

## Clouds on the horizon



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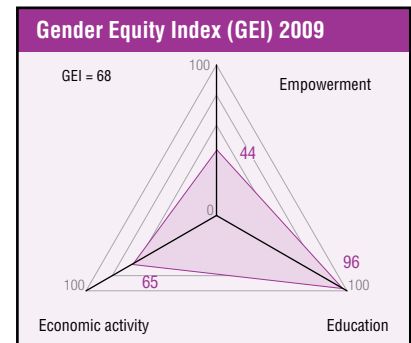
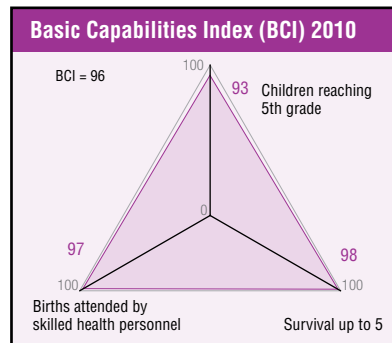
Social Watch Brazil  
IBASE – Brazilian Institute for Social and Economic Analysis

In the last quarter of 2008, the global crisis hit Brazil, breaking the trend towards relatively fast growth that had distinguished the preceding three quarters. As reported in the 2009 issue of Social Watch, the Brazilian economy was hard-hit when capital inflows suddenly turned into outflows, sharply devaluing the domestic currency, and threatening a group of large firms that had bet on the continuing appreciation of the Brazilian real in the derivatives market.

The shock was serious but not deadly, as in past crises. In fact, after about six months of economic contraction, the Brazilian economy began to recover in the second quarter of 2009. Growth has accelerated since then, and forecasts for 2010 range from a minimum rate of 5.5% to about 7% Gross Domestic Product (GDP) growth. Capital inflows were resumed still in mid-2009, and the country again began to face a period of exchange rate overvaluation, with all the risks such a situation brings. During the first semester of 2010, financial instability again increased, caused by the balance of payment problems of Greece, Portugal, Spain and Italy, among others, but it was still early to identify their impact on Brazil.

### Social policies can also support economic growth

The fast and strong recovery of the Brazilian economy in 2009 was mostly due to a combination of non-orthodox compensatory policies. President Luiz Inácio 'Lula' da Silva's administration has come a long way from the neo-liberal policies that defined his first term in office, from 2003 to 2007. Recovery was achieved on the strengths of domestic demand, fed by: policies to rise the minimum wage; social policies, of which "Bolsa Família" (family grant) is the most important; credit expansion policies led by public banks; and, to a lesser extent, fiscal policies under the umbrella program known in Brazil as PAC (Program for Growth Acceleration). Lower income groups were also the target of policies that have expanded the number of poor people receiving cash benefits (equal to a one-month minimum wage), such as those with a family income equal to or lower than 25% of the minimum wage per capita, people with disabilities, poor people over 65 years old, and extended retirement benefits to rural workers (even in the cases where no previous contributions were made).



Bolsa Família, which channels income supplements to families in extreme poverty, distributes about R\$ 12.5 billion (around USD 6.94 billion), practically over the entire national territory. Besides its effectiveness as an instrument for the reduction of extreme poverty, which has been generally considered very successful, Bolsa Família provided important support to domestic demand, particularly for non-durable consumption goods. Since poor families tend to consume all of their income, these grants constituted a direct boost to demand, putting a floor under any possible reduction of consumption expenditures in the country. Expenditures based on Bolsa Família have also an indirect expansionary impact on demand and the level of economic activity. The original expenditures become somebody else's income, which will also be spent, giving additional stimulus to other activities. The decentralized nature of the program allows these stimuli to be directed at local activities, magnifying the impact on employment and on additional consumption.

These expenditures were certainly instrumental in preventing the contraction that would result from the negative impact generated by the balance of payments disparities shown in late 2008 and early 2009. The Brazilian experience showed that social policies can also be supportive of economic growth, since the poorest families, who received the benefits, usually exhibit very high propensities to consume. The macroeconomic impact of these policies compares favourably with those implemented in other countries, such as tax reductions. The latter tends to favour higher income groups (those who actually pay direct taxes) which they use to save part of their windfall gains, attenuating its expansive impact.

The second pillar of the Government's counter-cyclical policies was credit expansion. Under con-

ditions of heightened uncertainty, credit tends to contract because financial institutions usually seek safer assets rather than extending profitable but riskier credit to firms or to consumers. This causes production to contract, since without working capital firms cannot hire workers or buy raw materials and consumers cannot finance their purchase of durable goods. The Federal authorities broke with the neoliberal orientation followed by former president Fernando Henrique Cardoso and by Lula himself in his first term which treated public banks as if they were private.

As private banks in Brazil, as in other countries, shied away from loans, Banco do Brasil (a commercial bank controlled by the Government, not by the Central Bank), the National Savings Bank (CEF, specialized in financing construction and sanitation) and the National Bank of Social and Economic Development (BNDES) were directed to fill the void. The three banks, which cater to different constituencies, expanded activities aggressively, taking market share from private banks, which were then obliged to expand their own operations. As the three banks increased their credit supply, they reduced their spreads, putting additional pressure on private banks to expand in order to avoid losing even larger shares of their markets.

BNDES was a particularly important player in this game, since it finances investment. The increase in investments is a condition to turn this growth spur into a sustainable long-term trajectory. Some controversy has surrounded the choice of projects to which the bank gives financial support, in particular because of environment concerns but also because of their impacts on local communities, but as a strategic element of a growth recovery process, BNDES' action was highly successful.

Even more controversial have been fiscal policy initiatives, among which PAC stands out. The program was launched amid a heavy barrage of publicity, in part motivated by immediate concerns (the incoming presidential election), but also because of its possible impact on the entrepreneurial spirits of Brazilian small businesses. In part, PAC was little more than the consolidation of older projects of public investment or investment made by state-owned enterprises, most notably Petrobras, the oil company controlled by the Federal Government. A number of projects seemed to have met all sorts of difficulties, including with the audit entities that control Federal Government expenditures. Many critics point out that actual implementation of the projects listed in PAC fell far short of what was announced, that projects were not always selected rationally or with the highest social rates of return in mind.

Nevertheless, the impact on the entrepreneurial spirit seemed to be positive, stimulating some recovery of private investment. Even more important was the discovery of large new oil reserves known in Brazil as Pré-Sal which promises to change the country's position in the international oil market. The time to actually exploit these reserves is still relatively far in the future, but the news itself was enough to stimulate additional private investments.

Other positive factors also made their influence felt. The early and strongest recovery of the Chinese economy had an expansive impact on the whole continent, as exports of minerals and agricultural goods to China expanded overall exports. The net impact of international trade was, however, negative, since imports grew faster than exports. In other words, Brazilians bought more from the rest of the world than the rest of the world bought goods and services produced in the country, so the net impact acted to contract local output.

One important difference in this crisis was the behaviour of the capital account. The Brazilian economy suffered the negative impact of the international crisis in its balance of payments in the last quarter of 2008 mainly in the form of capital outflows. These outflows, however, resulted from the return of foreign financial investments in Brazil, which were made in response to stock exchange prospects, and to a smaller degree to interest rates that exceeded those in the rest of the world. As these foreign investors suffered losses in the markets of advanced countries, they closed their positions in emerging economies and repatriated their capital to make up for those losses.

In contrast with past crises, this time there was no capital flight by Brazilian wealth-holders. In

fact, since the crisis was centered in the developed world, foreign capital markets were not attractive to domestic financial investors. Domestic market assets certainly paid more than financial investments abroad and with lower risk. The Brazilian economy was not suffering any pressure to make payments, since its public external debt is reasonably under control and its international reserves are high for the scale of the economy. Capital outflows could be easily accommodated given these reserves. A preventive dollar swap line negotiated with the Federal Reserve strengthened these defenses and reduced any pressures that could lead to capital flight, making it easier to manage other pressures.

### Some risks ahead

Not everything is that bright, however. It is true that the crisis was short-lived and relatively benign in its effects, considering that this is the second worst crisis in the history of modern capitalism, after the Great Depression of the 1930s. By mid-2009, as already observed, the economy was again moving almost at full steam towards rates of very respectable growth, even if far from those reached in countries like China or India.

Recovery also brings the capital inflows that may become very dangerous to Brazil in the near future, since they appreciate the local currency (a trend which resumed after the devaluations of late 2008), which hurts exports and stimulates imports, leading to current account deficits and an increase in external indebtedness. The situation is still under control, but it is deteriorating very rapidly and it is certainly a concern for the near future. The accumulation of reserves per se is not enough to make the position of the Brazilian economy safe. Increasing external debt makes the country more and more dependent on external finance and can turn into a full fledged crisis if these inflows are interrupted as they were so many times in the not-so-distant past. The picture is even more worrying as no solution seems to be on the horizon of Brazilian policy makers. It is generally recognized that the combination of high interest rates and overvalued exchange rates can be lethal, but very little seems to be in the works to change the situation.

On the social policies front, Bolsa Família has been consolidated, and the Lula administration announced plans to make it permanent, making the grants legally mandatory on future federal administrations. A step forward, at this point, would be to define policies for social advancement, including consistent employment policies, policies to reduce unemployment and the expansion of

the informal economy, and education and social policies that would not only increase the welfare of lower income groups but also their qualifications and productivity.

On the credit policy side not much needs to be done at this point. Financial regulation is being redesigned in international forums but the Central Bank of Brazil does not seem to want to be innovative in this field. The aggressiveness with which public banks acted during the crisis seems to have served as a wake-up call for private banks, which are taking steps to expand their own credit supply. This can be beneficial in terms of improving the cost of capital for productive activities and to finance consumers' expenditures.

It is on the investment front that, together with the balance of payments risks referred to above, the horizon is more uncertain. The relatively small degree of damage caused by the first wave of the crisis to hit the economy in late 2008 and early 2009 seemed to strengthen the investment proclivities of the Brazilian economy. However, the investment rate is still very low, much lower than necessary for a developing economy seeking to make the transition to developed nation status. In particular, infrastructure investments are still very far behind what is urgently needed. Besides, environment concerns are not adequately taken into account and the country may be promoting investments in sectors and processes that may become rapidly obsolete. Also some investment projects, particularly in electric power generation, are surrounded by controversy as to their impacts on local communities and the environment, raising debate as to the wisdom of these types of investment.

The most important risks ahead result from the fact that, clearly, the world economy has not yet turned the page on the global financial crisis. As the strong turbulence hitting the Euro zone has shown, there are still great dangers waiting in the future. In fact, the effects of a full-fledged crisis in the Euro zone may have an even worse impact on developing economies and on Brazil in particular, than the financial crash of 2008. Available policy instruments were enough to control and overcome the 2008 crisis. A second wave of crisis and instability may be forming right now with no clear picture of what the outcome may look like.

One important lesson, however, seems to have been learned: that neoliberalism and the *laissez passer* attitude characteristic of the Brazilian governments up to 2005-06 would have been lethal. The activist posture of 2009 may be a better guarantee of a safer future for the country's economy and society. ■