"May you live in interesting times", says the famous Chinese curse. Yes indeed, these have been overly interesting times to say the least. The global crisis brought many new challenges, especially for us in emerging market economies (EMEs). But when living in interesting/challenging times, you have also to remember Yogi Berra’s advice: “You've got to be careful if you don't know where you’re going because you might not get there”. That’s why, in Brazil, we are keeping our focus on maintaining our sound and tested economic policies but also looking at medium-term goals. There has been --as usual about that-- criticism and debates, of course but let me quickly list some of these directions:

First and foremost, keep macroeconomic stability, because we --in emerging market economies (EMEs)-- have seen this movie before and too many times; and we of course pay the utmost attention to financial stability because it’s impossible not to have seen this new (horror) movie coming to a theater near you; second, foster social inclusion that enables resilient social pacts; third, incentivize productivity and innovation including from external sources and strengthen institutions to enable competitive and efficient business practices; fourth, promote more balanced growth (in terms of inter-temporal consumption-saving choices, environmental sustainability and domestic vs. external demand); and fifth, work and look for opportunities for regional, global integration and cooperation.

Now while working on this broader medium term agenda we also need to get an accurate, precise reading of what’s going on in the short-term. That means a good reading of the still weak global recovery because it does affect our policy room for maneuver and immediate growth and inflation prospects.

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1. **The long and winding road... toward a new social pact in advanced economies**

Turning to the global economy, pretty much the whole old and the brand new arsenal of macro policies have been used in advanced economies (AEs). The good news: powerful bazookas were fired and succeeded, no doubt thanks to the unprecedented, bold, timely and coordinated fiscal cum monetary policy action taken by the Group of Twenty (G20) countries. All that including zero bound policy rate monetary policy plus quantitative easing (QE) in many advanced economies managed to avoid a 21st century New Depression. That’s good, but how come then it’s taking so long, that the recovery is still so weak perhaps with the exception of some green shoots in the US?

The bad news is what we suspected in 2009 but now know in 2013: this new combination of unprecedented conventional and unconventional monetary policy cannot solve all the fundamental problems advanced economies face. Almost five years into the crisis, behind the word “over indebtedness”, what seems to be dragging the recovery are political economy issues. They are about the size and fiscal characteristics of Welfare States mainly in advanced economies. Those unresolved issues affect confidence and “animal spirits”; and quite possibly can only be addressed by new “social contracts”: perhaps only innovative new social pacts could really overcome the seemingly intractable political economy paralysis in AEs. Yet, it is hard to see how, when and with whom in the presently fragmented and divided political arena in the US, Japan and Europe. The best modern political economy literature (see Acemoglu et al. (2012)) does not get into the details of how to construct a delicate budgetary compromise that entails changes in existing entitlements, rights and the distribution of tax burden and/or incidence of expenditure cuts. So, as much as James Carville may have been right in saying that, in politics, "it's the economy, stupid", we may now just as well conversely say that, when it comes to the economy, "it's the politics, stupid".

However difficult, many are now arguing that a feasible detailed new social pact is crucial for advanced economies (see Coeuré (2013)). Why? If, as the markets are saying, debt is too high even when guaranteed by any sovereign, it means: (a) some deleveraging needs to take place (it’s ongoing); and (b) that the pre-crisis model of consumption growth fueled by credit is gone for a long time, perhaps forever. If this is true, it has important implications: (c) growth will be slower—in the absence of new total factor productivity (TFP) gains—and also (d) the “keeping up with the Joneses”, the consumption catch-up through higher indebtedness and credit will be harder to achieve if at all possible anymore. But consumption backed by credit allowed the emergence and maintenance of large middle-classes in most advanced societies. And various forms of social protection were also instrumental in holding their social fabric together.

If those are important components of AEs’ socio-economic and political stability in the long run, and if credit is at least to grow less, then in the short-run a compromise is needed to hold a reasonable socio-political equilibrium together. What? Something that would strike a balance between targeted social services, (some) transfers cum expenditure cuts and (some) increase in revenue collection. Without that compromise, we might have repeats of the 2011 and 2012 risk-on, risk-off roller-coaster, and confidence and the recovery be derailed. We have seen this spiral in EMEs and that is why in Brazil we paid attention and we value so much our federative pact and our social inclusion policies. When we look at the global picture, we hope for the best but also realize that it’s likely that solutions will take some time to construct this sustainable medium-term. Each society will have to design its own compromise following its own cultural premises and political arrangements.
What does it mean for EMEs and us in Brazil? Well, we have been saying for quite a while that the world will have to cope with a prolonged period of slow growth in AEs. These economies will undergo a number of slow structural changes that will affect important global investment parameters, rebalance global growth, savings and investment patterns, change their own NAIRUs, modify relative risk perceptions about safe assets and possibly provoke evolutions in some of the operating frameworks that we have been using so far to ensure macroeconomic and financial stability.

2. Heading toward a “middle income growth trap”?

Are these structural changes in AEs going to increase the risk for EMEs to fall into a “middle income growth trap”? This expression refers to episodes of growth slowdown due to the exhaustion of a growth model’s drivers. Are we heading in Brazil towards something like that after been also under a similar threat during our “lost decade” in the 1980s? Are we going to be hit simultaneously by the AEs’ prolonged period of slow growth, the exhaustion of our own growth model (consumption plus credit and commodity exports) and the competition from low-cost low per capita income economies?

I frankly don’t think so. Brazil is not falling into a “middle-income growth trap”. It’s an interesting story but it doesn’t really apply to us although we have to be careful, very careful. We have some points in our favor: (1) we have a pool of existing and untapped productivity, in commodities; and we have space for financial deepening and more social inclusion(2) we are aware of the risks of non-diversifying our economy and working hard to boost our future total factor productivity (TFP) potential; (3) our demographic bonus plus the on-going supply-side reforms on infrastructure, education and factor cost reduction could generate TFP through networking positive externalities; (4) our institutional policy framework and our fundamentals are strong and tested. And (5) last but not the least, it’s difficult to fall asleep at the wheel in Brazil: we live in a vibrant, noisy, colorful democracy with checks and balances everywhere, a vocal academic intelligentsia, a free press, a demanding but resilient federative pact, and a painfully gained and uncompromising anti-inflation consensus in society.

But yes, there are always risks and it means that we need to be “ahead of the curve” and to listen to every warning. We do, and a lot. Getting away of a “middle-income growth trap” is about being capable of bringing more and more TFP into the game as your natural advantages fade. The name of this new game is “true innovation” and not purely “imitation”. That requires specific skills, incentives and institutions. That is why Brazil is implementing a set of supply-side structural reforms. They will boost our TFP and they go in three broad directions: (1) infrastructure, a key to Asian success, a must for us to reduce cost and create positive externalities; we’re launching this year an ambitious program of concessions in ports, airports, railways and roads; (2) human capital, a key to absorb/create technological change and broaden/increase our competitiveness beyond commodities; and (3) reduction of production factor costs through inter alia tax reductions and energy tariff cuts.

But so much for productivity, innovation and supply side policies. I mentioned earlier that keeping macroeconomic and financial stability was of the utmost importance these days. Well, in addition to the mundellian Impossible Trinity, since the crisis, we macroeconomists are also searching for the Holy Grail to achieve both macroeconomic and financial stability.
3. The Holy Grail: achieving both macroeconomic and financial stability

If you want a good handbook to teach you how to achieve financial instability, read the first chapters of Alan Blinder’s most recent book (“After the Music Stopped”). There, he masterfully describes the run-up to the global crisis, its causes and policy lessons. Needless to say, he makes a strong case for more regulation, both in quantity and quality or intelligence (which is more difficult) if only for the very good reason that “thou shalt remember that people forget” the causes of past financial crises and that “thou shalt not rely on self-regulation”.

Basel III is a case in point: in a nutshell, it’s a systematic global regulatory response to prevent us from the excessive pro-cyclicality that drives financial systems to recurrent crises. Accordingly, the Central Bank of Brazil (BCB) has just released its Basel III package. We published on March 1st 2013 a set of four resolutions and fifteen circulars that implement in Brazil the recommendations of the Basel Committee on Banking Supervision (BCBS) regarding the capital structure of financial institutions. The measures aim at improving the ability of financial institutions to absorb shocks, strengthening financial stability and promoting sustainable economic growth.

One question for all regulators is why did it take so long? The dangers of (irrational) exuberance were known long ago (and recently nicely described by Niall Fergusson (2008)). But perhaps not enough attention was paid to Minsky and Kindleberger before the Lehman event. And the tools we had were essentially either microprudential or applied with a microprudential mindset, like LTVs, DTIs and even forward-looking provisioning. When macroprudential, counter-cyclical tools were available like reserve and capital requirements, they were not necessarily used in coordination with a more comprehensive fiscal and monetary framework, either because of political economy factors or because of the absence of an adequate comprehensive macro-financial analytical framework that could calibrate and guide them.

So we will still face challenges under Basel III and beyond. These challenges are especially important for emerging markets because of our openness to sudden stops and floods of resources that affect the liquidity and structural conditions of our credit and asset markets.

What are some of these challenges that need to be carefully thought through?

The first challenge is how to use wisely the counter-cyclical macroprudential tools that Basel III has provided us with. The counter-cyclical capital buffer is a case in point: we all know that excessive credit growth has been a prelude to (and even a leading indicator of) all financial crises on record since the Tulip bubble. There is a need to develop a proper methodology for estimating credit gaps, a key variable for assessing financial stability, perhaps even the most important indicator to ascertain the (very) difficult concept of “systemic risk”. Credit gaps cannot be thought as a simple filtered trend irrespective of the quality of the statistical procedure: that would not capture structural growth stemming from financial deepening and inclusion, a fundamental factor that is present in the credit dynamics of emerging markets.

Another second challenge is the institutional setup that would best promote the coordination between monetary and macroprudential policies, in other words the close coordination between the monetary and macroprudential authorities if - unlike in Brazil - they are under separate umbrellas.
This question leads to a third important challenge: since the onset of the global financial crisis one issue which has been brought to the attention of policymakers is the role of both macroprudential policy and monetary policy in mitigating pro-cyclicality and promoting both price and financial stability. The debate has been centered on how monetary policy and macroprudential policy should be used. The pragmatic solution has been dubbed a "separation principle", stretching the argument à la Tinbergen: use one instrument --monetary policy-- to ensure one objective, price stability; and use a second instrument --macroprudential regulation-- to ensure a second objective, financial stability. This separation cum complementarity is especially useful in a post-crisis world of volatile and more intense capital flows that can have destabilizing effects on emerging markets.

A fourth ensuing challenge is that to perform well, any monetary and regulatory regime must also have a strong fiscal position that maintains stable and low risk premia. Strong public sector accounts with accumulated precautionary resources may provide some fiscal space to act counter-cyclically without losing credibility and mitigate the risks associated with large and volatile capital flows when needed. In this vein, a comprehensive framework that comprises monetary, fiscal and macroprudential policies seems to emerge as a good and pragmatic policy framework well-suited to achieve both price and financial stability in emerging markets and ensuring debt sustainability as well. Operating along these lines is not trivial but many emerging markets have been, implicitly or explicitly, using some variant of this framework when facing the complex post-crisis economic and financial environment.

A fifth and final challenge is the post-crisis volatility of exchange rate. What to do with it? Can we expect some degree of cooperation among G20 countries? All currency issuing countries claim unconventional policies have good intentions only directed to the revival of their domestic economy. Yes, indeed, but as the proverbial say goes: “the road to Hell is paved with good intentions”.

4. The road to Hell is Paved with Good Intentions: on global policy coordination vis-à-vis exchange rate volatility

Before the crisis, (almost) free floating exchange rates was the rule and somehow easy to follow including through accepting some global coordination and formal Accords (e.g., the Plaza example). In emerging markets, we knew very well that to strengthen the efficiency and credibility of our inflation targeting (IT) frameworks, we need not to have any commitment to target exchange rates. After the crisis, things somehow changed. For us in emerging markets, the global financial crisis provided clearer evidence—if need be—that the stability of our financial systems were affected by the monetary and financial conditions prevailing in advanced economies through sudden stops and sudden floods of capital and their consequences on our asset prices—including the exchange rate—and credit market conditions.

We did manage in Brazil (after a while) to successfully master how to handle such episodes, using inter alia a set of macro-prudential instruments. Many other emerging markets did pretty much the same, adding sometimes capital controls to their policy toolkits. It worked very well indeed in Brazil, we controlled financial instability, stabilized our exchange rate volatility but there’s no free lunch: we also had to pay a price in terms of foreign investors’ perception, of policy transparency and predictability and perhaps in retrospect in terms of our own “animal spirits” at home.
Now in 2013, the issue is not to finger point anyone. Certainly, advanced economies’ policy-makers were concerned—and quite rightly so—about weak domestic activity and/or deflation at home. But their policies did produce an unintended collateral effect: term spread reduction policies affected their exchange rates and thus while helping activity, also triggered unusually strong capital movements. There is controversy as to the effectiveness and possible global spillovers of such “unconventional” monetary policy measures. A number of interesting reports and papers have been published, from the IMF, the BIS, the World Bank, the OECD and academia. The IMF (2012) has undertaken a set of studies on the possible spillover effects of policies conducted by five major systemic economies (the US, the Eurozone, Japan, China and the UK) in the post-crisis environment. We in Brazil did our own homework as well using a rigorous Heckman type counterfactual methodology.

What is the bottom line here? The G20 seems to have evolved towards accepting a “pragmatic” laissez-faire: advanced economies can operate monetary policy at the zero bound and do QEs that they see fit while emerging markets are allowed to use countervailing capital flow management (CFM) measures and in some cases, to use some forms of capital control. We can certainly live with that, since as I mentioned earlier we know how to do it and have the tools for that. However, this combination is risky, sub-optimal and certainly not conducive of welfare-enhancing outcomes globally. It might be the only possibility given the current state of global political economy but I would much prefer a discussion—perhaps at the G20—that considers a more coordinated and balanced framework to deal with exchange rate volatility in advanced and emerging economies.

5. Conclusions

The post-crisis environment will most likely continue to be one of slow growth for a prolonged period of time in advanced economies. Many of these economies are undergoing structural transformations and adjustments. Some, hopefully, will emerge with a new social contract that will be better suited to each society’s welfare preferences and willingness to pay for it.

These are challenges for EMEs including Brazil. We have a window of opportunity while AEs conduct their own mutation, to continue working out our own process of reforms while maintaining macroeconomic and financial stability. The post-crisis world is not easy. We are prepared and have—it seems—sensible directions for us going forward. We learned to deal with crises. We need to continue learning how to deal with (some of our) successes. We have to remain alert, avoiding excessive exuberance or its opposite, cyclothymic pessimism. We have truly excellent opportunities and valuable assets but we will not be complacent and neglect our daily homework because our good fortune could compensate any lack of virtue elsewhere.
Notes:

i And the solution is not in the exceedingly interesting pieces of the modern political economy literature (see Acemoglu and Robinson (2012)) how insightful they might be. Yes, it quite rightly points to the importance of property rights, competition, and enforcement of rules of laws that are all needed to foster development and growth. But the issue is not about the two Nogales or the two Koreas: the issue seems to be what arguments are present and with what weights in the utility function and discount rate in the alleys of Capitol Hill, the Diet, the Palais Bourbon, the Cortes, etc.

ii Political consensus in advanced economies might be even more complicated in the new context of well-informed, inter-connected web-citizens as portrayed by Michel Serres (2012). You need to have expertise à la John Rawls and Jürgen Habermas but probably and most importantly giving them a crash course at the Office of Management of the Budget (OMB).

iii An usual explanation of these slowdowns uses a typical Lewis two-sector development model: there are decreasing returns and/or physical limits to the process of integrating higher marginal return production factors into the economy; a kind of “plateau” or growth stagnation comes when for example low-cost labor and imitation of foreign technology either disappear or lose its original efficiency i.e. when middle- and upper-middle-income levels are reached (see Agénor et al. (2013), Eichengreen et al. (2011)).

iv Among many issues, Blinder flags this perverse combination of deterioration in the quality of mortgage origination (the subprime debacle), opaque and complex built-up of poorly regulated derivative instruments, disseminated in excessively and highly leveraged interconnected balance sheets, etc. and all that allowed by lax regulation-supervision and (very) bad incentives.

vii The IMF study concludes that we have evidence of highly correlated asset prices, negative effects of financial shocks, and that “the actions and inactions of systemic economies have far greater effects on the world than in normal times”, the report is mostly based on Fund’s global macro-model simulations which did not explicitly consider counterfactual scenarios.

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ix We did in Brazil our own homework, reaching similar conclusions than the Fund and the BIS. But we tried going beyond the general “intuition” about potential destabilizing effects of QEs. Being more rigorous meant that we needed to define an exact counterfactual. Our counterfactual evaluation shows results that are consistent with the view that QE policies in advanced economies had significant spillover effects on the Brazilian economy. These effects were mostly transmitted through excessive capital inflows that led to exchange rate appreciation, stock market price increases and a credit boom. Our results quantify the economic significance of the effects which appears clearly and are sizeable. We used a VAR model of the endogenous variables where the different channels are represented. Our methodology is in the Heckman counterfactual tradition and result in estimates of ex-ante and ex-post policy effects over a grid of well-measured
counterfactuals. The additional capital inflows resulting from QE2, for instance, are of the order of 100 USD billion (almost a third of our international reserves). This was associated with additional 0.9% of GDP of non earmarked credit to households, a fall of 5 percentage points in interest rates in reference loans, an increase of 12% of GDP in the stock market value, a nominal exchange rate appreciation of 20 basis points, with a counterfactual exchange rate of 1.8 against the actual 1.6 BRL/USD. These are non-trivial effects indeed and make it harder for emerging markets to manage both macro (price) and financial stability.

Perhaps incentives to increase credit multipliers in advanced economies, including using their prudential-regulatory framework to define higher risk-weights for cross-border flows into emerging markets temporarily while their recovery takes strength would allow in turn emerging markets to lower their own CFMs and their own controls. That might succeed in producing a closer to Pareto-type global outcome with a more predictable, smooth and business friendly environment for all.

References:


