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Brazil Growth Momentum & Challenges When Normalization Begins

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I want to convey a message of realism and pragmatism about Brazil's growth prospects and policy responses to the transition period we're going through. We're at the beginning of exiting (in the US) the set of necessary but exceptional policies that were put in place during the Global Financial Crisis. Realism for Brazil means looking with no complacency to the difficulties of our challenges but also leaving behind what we always thought was an excessive exuberance a couple of years ago[2] that turned into its opposite –as we expected-- becoming a few years later a perhaps excessive pessimism. In EMEs in general and in Brazil in particular, we know very well these cycles. So we learned to build patiently in good years, as the best self-insurance against these sudden shifts in market sentiment, stronger economic and financial fundamentals. As a result, Brazil is now much more resilient to external shocks, has effective policy tools and large buffers to cope with the challenges posed by the transition which the global economy is undergoing.

I will focus on: (1) the Global Economy; (2) Emerging Market Economies (EMEs); and finally (3) Brazil's Growth Outlook and Challenges, with a special note on our "low hanging fruits".

1. Global Economy and its complex recovery when normalization begins

The global economy is a bit better (e.g., the US recovery is holding despite worse than expected 1st quarter 2014 data, there are somehow less tail risks/false positives in the EuroZone and China is soft-landing and working towards its more inward-looking, consumption-based, sustainable growth model). The normalization of Unconventional Monetary Policy (UMP[3]) in the US has begun. And from May 2013 till now, there has been much better communication by the FED on UMP exit (e.g., explaining the separation between its phases, acknowledging spillovers into other jurisdictions and willingness to proceed with caution). All these are good news and the Brazilian Central Bank has been possibly one of the first to say that normalization is a net positive for all of us.

But despite these good news and some improvement in the global economy my view of the recovery is that it's still complex, and might still entail some volatility. It's not going to be a walk in the park. Why? UMP was an unprecedented policy experiment; it succeeded and indeed saved the World but

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[2] including in some very respected international reviews and newspapers

[3] UMP is taken here as the combination of reaching the Zero Lower Bound for Monetary Policy (ZLB), using the central bank's balance sheet with asset purchase programs ("quantitative easing") to influence the slope of the yield curve and level of long-term interest rates and "forward guidance" to administer market expectations.

exiting from it is perhaps more complicated than we thought. Despite the FED's much improved guidance, there are still in Advanced Economies (AEs), especially in the US, many post-crisis analytical and policy questions being debated (Blanchard and alii. (2012)). For the short-term they are policy-related: the flattening of Phillips Curve; how different "measures" of unemployment (short-term, by skills? See Krueger, Alan B. Cramer, Judd, and Cho (2014)) influence most wage inflation in the US; there are also different studies trying to ascertain the neutral interest rate in AEs whose level after Great Moderation and Global Financial Crisis (GFC) might have changed, see Bayoumi T. and alii, (2014)) whose result affect how policy should react and/or will be expected to react. For the long-term, there are fundamental questions about the pace of future growth, how the typical high debt-related gloom (Rogoff and Reinhart (2009) will apply to growth in AEs when they cope with debt deleveraging, whether AEs will mimic Japan's lost decade and plunge into "secular decline" (Summers (2014))? Why is all this important for us in EMEs? Because financial volatility and growth prospects in AEs affects our asset prices, our yield curves and our "animal spirits".

2. **What about Emerging Market Economies (EMEs)? Until quite recently, it was "Chronicle of a Death Foretold".**

The story went a bit like the tale of the "The Ant and the Grasshopper". The presumption was that EMEs benefitted from "easy money" and allowed excessive relaxation of policy stances; our local political economy favored counter-cyclical policy (especially the expansionary bit); fundamentals deteriorated (e.g., asset-credit bubbles, higher current account deficits, inflationary pressure, too loose a fiscal stance that deteriorated debt-to-GDP ratios, too much external financing for both corporates and sovereigns, etc.). There were no structural reforms undertaken in good times: hence we would get lower growth prospects in the future. And therefore, EMEs were heading to the perfect storm: higher vulnerability to "sudden stops" and the usual financial-currency crisis.

Now with hindsight, there is nothing really new in these challenges faced by EMEs[4]. Our monetary policy frameworks (Inflation Targeting (IT) or not) always had to cope with flows and address challenges posing significant risks to our monetary independence and/or financial stability (e.g., typical "boom" & "feel good" moments, followed by "sudden stop", reversals). We have been used to manage pragmatically the Impossible Trinity to keep the independence of our monetary policy (e.g., paying attention to the transmission of capital flows into inflation, asset prices, exchange rate, credit market, etc.). And having gone through so many crises in our history, EMEs got more experienced, more prepared because we are always riding some global financial cycle (local MP in AE have global effects). We are always into some kind of "beauty contest", especially deficit-savings countries.

[4] To begin with, excessive exuberance is not only an EME problem (e.g., see the Eurozone periphery, the Baltics, the UK, the US). Debt-financial-currency crises are a perennial (and now, given what happened to Advanced Economies, an equal opportunity menace). And it seems to –contrary to some cultural explanation about the propensity to save/spend/borrow, crisis seems to affect Confucean/Protestant jurisdictions of "savers" as much as Latino/Catholic jurisdictions of "consumers". For debt to rise, public, private or both, there is always the following combination: (1) someone saying "This time is different" (I agree with Ken Rogoff & Reinhard); (2) some excessive irrational exuberance in lending and borrowing (it takes two to tango and I agree with Robert Shiller); (3) some mispricing of risk (the financial World is not Gaussian nor linear, as Benoit Mandelbrot reminded us and even if it was normally-distributed you need to pay attention to fat tails as Nassim Taleb warns us); (4) some lax regulation, lack of supervision, explicit or implicit guarantee that compounds (2) & (3) as "people forget about the last crisis" (I agree with Alan Blinder); and (5) some political economy institutional set-up that favors pushing the bill to your children, the next government, or both.

But nevertheless, this overly pessimistic story went out and became popular, with new fancy "acronyms", e.g., "*The Fragile Five*", the "*crash of the BRICS*", etc. Most of the analytics behind these narratives were based on simple cross-section static comparisons between pre-"tapering-related" nominal exchange rate depreciation and any kind of variable showing an (unsustainable) external financing need. And the dynamics of this story was the old Dornbusch-Edwards (1991) spiral of macro-populism: uncontrolled depreciation passing-through actual inflation, rising inflation expectations, growth-income reduction, further populist fiscal stimulus, more deficits & debt, more monetary financing, higher inflation, and so on and so for. The "proof of this pudding" mixed actual socio-political unrests in countries far apart, scheduled elections in several countries, and pre-tapering risk aversion. For most if not all EMEs, the narrative built an inescapable conclusion: after excessive complacency and exuberance, life after "easy money" and the commodity super-cycle was going to be gloomy. Good bye "decoupling" and hello "middle-income growth traps" and "mid-life crisis": these topics were "hot" and fashionable in many international forums such as Davos 2014.

Let's recognize upfront that fears about old or modern versions of macroeconomic populism[5] are legitimate, and that there is one question markets were quite rightly so asking: how, after the "easy money party", would local political economy conditions in EMEs allow the necessary and timely adjustments? Let's remember, however, that for any difficult question, there is usually one simple answer and this simple answer is usually.... wrong. And after Chairman Bernanke's May 22 speech, shorting EMEs across any class of risk was probably a relatively straightforward strategy. Easy since there was little need to differentiate and to be analytically more perceptive.

Now my view is that this story was simplistic, wrong and now it's changing quickly. First, even from a simple growth accounting perspective, what we could be observing for many high-growth EMEs (e.g., China and India) is simply the old "convergence to the mean" (Pritchett and Summers (2013)). Second, even these dark tales and perceptions are changing, because of differences in fundamentals, initial conditions and policy responses by each EME: increasingly a number of investors are actually much more bullish on EMEs, capable of differentiating within that class of risk, and putting their money where their mouth is. Brazil is a case in point, let's turn to it now.

3. **Brazil kept Strong Fundamentals, has been Increasing its Differentiation, and was capable of a Preemptive Policy Reaction before the "tapering".**

We in Brazil never got over-excited about market excessive exuberance and we knew that a reversal of market sentiment would eventually come, that this movement of euphoria would at some point end.

Our policy response before, during and now at the exiting of the GFC has been designed and conducted in a cool-headed manner. We kept strong fundamentals and prepared ourselves: we

[5] The classical illustration of Dornbusch-Edwards macro-populism pictured Latin-American regimes with high inflation resulting from monetary financing of large fiscal deficits to subsidize popular consumption and (unsustainable) social transfers under a fixed exchange rate regime with low reserves. However, the model can probably get modern interesting extensions with Asian financial repression to finance large infrastructure investments under fixed, under-valued exchange rates and even AEs' implicit or explicit public guarantees to engineer private sector unsustainable housing booms compounded by very high, loosely supervised financial leverage and opaque, unregulated investment vehicles.

accumulated sizeable reserves in good times to be used as buffers[6] during reversals. We always had (and kept) a strong Financial Sector that has proven resilience, strong capital, provisions and liquidity indicators. Our Ratios of external financing (stocks and flows) are strong and sustainable; we were always cautious and restricted any over-reliance on external sources of funding by our banks.

In terms of policies, we took preventive measures during the upswing (e.g., we used macro-prudential instruments (MaPs) to moderate excessive credit growth). We kept our floating exchange rate regime as a first line of defense, allowing it to appreciate during the upswing but knowing that the repricing of our assets and some depreciation of the Brazilian Real in the downturn was part of the solution and is certainly not a sign of external "vulnerability". We also took early and sizeable action on Monetary Policy to address domestic inflationary pressure, complemented by Fiscal Policy. Finally, last but not the least, we also implemented a large program offering FX-hedge to our private sector in order to contribute to reduce FX volatility, including after "perfect storm" events (e.g., the real beginning of the "tapering", the EME January sell-off and Brazil's sovereign rate downgrading by one rating agency). Our real sector private firms with liabilities in dollars were able to hedge and plan accordingly. This has been working very well.

Brazil's textbook and classic response in this transition is working well. We are not behind the curve; we are not reacting to a phenomenon that we did not anticipate. We acted preventively.

But of course Brazil's challenges remain. Let's turn to that now:

Inflation headline was hit by a temporary supply shock early this year; naturally, headline inflation impacts expectations. Inflation has been high and resistant; reflecting services inflation inertia and the realignment of administered prices. The BCB has acted to secure the convergence of inflation to the target starting very early at the beginning of 2013. In that respect, we must remember that monetary policy effects on inflation are cumulative and take place with lags. There should be no doubt that the policy is effective. In this sense, a significant part of prices response to the tightening cycle has yet to materialize. At this moment, there are renewed domestic food price shocks, but they are beginning to subside which has helped to begin reducing current inflation expectations and are in any event operating in a much tighter monetary conditions environment.

Brazil's growth and development model is performing well. We have followed an inclusive strategy in which unemployment and informal employment were reduced to their historical minimum as 18 million jobs in the formal economy were created; measured by our Gini, income inequality fell and the share of poor households was more than halved, meeting in advance the UN's Millennium Development Goals. We have more than 40 million people that joined the middle class.

Since we're now near full employment[7], it is quite straightforward that in order for Brazil to grow faster, we need to increase capital ratios and to increase productivity. More physical and human capital combined will yield higher total factor productivity. It is a win-win strategy, creating more room for non-inflationary domestic absorption. And precisely, Brazil is implementing a set of textbook supply-side structural reforms. They will boost our (total factor) productivity (TFP). They go

[6] An alternative strategy is to accumulate less reserves and have more faith and reliance on multilateral IMF-FCL lines of support

[7] Our unemployment rates in the last years and especially in 2013 have been the lowest in the country's recent history

in three broad directions: (1) infrastructure[8], a key to Asian growth success story, a must for us to reduce cost and create positive externalities; the ample concessions program, includes the transfer of airports, roads, railroads and port management to private sector; (2) human capital[9], a key to absorb/create technological change and broaden/increase our competitiveness beyond commodities; and (3) reduction of production factor costs through inter alia improvements in the business climate. **We know that a stronger growth performance requires improvement in confidence and the pursuit of the present supply policies**.

The good news is that, from what we know from our own studies and a constructive dialogue with foreign and domestic private investors we know that there are a number of "low hanging fruits" available in Brazil, i.e. investment projects that are bankable, profitable with relatively low costs and high returns. We know –and there's paradoxically quite a consensus about our supply-side reforms among a variety of economists in Brazil (see Pereira da Silva (2014)-- that put together these initiatives will make the Brazilian economy more competitive and we also expect that they will produce externalities and induce higher private investment.

Good examples of Brazilian "low hanging fruits" are: (a) the potential cost reduction impact of the expansion and improvements to the BR 163 highway, which will connect grain-producing areas in the western states of Brazil to ports in the north and northeast of the country; improvements there may decrease shipping time to Europe by 3 to 5 days; (b) according to one large soybean producer, changing their transportation logistics, from South to North and from mainly road trucks to mainly river ships, is already given them a 30% positive return.

Without getting too technical, in Brazil, as in some other EMEs, we are still catching-up with capital ratios of advanced economies and narrowing the variance between our sectoral labor productivity (McMillan and Rodrik (2011)). It means that the potential for productivity increases due to higher returns to investment in human and physical capital and/or from simplifying business, tax procedures, management practices, are very high.

Therefore, it is hard to believe that Brazil is falling into the so-called "middle-income growth trap" (Eichengreen and alii. (2013))**.** This is an old and interesting story where after reaching a certain level of per capita income some EMEs can't go further to find new sources of productivity-based growth. Policies, reforms do not improve, the country gets stuck. It's important to keep that risk in mind but doesn't fit Brazil's current story and what we have been doing[10].

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[8] For investment in infrastructure, Brazil developed an extensive program of private sector concessions. From the second half of 2013, several auctions were held: (a) 4.2 thousand kilometers of highways, (b) twelve private port terminals, with a total investment of about US$3.5 billion and an estimated throughput of 116 million tons per year; and (c), two international airports with estimated investments of over US$4 billion, along with four airport concessions granted in previous years with total investments, already underway, of about US$7.5 billion.

[9] For labor force skills, there are two programs: (a) Pronatec provides technical training to 8 million students over four years – 6.8 million students have already participated; (b) Science without Frontiers provides 100 thousand scholarships over four years for undergraduate, graduate and postdoctoral studies abroad in fields related to science, technology, and innovation.

[10] (1) we have still pockets of existing productivity, well-established and growing in commodities and the pre-salt oil; (2) our productivity potential is also growing not decreasing; our demographic bonus plus the on-going supply-side reforms on infrastructure, education and factor cost reduction will generate significant networking positive externalities; investment started to grow again in 2013 (~6% more than the ~2% for private

Brazil has indeed many challenges but also huge business opportunities. We are continuing to ensure macro-financial stability; we will weather well through the normalization of policies in the US and AEs; we are beginning to feel the differentiation by markets, based on our fundamentals, our resilience and our policy readiness; we are now beginning to see a shift in many financial variables (e.g., exchange rate, risk premium, capital flows, etc.). Therefore, in a context where our macro-financial environment provides us stability, we will continue implementing our reform agenda toward a more efficient allocation of production factors in our economy that will bring future productivity gains. We know what our weaknesses are, but also what our potential is. We do react on time, and we know where we are going. There is no complacency and there is no denial about the challenges we need to address. The current moment for the global economy, as I said at the beginning is still complex and that's why in Brazil we are working hard, very hard. There's no rest since we want to provide sustainable growth, social inclusion and the best investment opportunities to our society and our partners.

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consumption) – strengthening this trend will depend on confidence and tends to gain traction led by infrastructure projects and oil fields exploration; (3) our institutional framework and our fundamentals are strong and tested; checks and balances everywhere, low debt, high reserves, entrenched stabilization culture, resilient federative government structure with clear rules, social and political stability, crisis-weathered financial sector, etc. you name it.