDP fell by over 6% annualized in the last quarter of 2008.

Obviously, the shock did not spare the emerging economies. In the BRIC countries, there is a significant change in growth rates between 2007, when growth peaked, and the projections for 2009 advanced by the International Monetary Fund (IMF). Brazil is projected to slow from +5.7% to −1.3%, Russia from + 8.1% to −6%, India from 9.3% to 4.5%, and China from 13% to 6.5%. These figures, according to many pundits, killed the idea that the main emerging economies would be able to weather the severe crisis better than the developed countries. However, there are indications that the decoupling thesis might still be valid.

Emerging economies
To find out, the first step is to determine whether the assumption that there was some sort of decoupling before Lehman’s collapse was true. Indeed, there are signs that the global boom over the past decade was to
a great extent boosted by emerging countries, whose driving force continued even after the developed world began to decelerate because of its imbalances.

In 2007 world oil consumption was broken down as follows: 56.8%, OECD (including all the major wealthy nations, and a few emerging economies); 4.7%, countries from the former Soviet Union; and 38.5%, the rest of the world (essentially major emerging countries). Those figures might lead one to defend the traditional view that, in spite of the already substantial share of the emerging countries, the global economy is still driven by wealthy nations.

However, it is important to look at the growth trends. From 2000 through 2007 emerging countries accounted for 85% of the increase in world oil consumption, while OECD consumption grew by only 12%. Even considering that many rich countries have begun to work to make their energy mix cleaner — the European Union was responsible for only 2% of the increase in consumption during this period — the data suggest that world growth dynamism has been shifting toward the emerging countries. Obviously, the most dynamic portion of the emerging world is Asia and the Pacific region, which was responsible for 50% of the increase in world oil consumption from 2000 to 2007. China alone accounts for an astonishing 37% of that increase.

As far as world trade growth is concerned, the OECD countries were responsible for 56% of total growth between 2000 and 2007. This figure, however, is inflated by the vigorous increase in trade within the European Union, which represented 26% of the growth in global trade during that period. China alone contributed 13%, and the USA 5%. OECD countries accounted for 47% of GDP growth. In other words, the world today is very different from the world a few decades ago, when the developed countries accounted for about 80% of production and trade.

It is important to underscore that the wealthy part of the world was already decelerating before the terrible fourth quarter of 2008. After their growth peaked in the third quarter of 2006 — 3% yearly compared with the same quarter of the previous year — the OECD countries began to slow down. By the third quarter of 2008, growth was 1.8% compared with the same quarter of previous year.

The growth path for the major emerging countries was different. In the case of Brazil, growth peaked at 6.9% in the third quarter of 2008 compared with the same period in 2007. China registered its best growth in 2007 — about 11.5% — and still grew 9% in the third quarter of 2008 year-on-year. India recorded growth of 9% a year in 2005–2007 and was still growing at 7.6% in the third quarter of 2008. And Russia shifted from 8.5% maximum speed in the first quarter of 2008 to 6.2% in the third quarter compared with the same quarters of 2007.

**Resilience**

These data make it clear that just before the great disaster of 2008 most of the emerging economies were not going through as sharp a deceleration as the OECD countries were. Somehow, the emerging economies were resilient — though not invulnerable — to the negative thrust of the developed countries. The emerging economies were sustained by the gradual increase in domestic demand and by the expansion of South-South trade. In particular, deceleration in developing countries was the consequence of tight monetary policy to fight an inflation surge. This approach contrasted dramatically with the loose monetary policy in the US. There thus seems to be little doubt that pre-Lehman there was a relative decoupling of the emerging economies from the developed countries.
On the other hand, it is unquestionable that the emerging countries have not maintained that decoupling in the quasi-catastrophic period since September 2008. Comparing the fourth quarter of 2008 with the same period in 2007, Brazil grew by 0.8%, China by 6.8%, Russia by 1.1%, and India by 5.3%. Those growth rates are far inferior to the rates registered in the previous quarter. The important question now is whether, after riding out the current severe turbulence, the emerging countries will go back to the previous pattern of relative decoupling or, following the shock at the end of last year, they will become more dependent on the performance of the OECD countries.

It is too early to give a definitive answer to the question, but there are signs that suggest that the decoupling thesis, at least as far as Brazil is concerned, is justifiable. In addition to monitoring indicators of activity and employment, which have longer cycles, it is important to monitor what is happening in foreign trade, one of the most important channels of transmission of the crisis.

In the first four months of 2009 Brazil’s daily average exports declined by 16.5% compared with the same period in 2008; imports fell by 22.8%. Thus, the trade balance surplus grew by 51.3%. However comforting they may seem, at first glance those figures indicate that the country is still suffering the full impact of the brutal reduction in foreign trade that started last September. Indeed, in the first four months of 2009 trade fell by 19.5% compared with the same period in 2008.

On more careful examination, however, the signs are more promising. While the decline in manufactured (28.7%) and semimanufactured (21.5%) exports for the first four months of 2009 compared with the same period in 2008 is certainly significant, basic product exports increased by 8.7%.

What is most promising is that the good performance of basic products, sustained in both prices and quantities, is caused by Asian, especially Chinese, demand. This becomes obvious from a consideration of trading partners’ shares in total trade with Brazil. Comparing the first four months of 2008 and of 2009, the share of Brazilian exports to the European Union declined from 25.1% to 23.1%, to Latin America from 26.6% to 21.3%, and to the United States from 14.4% to 11.3%. Performance of the Asian market was the opposite: the share of Brazilian exports to Asia increased from 16.1% to 24.8%. Brazilian exports to China rose by 66.7%, and the share of our exports to the communist giant rose from 6.5% to 12.9%.

At the outset of the international financial crisis, marked by Lehman’s bankruptcy, the doubt was whether Asia could stand on its own feet by stimulating internal demand. Because the US and the rich countries were struck by a structural crisis from which they will take a long time to recover, China could not count on the buoyant foreign demand of pre-Lehman days. The success, or lack thereof, of the gigantic fiscal stimulus package launched by China is thus fundamental to assessing global dynamics after

Up to the bankruptcy of Lehman Brothers, the emerging countries showed resilience to — but were not invulnerable to — the negative thrust of the developed countries.
the most dramatic moments of turbulence had been overcome. What the figures on Brazilian foreign trade and even the Chinese indicators seem to suggest is that Asia is indeed breathing again.

**Advantage**

If it continues, this breath of life should also be able to gradually pump up economic activity in large suppliers of raw materials and basic products to the Asian markets like Brazil and other Latin American countries. Another advantage is that the Latin American economic fabric has not been devastated or even contaminated by the financial bubble of the rich countries, as was the case in Eastern Europe. In other words, a new demand for commodities will find Latin American producers with governments, businesses, and families that have acceptable levels of debt.

This scenario suggests that Latin America and Brazil have a chance to come out of this recession fairly quickly, though the recovery is still not likely to be strong. There is also an indication that the major consumers of Brazilian manufactured products — Latin America and the Caribbean — will come back to buy in a not-too-distant future. Thus, we can expect more encouraging volumes of exports of manufactured and semimanufactured goods. If that happens, of course, it is obvious that Brazil will run up against increasing competition from Chinese manufactured goods. But this is a long-term structural challenge not directly associated with the post-crisis cyclical recovery.

Recent economic history has another encouraging lesson specifically for Brazil. By mid-2008, when commodity prices peaked, Brazil's terms of trade had increased by no more than 10% compared with the average in early 2006. That is further evidence that Brazilian import and export activity is diversified to the point that the country is not too vulnerable to drastic changes in relative prices. Thus,

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unlike what happens in Chile, which is heavily dependent on the price of copper, and in Venezuela, a hostage to oil prices, the Brazilian economy is not at the mercy of a specific product or service.

Despite having been brutally affected in the last quarter of 2008 by the global crisis, which will inflict a heavy toll on growth in 2009, Brazil's economic structure, which is behind the country's very positive economic performance since 2004, has not been fundamentally destabilized. This suggests that Brazil is likely to come out of the crisis more rapidly than the rich countries. This could be the start of the second chapter of decoupling.
“The G20 is here to stay”

Rubens Ricupero
Former Finance Minister and Director of the School of Economics at the Armando Alvares Penteado Foundation (FAAP)

The Flexible Credit Line (FCL) recently created by the International Monetary Fund (IMF), which allows member countries access to resources without imposition of conditionality, is considered a turnabout for the institution. Since April Mexico, Poland, and Colombia have applied for FLC lines of credit. The FCL concept, however, is not something brought about by the current crisis; in fact, Brazil has been one of the countries that contributed most to turning it into reality, according to ambassador Rubens Ricupero, former Finance Minister and former Secretary-General and currently director of FAAP in São Paulo. In this interview, he discusses the importance of the G20, a group that is “here to stay,” and the Brazilian position on international institutions and protectionism.

For this diplomat, the country’s position is solid as long as the global crisis does not persist for too long. “If signals start to inspire caution, the best would be to follow Mexico and, as a preventive measure, access IMF flexible funds, assuming that they continue available.”

The Brazilian Economy — The G20 summit in London last April has been considered a landmark in international relations, where the proper status of emerging countries like Brazil was recognized. Is it conceivable that once the current crisis is over, everything will go back to the way it was before and the “new economic world order” will be postponed once again?

Rubens Ricupero — The G20 is here to stay. It is the result of the combination of two ideas. Institutionally, it is a commission created in 1999 in the framework of the Bretton Woods organizations to discuss updating the governance of the IMF and the World Bank, and to try to minimize the turbulence caused by financial crises. Furthermore, the G20 stands for the search for an informal, noninstitutionalized forum where the world’s major problems — not just economic but also political, environmental, and humanitarian issues — may be discussed in a wider framework than that provided by the G7 or the G8. The G7, an initiative of Giscard D’Estaing in the 1970s, was becoming too narrow to reflect the new international realities.

The G20 is far from ideal if we consider that the members of the UN today total 192 countries, and that some regions like black Africa are under-represented. No one can deny, however, that the G20 gathers the most populated and most important countries from a political, military, and economic perspective.
It is a practical formula that allows reasonable discussion of relevant issues. As such, it is a more representative debate forum than the G7 and more manageable than the enormous UN General Assembly. Indeed, when referring to the recent G20 London summit, Prime Minister Gordon Brown talked about the emergence of a “new international order” — he did not say economic order.

Nonetheless, one should neither overestimate the scope of the G20 nor misinterpret its nature. The group does not enjoy the legitimacy that can only come from an all-inclusive, universal consensus, conceived in a text resulting from negotiations with consent gathered from the totality of the members of the international community, like the UN Charter or the Articles of Agreement instituting the IMF and the World Bank. Because it is not an institutionalized body like the UN Security Council and the Bretton Woods institutions, G20 recommendations, including those formulated at the London summit, will have to be converted into decisions by the competent institutions.

The very idea that the “new economic order” could be postponed once the crisis has been managed assumes a high dose of optimism. In a way, it is based on the belief that after a short period of turbulence, things will be as they were before. Few people share that view. All one needs to do is read Martin Wolf’s assessments in the Financial Times. According to him, nothing in the treatment currently being applied allows one to believe that the structural imbalances will be corrected between on the one hand countries characterized by low savings, high indebtedness, and dependence on foreign financial flows (the USA, the United Kingdom and a large part of the Western world), and on the other the economies characterized by high savings, external balance surpluses, and enormous reserves (of which China is an example). If these predictions are confirmed, the recovery will be nothing but a truce between crises.

**Why doesn’t Brazil apply for OECD membership, following Mexico’s example?**

Brazil does not need full membership to enjoy the benefits generated by the research and debates promoted by the organization. In fact, Brazil has for years participated fully in those OECD groups that are most relevant for us, such as the one dealing with the steel industry. To go beyond that would bring about disadvantages that would more than offset the limited benefits of membership.

Indeed, the OECD, a product of the old Marshall Plan Secretariat, is a kind of “club of the rich,” congregating about 40 of the most advanced economies. As an organization it has been highly focused on defending market economy theses that are aligned with an orthodoxy that has dominated over a long period of time — a stance that comes out of this current crisis quite scratched. Joining the OECD normally means that a country must leave the Group of 77 and China, a circle of over 130 developing countries in all international forums, that initially only covered economic issues but today embraces almost all areas, including environmental issues.

For Brazil — a country nurturing an active multilateral diplomacy, aspiring to play an independent first-line role in world debates, a leader of initiatives such as the creation of the Group of 20 in the World Trade Organization (WTO) for agricultural negotiations, defending critical and demanding positions regarding the internal distribution of power at the IMF and the

**The G20 stands for the search for an informal, non-institutionalized forum where the world’s major problems — not just economic**
World Bank, and a country with frequent applications to elective posts at the international level — relinquishing the G77 and China group to acquire OECD membership would be the equivalent of political suicide. Most of the time, on all those issues, the positions assumed by Brazil are not only different from but often opposed to those of OECD member countries. Mexico opted to join the OECD in the euphoria following the celebration of the Free Trade Agreement with the USA and Canada (NAFTA); today, the country is quite isolated and unremarkable in multilateral diplomacy forums.

How relevant is the United Nations Conference on Trade and Development (UNCTAD) today?

UNCTAD was created in 1964 mainly thanks to the influence of Raúl Prebisch, its first Secretary-General. While at the United Nations Economic Commission for Latin America and the Caribbean (ECLAD), he became aware that, particularly in the area of trade, the changes needed to promote the development of Latin-American, Asian, and African countries could only be introduced if promoted at the universal level. At that time, the rules laid out by the General Agreement on Tariffs and Trade (GATT), the predecessor of the WTO, did not allow for exceptions to foster the trade of less mature economies.

The efforts of Prebisch and UNCTAD bore fruits when important exceptions to the GATT rules were approved, among them the Generalized System of Preference and special and differentiated treatment for developing countries in the negotiation and implementation of the rules. These reforms opened the way to a current and greatly successful trend: that of a significant portion of the production and export of manufactured goods.

It is curious that the policies and strategies developed by Prebisch and his Latin American colleagues often ended up being applied much more effectively and successfully by Asians; thus the current and most welcome emergence of China, India, and other Asian countries is a tribute to Prebisch’s, and UNCTAD’s, farsightedness. Indeed, far from following the prescriptions laid out by the IMF, the World Bank, or the Washington Consensus, those Asian economies adopted gradualism in trade liberalization and extreme prudence in financial liberalization while prioritizing the creation of domestic supply capacity before engaging in opening the economy — all of which were principles supported by UNCTAD and Prebisch against conventional wisdom, which favored the shock treatment.

The IMF has recently created the Flexible Credit Line (FCL), allowing member countries access to resources without conditionality. Mexico (US$47 billion), Poland (US$20.5 billion), and Colombia (US$10.4 billion) have already applied for this credit line, which would be a sort of “insurance” to contain the global financial crisis.

The idea of a flexible credit line was discussed long before the outset of the current crisis. Brazil has been one of the countries most dedicated to turning it into reality. The idea was to allow those economies with solid performance to overcome temporary difficulties in a swift and expeditious way, without having to go through the long and exhausting conventional procedures. The coincidence that the FCL has become operational at this time will, however, help to make it, if not an insurance against
crisis, at least a guarantee to prevent its spread to new countries and more serious levels.

The fact that Brazil has earmarked US$4.5 billion for the IMF is seen as good business, because the funds invested in Special Drawing Rights (SDR) remain part of Brazil’s currency reserves and are not subject to an eventual devaluation of the dollar. How do you see that?

There is more to it than financial investment of international reserves. Clearly, it constitutes a far-reaching political signal on the part of a recalcitrant debtor to the IMF, as President Lula pointed out. On the other hand, there remains a certain degree of ambiguity and confusion as to the actual position of the country regarding transfer of its resources to the Fund. Up to the eve of the G20 summit in London, the Brazilian director at the IMF had made public declarations that the country would only make a favorable decision to assign funds after changes were made to governance rules to guarantee a stronger voice and increased voting power to developing countries. Apparently, that position softened somewhat in London, and it is possible that the Brazilian government’s position will finally become clear at the spring IMF meetings.

President Lula has recently said that Brazil will only lend the IMF money to help poor countries. Is that possible, i.e., is Brazil in a situation to exert such influence on the Fund?

Brazil’s influence is very limited and would not be sufficient to affect the Fund’s decisions. Lula’s declarations have to be interpreted in the context of a rhetoric in defense of the poor, somewhat in line with his original initiative, after his inauguration, to create a campaign to eradicate world hunger. Here a couple of comments are appropriate. The first is that, according to the current rules, the SDRs must be distributed in accordance with established quotas. This means that most of the funds will be necessarily directed to the richer countries. It is therefore indispensable that those countries agree to relinquish their right regarding the SDRs.

The second observation is that if in fact the IMF insists on imposing on more needy countries the usual diet, which reinforces the trend of the cycle, it will further aggravate their situation. In times of severe economic contraction, the last thing they need is conditionalities that deepen recession.

To stimulate trade the G20 decided to open a US$250 billion credit line through the World Bank. Do you consider that to be a wise decision? Will that work and contain protectionist trends?

The US$250 billion is earmarked to finance exports, substituting for conventional credit lines for trade, which disappeared when international financial liquidity vanished. Those funds will certainly help sustain exports as long as the demand is there and as long as what is missing is only short-term credit (part of the reason for the drop in Brazilian meat exports three months ago). Nevertheless, those credit lines have no direct bearing on protectionism, which answers to other motives and is not a consequence of credit scarcity but rather of demand that is insufficient to cover, at the same time, both the outflow of internal production and imports.

Has the G20 summit paved the way to the Doha Round?

Only time can tell. As far as the
Doha Round and protectionism are concerned, the London summit played the same melody with slightly different lyrics. No binding agreements were reached, though. The world has already lost count of the number of times the countries engaged in the negotiations have made declarations of this nature, only to fail to follow up with concrete action. As far as the important issue of reduction of the gigantic subsidies paid by the US government to agriculture go, for instance, the signs are not encouraging. In his State of the Nation speech, Obama mentioned his intention to eliminate subsidies to wealthier farmers; that, however, was later contradicted by Congress when it announced that it did not plan to touch the Farm Bill before 2012.

According to the World Bank, 66 countries have already taken protective measures. If protectionism is unavoidable in the current crisis, what should Brazil do in such a situation?

There is a certain degree of exaggeration in what is reported, the reason possibly being good intentions to say such things out loud and in public as a preventive measure to discourage possible offenders. In practice, however, what has been seen so far cannot be even slightly compared with the terrible protectionistic wave of the 1930s. That was triggered by legislation promoted by President Herbert Hoover and the Republican Party, which were protectionists. Two years later, more than 30 countries had passed retaliatory legislation. It should not be forgotten that at that time there was neither the GATT nor the WTO, or anything even slightly comparable; there were very few obstacles to unilateral measures in the trade area. Today’s Buy American measures, for example, are no more than intentions so far, nothing has been approved, and the idea has since been softened by the suggestion that, once approved, the measures will be enforced in accordance with US international obligations.

As far as Brazil is concerned, the country should continue to do what it has been doing: insist on continuation of the negotiations for liberalization of agricultural exports, and systematically explore export opportunities in markets that still have the capacity to import and pay. In the beginning of the year, it is worth noting, while our exports to the US and the European Union contracted, exports to China, India, Venezuela, and other buyers expanded.

Brazil has reserves in excess of US$200 billion, and a deficit in current transactions of US$5.020 billion in the first quarter of 2009 — 51% less than the same period last year (US$10.260 billion). Is the country safe from a foreign exchange crisis?

Brazil will only be spared if the economic crisis and the contraction of the world trade do not persist for too long. If in the future there are signals that start to inspire caution, the best would be to follow Mexico and as a preventive measure access the IMF flexible funds, assuming that they continue to be available.
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Assine Conjuntura Econômica, editada desde novembro de 1947 pelo IBRE/FGV, e receba em casa as mais profundas análises econômicas, políticas e sociais do país e do mundo.
Savings: Patchwork solutions versus comprehensive reforms

Fernando de Holanda Barbosa

In its meeting of March 29 the monetary policy committee (COPOM) reduced its policy rate, the SELIC interest rate, to 10.25% a year — the lowest rate in its entire history. This deserves no celebration, however. The economic environment is one of rough seas after the passage of the American tsunami, which led central banks in the northern hemisphere to cut their rates close to zero. The IPCA (National Consumer Price Index) inflation rate forecast by the market for the next 12 months is about 4.2%. Thus, the annual real interest rate expected for the period is 5.8%.

The reduction in interest rates, nominal and real, might make savings accounts rather attractive because their earnings are not taxable. To deal with the problem of savings accounts having relatively higher yields than other assets, different suggestions have been advanced by the press. An improvised half-measure to solve the problem would be to reduce earnings on savings, taxing the earnings of those accounts in the same way fixed-rate investments are taxed. The income tax would only apply to deposits above a certain value to protect the small saver, who would still be guaranteed his or her full earnings.

Brazilian society in general and economists in particular seem to prefer improvised measures, patching up here and there, instead of adopting comprehensive reforms of inefficient systems and institutions. The financial system is one of these. The cost of financial intermediation reflected in high spreads (the difference between deposit and lending rates) is a symptom that something is wrong. The recent replacement of the Bank of Brazil management will not solve the problem of financial intermediation in that institution. It must be addressed not by substituting people but by redesigning the entire system. Assigning culprits is a typical attitude of our society, in constant search of scapegoats for everything.

During the Castelo Branco administration (1964–1967), the Campos-Bulhões team chose reforms over improvisation. Fiscal, financial, capital market, and social security reforms were carried out. Toward the end of military rule, the reforms were diluted and, because they had been im-
posed by force, did not gather support from society. The Fernando Henrique Cardoso administration introduced a series of reforms, among which the most important was monetary reform. That administration may be criticized for the reforms it failed to introduce, but not for the reforms it did carry out. One that should have been introduced at the time of monetary reform was financial reform. The current crisis opens a window of opportunity for that, but it seems that improvised short-sightedness will continue to prevail.

In the 1980s banks started offering multiple services, and the model of financial market segmentation created in the 1960s was abandoned. It was a natural evolution resulting from the dynamics of the financial sector. Now, instead of operating one company dedicated to real estate credit, another to finance durable goods, and yet another to finance investment, all activities were absorbed by a single institution, the multiple service bank. However, the freedom on the asset side to finance different types of operations has no counterpart in freedom on the liability side because restrictions remain, such as earmarked credit that binds liabilities to assets. Savings accounts are part of this mess. Instead of patching up the old shoes, it is about time to buy a new pair.

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The current crisis opens a window of opportunity (for reforming inefficient systems and institutions), but it seems that improvised short-sightedness will continue to prevail.
Has the financial crisis corrected the exchange rate in Brazil?

Márcio Holland

Previous international financial crises have in general caused a severe devaluation of the currency in emerging economies like Brazil. The currency crises had very negative consequences for the entire economy, always expressed as an increase in the domestic interest rate and a fall in gross domestic product. However, during the crisis that started in August 2007 there was no significant devaluation of the real until mid-2008. The Brazilian currency followed a clear path of appreciation from late 2002 until June 2008, when the trend reversed with a nominal devaluation of about 50% in only seven months, from August 2008 to February 2009. Not only have interest rates fallen but the Brazilian currency even recovered value between March and April 2009.

In real effective terms — adjusting for inflation and taking into account a basket of currencies relevant for Brazil’s foreign trade — the exchange rate devalued between 6% and 9.5% in August 2007 and February 2009. Having appreciated by 15% between August 2007 and August 2008, however, in the second phase of the crisis, after August 2008, the Brazilian currency underwent a severe real effective devaluation of 22%.

In sum, the 50% nominal devaluation represented only about 22% in terms of real effective devaluation, because many other currencies — such as the Mexican peso, the Russian ruble, and the pound sterling — also devalued. For this reason, our currency was devalued by close to 26% in nominal effective terms — much less than the 50% nominal devaluation, without a currency basket. In other words, our currency devalues as the currencies of other countries devalue.

Is such a currency devaluation, whether nominal or real and effective, enough to bring the Brazilian exchange rate to some sort of long-term equilibrium? Or could it be that the international financial crisis has made the job of the Brazilian Central Bank easier by correcting the distortion of exchange rate parity that prevailed for such a long period in Brazil?

Equilibrium

The major problem here, of course, is to determine the long-term equilibrium of the exchange rate, because when
discussing whether a currency is devalued or not, the issues are: in relation to which exchange rate? and over which time period? Economists usually say whether or not a currency is devalued, but they do not establish the long-term equilibrium rate. Whether the exchange rate registered in March and April 2009, 2.20 to 2.40 reais per dollar, is the true exchange rate is something that can only be established a few years from now. This is the constant problem of hindsight.

Exchange rate misalignment seems to have been a recurrent issue in Brazil since domestic inflation started to converge to international levels, that is, since 1995. Between 1995 and 1998 the signs were clearly pointing to external imbalances — the generation of successive deficits in external current transactions. Since 1999, with a floating exchange rate and after a sharp devaluation to accommodate the shock caused by the exchange rate crisis in early 1999, the nominal exchange rate has been subject to remarkable appreciation. More recently, with inflation stabilizing and some growth in domestic income, it was again argued that the exchange rate could be misaligned (appreciated), particularly in 2008, due to the rapid reduction of the external trade balance and the accumulation of deficits in external current transactions. Nevertheless, there was some doubt because those deficits seemed sustainable considering the net flow of foreign investment and the solid accumulation of foreign currency reserves. In other words, until mid-2008 the deficits in current transactions were temporarily consistent with the country’s net international investment position.

The chart demonstrates the initial evolution of the nominal rate, which closely tracked the evolution of the real currency. After January 2003,
however, the exchange rate fell faster
than the nominal rate, probably due
to the accelerated decline of inflation
in Brazil. Also interesting are the
weights adopted for calculating the
effective exchange rate at about that
time. Since 1980, it is important to
emphasize, the weights of the main
Brazilian trade partners have chan-
ged along with the many changes
in their shares of trade with Brazil.
In 1980, for instance, Brazilian ex-
ports to the United States accounted
for 17.5% of total exports; then,
as the Brazilian external account
underwent a macroeconomic adjust-
ment, the US share rose to 28% in
1986. However, by 2008 it had fallen
to 16%. Meanwhile, trade with the
euro area dropped from 26.5% in
1980 to 22% in 2008; with China it
rose from 0.35% in 1980 to almost 7% in 2008, and the
rest of South America¹ also grew in importance from 8%
early in the 1980s to over 16% at the end of 2000.

The chart also shows the difference between the real
and the nominal exchange rates. In nominal terms, the
exchange rate, even after appreciating significantly, had
by June 2008 still not reached the average values for
1994–98 when the exchange rate was fixed: by mid-2008,
the nominal rate was still about 20% devalued compared
to the fixed rate period. However, the real and effective
exchange rate in June 2008 reached the average values
registered during the period when the exchange rate was
maintained at relatively appreciated values. Since the real
effective exchange rate is more relevant for assessing a
country’s competitiveness, one might justifiably wonder
whether the mid-2008 levels might threaten Brazil’s ex-
ternal equilibrium.

External balance

When growth of exports is compared to growth of imports,
the fall in the trade balance becomes increasingly clear.
On the other hand, by examining investment flows, one
could say that the external sector of the Brazilian economy
could sustain a long period without any risk of a balance
of payments crisis. The accumulation of foreign reserves
seemed to indicate that an exchange rate below 1.6 reais
per US dollar did not represent a macroeconomic threat
— even though it represented a tragedy for some sectors
of Brazilian industry.

Note, too, that the appreciation of the real effective
exchange rate from the beginning of 2003 to mid-2008
had already reached the average for the fixed exchange
rate period. However, that cannot be said of the nominal
exchange rate. Because this is a period when domestic
prices plunged compared to international prices, it is not
unreasonable to conclude that by mid-2008 the fall in the
nominal foreign exchange rate was much more significant
than the drop in general domestic prices.

A very simplified way to assess the possible imbalance
in the exchange rate is the Big Mac index calculated by
The Economist based on the price of a McDonald’s Big
Mac sandwich in different countries². According to the Big
If the financial crisis persists, the Brazilian currency might have to devalue further

Mac index, an exchange rate of about 1.60 reais per US dollar — the June 30, 2008 rate — was appreciated by about 21%.

Lucinda, Holland, and Gala\(^3\) studied Brazilian exchange rate misalignment controlling for the Balassa-Samuelson effect, (i.e, differential productivity effect), estimating the relationship between relative prices and per capita income as a proxy for the productivity of a series of countries. According to their calculations, the Brazilian currency was relatively appreciated by 1.8%–5.6% in 2005. As the real and effective exchange rate appreciated by 14% from 2005 to mid-2008, it is quite plausible that by mid-2008 the exchange rate misalignment surpassed by a large margin the percentages of 5.6%–11.8%.

In conclusion, the recent exchange rate devaluation leading the nominal exchange rate to about 2.35 reais per dollar (February and March 2009 average) would still not be sufficient to correct the misalignment, given historical data from 1980 or if cross-section estimates for a significant number of countries are taken into account. That means that if the financial crisis persists, the Brazilian currency might have to devalue further. Such additional devaluations are directly associated with corrections in terms of trade (commodity prices) as well as with a rise in the risk of default on domestic debt.

In view of the estimates suggesting exchange rate overvaluation presented here, we are witnessing something surprising for an emerging country like Brazil: Almost 20 months after its onset, a severe and prolonged international financial crisis has not triggered excessive devaluation of the domestic currency. It may be that the crisis has yet to hit the country in full, as history shows us; but it may also be that something unusual is happening in the world of international finance.

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1 Here South America comprises Argentina, Bolivia, Chile, Colombia, Paraguay, Peru, Uruguay, and Venezuela.

2 However, this well-publicized index has severe limitations, including domestic consumption composition compared to that of Americans, the weight of the product in question in the basket of goods consumed domestically, and differences in per capita income in each country. Furthermore, the approach ignores transport costs in general, and by exclusively adopting the bilateral exchange rate instead of a multilateral effective exchange rate, it does not take into consideration the remaining Brazilian trade partners.

Solid performance and good investment opportunities

Ernesto Borges (Rio de Janeiro)

The financial hurricane that hit the insurance industry in Europe and the United States fortunately has not arrived in Brazil. The model of the Brazilian insurance market, which long has been criticized for being extremely conservative, suddenly, because of the crisis, became an example for regulators worldwide. The former “ugly duckling,” according to Armando Vergílio, director of the Superintendence of Private Insurance (SUSEP) — the government agency that supervises the insurance market — is now cited as a model by regulators in countries like England and the United States. He says,

“If the SUSEP has to intervene in any company in the coming months due to problems of solvency, it will not be because of crisis contagion but simply because of poor management. The slowdown of the economy since the end of last year is the main side effect of the crisis. Here in Brazil, it would never happen what happened with AIG in the United States. Indeed, the Brazilian AIG branch was very solvent.”

According to the Superintendence’s report released in February, for 2009, insurance premiums are projected to grow by 4.8%. For 2010 and 2011, the expectation is 12.1% and 10.5%, which means 7.3% and 5.8% real growth for the next two years. These projections are well below performance in the past two years. In 2007, the industry grew 17% and in 2008, even with the retraction in the last quarter, growth reached 15%.

Private pension plans

Also according to the report, in December 2008 the contributions of traditional plans were lower by 5% than in the previous year. The individual retirement management account (PGBL) showed growth of 11% and the life retirement management account (VGBL), 17%.Withdrawals from VGBL grew 58%, and from PGBL 19%. Withdrawals as a share of insurance company reserves for December 2007–December 2008 increased from 6.99% to 7.12% for PGBL, and from 13.64% to 17.53% for VGBL.

In December last year, total technical provisioning of the market reached R$100.7 billion (US$50 billion), com-
pared to R$81.8 billion (US$40 billion) in 2007. Technical provisioning in private pension plans grew less, from R$63 billion (US$30 billion) in 2007 to R$70.5 billion (US$35 billion) in 2008. In the same period, claims remained virtually stable — 53.87% in 2007, 53.36% in 2008 — after recording a fall of 2 percentage points in 2006.

Contrary to what many had predicted, instead of contracting some insurance products showed expansion similar to normal years. Car insurance grew 15% in the first half of this year, and the life segment should end 2009 with something close to 7% growth.

These outcomes are no miracle. The measures adopted by the government, such as reduction of the IPI tax on cars, and improved purchasing power of the population in recent years despite the recent increase in unemployment, explain the good performance. Also, the public works of the government’s Growth Acceleration Program (PAC) will ensure expansion of insurance guarantees for business contracts, which had not been much considered in 2008.

“If I believe the economy is already showing signs of recovery. Because the insurance industry is very much tied to the performance of the economy, I believe that in 2010, the sector will be in full recovery,” the superintendent of SUSEP states. The cautious optimism of Vergílio finds support among the executives of major insurance companies in Brazil. According to the group director-president of Bradesco Seguros e Previdência, Marco Antonio Rossi, several segments have been showing good performance since the beginning of this year. He believes Brazil has become one of the countries to invest in at this time.

“In some sectors, the scenarios are quite positive,” Rossi said. “We see life insurance with good growth, health insurance also has presented good results, and car insurance has not been bad, as we had expected. For now, it is the private pension plans that have felt the impact of the financial crisis most. I consider this normal, because investors shy away in times like this. I think Brazil is now a great opportunity for those who want to invest. The country has a different scenario from other countries.”

If the SUSEP has to intervene in any company in the coming months due to problems of solvency, it will not be because of crisis contagion, but simply because of poor management.

Allianz Insurance, according to its president, Max Thierman, expects to grow above the market average in 2009, repeating the performance of the last five years. He sees as promising sectors like engineering, especially policies for new power plants, whether hydroelectric, wind, or other.

“Agribusiness remains the focus of our work,” he added. “Insurance for sugarcane farms, sugar and alcohol plants, various crops, forests, and cultivated land are part of our portfolio, and we are investing to expand marketing of these products. We are also exploring new niche markets, launching products for film and entertainment productions. We insured the box office of Madonna’s show, and recently the
two presentations of Andrea Bocelli in Rio and Sao Paulo.”

Swiss Re, according to Cañado George, commercial director for Brazil and the Southern Cone, intends to keep its good position in specialized insurance, such as agribusiness, the maritime industry, and engineering. The company, which belongs to one of the largest groups in the world, is also attentive to the life and health segments, aiming to provide modern and efficient products.

**Reinsurance**

Opened up for new companies in April last year, the reinsurance segment was caught in the middle of the international financial storm. Despite the difficulties, the results of the opening are considered a success. Of the 20 largest reinsurers in the world, 15 are already operating in Brazil. While some companies have postponed plans to enter the Brazilian market, Vergílio foresees that soon they will resume their projects. Accounting for only 4% of technical provisioning of the insurance sector, the segment is seen as having great potential for growth in coming years.

Eduardo Nakao, chairman of IRB-Brazil Re, says the company will be cautious now that the market is being affected by global economic crisis, especially with companies in the financial sector. Nakao advises policyholders to be very careful as they renew their high-value insurance contracts to avoid unpleasant surprises in the future.

“I hope that, because of the difficulties that are affecting primarily financial companies worldwide, at the time of renewal of insurance contracts of high value, policyholders show concern for obtaining full coverage as well as knowing the reinsurers of their insurance companies. At the same time, if current liquidity conditions continue without economic conditions recovering, IRB-Brazil Re as a reinsurer will be observing a conservative underwriting policy, requiring that insurance companies become more dynamic and aggressive in monitoring their risks and include restrictive clauses in their coverage,” Nakao says.

1 The PGBL and VGBL are private pension plans that do not have a minimum yield. Their main difference is different income tax treatment.
How Brazil should respond to the crisis

A new book analyzes the impact of the recession on Brazil and shows that the best way to overcome is to maintain austerity in public spending and control inflation.

José Fuchs

Nobody doubts that Brazil is more prepared than many countries to face the global crisis. With currency reserves of almost US$200 billion, a large and sound internal market, and relatively little dependence on exports, the country could be one of those least affected by the world crisis. But despite the favorable situation and the optimism of the government and many analysts about the future performance of our economy, Brazil will still be severely affected by the slowdown in rich countries.

Most economists bet, with support from the World Bank and the International Monetary Fund (IMF), that Brazil will grow up to 1.5% in 2009 compared to 5.6% in 2008. The latest report released by the Economist Intelligence Unit, the economic research arm of the respected British magazine, was gloomier. It said that Brazil could even suffer a slight drop in gross domestic product (GDP), the sum of all goods and services produced in the country every year. “This will happen despite the fiscal stimulus and monetary loosening measures adopted by the government,” it said.

In this context, How to respond to the crisis? Economic policies for Brazil offers a valuable contribution to the Brazilian economic debate. Edited by economists Ilan Goldfajn, former director of economic policy of the central bank of Brazil, and Edmar Bacha, one of the architects of the Real Plan (1994), the book assembles lucid analysis of the crisis from 22 first-rate economists, many of whom have worked for the government. They do not limit themselves to diagnosis of the crisis. They also try to point out alternatives to reduce its impact and promote resumption of sustained economic growth.

Most authors are members of the Institute for Economic Policy Studies, Casa das Garças, based in Rio de Janeiro. The institute, which has historical links with the Brazilian Social Democracy Party (PSDB) and Fernando Henrique Cardoso’s government, promotes academic studies and debates on the economic policy of the country. The participants consist of former finance minister Pedro Malan; former governors and directors of the central bank like Arminio Fraga, Gustavo Franco, Francisco Lopes, Alkimar Moura, and Benny Parnes; and bankers like John Cesar Tourinho, executive director of the Safra Bank. “Our idea was to share with the public the thoughts we have been discussing about the crisis,” says Bacha. “Everyone believes the reaction to the crisis may not only affect the immediate future of the country but also shape the Brazilian economy over the next decades,” says Goldfajn.

There is a consensus in the book around the idea that the impact of the crisis in the national economy will be deeper and more prolonged than many have imagined. Nobody believes that the external “tsunami” will become a “ripple” here, as president Luiz Inácio Lula da Silva predicted late last year. There seems also a consensus that the government, despite its optimism, has so far adopted a proactive stance and acted in a reasonable way in combating the crisis.

Most of the authors, however, say the government is not doing something essential: managing
public finances carefully. If possible, the ideal would be to carry out social security reform and abort the swelling number of government employees. This would make room, say these experts, to reduce the interest rate and expand credit without creating inflationary pressures. This course would be much more sustainable in the long run than promoting tax exemptions and other measures, as was done in the automobile sector at the end of 2008. Any reduction in interest rates would also help reduce the large government payments to roll over the public debt. Reducing the interest rate would have a negative effect only if implemented artificially, for political reasons, and if doing so put at risk the attainment of inflation targets.

Although the public accounts are relatively controlled, it is believed that the government’s room for maneuver in this area is very small. Compared with other countries, Brazilian public debt still represents 35.8% of GDP, which is high by international standards. It is feared that excessive release of resources by the government to stimulate the economy might exacerbate the public deficit. “The government has greatly increased spending on personnel in recent years, counting on future tax revenues that will not occur,” says Bacha. “Now, with the prospect of a fall or very low growth in revenue in 2009, the blanket has turned out to be short.”

In the opening chapter, “Where we want to get?” Malan criticizes the use of the ideas of economist John Maynard Keynes, who advocated increasing public spending to stimulate the economy in periods of recession in all circumstances. Malan says that in Brazil, the hiring of a large number of public employees, increases in public salaries, large current expenditures, and a permanent increase in purchases of goods by the government began to be regarded, mistakenly, as if they represented the best of Keynes’s teachings. “The defeat of Antonio Palocci (former finance minister) and Paul Bernardo (planning minister) by the rest of the government was bad for the country,” Malan says. “If the winners (Guido Mantega, finance minister, and Dilma Rousseff, President’s chief of cabinet) are able to sell the country the idea of increasing expenditure as an answer to the current crisis, we are on a collision course with our desire to be seen by ourselves and the rest of the world as a reliable country.”

According to Malan, the best way to ensure a healthy economy is to keep fiscal policy austere. “The widespread desire for lower real interest rates would be more easily achieved with a policy marked by fiscal austerity and the pursuit of efficiency in the management of scarce public resources,” he says. “The central question today is to contain the expansion of current public spending. This is the only way, since it is not possible to increase the tax burden or allow the return of inflation as a mechanism for financing the government, add much to the debt, or further reduce public investment, today less than 2% of GDP.”

Another concern, according to several authors, is the use of federal banks to expand credit so as to avoid a significant fall in economic activity. This has happened previously and ended up compromising the performance of banks, which in turn forced the government to invest billions to cover bank losses caused by bad loans granted for political reasons without meeting technical criteria. “Contrary to what is seen abroad, the Brazilian banking system is well capitalized and provisioned (to cover potential losses in credit),” said Arminio Fraga. “If banks do not take the lead and keep financing growing fast, it is because they fear losing money with the reduction of capacity of debtors to pay in a crisis.”

This book is, of course, not a light read. The authors often look into details of the economy that are almost solely of interest of technicians. But in general the book can help form a critical opinion on the proposals implemented by the government to combat the crisis. At a time when there is almost unanimity around solutions that involve more government spending to resume economic activity, a book like this brings light. It should be compulsory reading for those, whether or not they are trained in economics, who seek a broader vision of Brazilian reality and the impact of the global crisis on the country.

Special reporter of the magazine Época specializing in the economy, business, and finance.

Reprint from magazine Época, Editora Globo, March 10, 2009
Economic and financial indicators

Consumer confidence
The FGV Consumer Confidence Index (CCI) fell sharply from last August, reaching its lowest historical point in February. In March and April, the CCI increased two months in a row by 2.5%. Despite the increase in confidence, the worsening of labor market in recent months, and the environment of uncertainty will keep consumers cautious and purchases on hold for several months.

Industry
Brazilian industrial production dropped sharply in the last quarter of last year. According to the government’s statistical agency (IBGE), the physical production index fell by 30%. In early 2009, the government enacted measures to stimulate the car industry and production started to grow slowly. Further monetary loosening and fiscal stimulus should help to support the recovery trend, which intensified in April. Compared with other countries, the FGV confidence index of Brazilian industry declined by less than Europe and USA. Brazil seems recovering in line with other emerging markets with strong economic fundamentals.

Inflation
After getting close to the 6.5% upper limit of the central bank’s inflation target last October, 12-month inflation, measured by the official consumer price index (IPCA), declined to 5.5% in April. Food prices fell significantly, while service prices remained sticky. For the next few months, the prospects for a declining inflation remain favorable as the prices of industrial and primary products are declining sharply. 12-month inflation measured by the FGV General Price Index (IGP-DI), which relates closely to industrial and primary product prices, declined from 14.81% in July to 4.74% in April, dispelling the threat of passing through costs. Official inflation (IPCA) is likely to the year near the center of the central bank’s inflation target (4.5%).

Trade balance surplus declines
Although the current crisis has contributed to reduce the trade balance, there has been a clear declining trend, since mid 2006, when imports started to grow faster than exports. Some observers argue this is evidence that the Brazilian currency was overvaluated. However, continuing investment inflows and strong accumulation of international reserves seems to suggest that a strong currency is not a threat to Brazil’s macroeconomic stability. Nevertheless, if the crisis persist, the Brazilian currency may have to devalue further.

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.