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A route to economic growth: the restructuring of the economic policy framework in Brazil in a context of crisis*

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Abstract

After years with an economic policy framework based on a convention around stability in force, which locked the Brazilian economy in a low growth, high interest rates, high inflation and overvalued exchange rates situation, several changes started to occur. Since the second Lula administration (2007-10), some initial attempts to get out of this 'trap' were implemented – a process that gained momentum with the 2008's financial crisis downward effects. In this context, the aim of this paper is to carefully analyze the economic policies and measures carried out in the most recent years – fiscal, monetary, financial and foreign exchange –, in order to provide an understanding of what are the consequences to the economic functioning and what to expect from the Brazilian economy in the future. We argue that some flavors of *Post-Keynesian'* and *structuralist'* policy prescription can be identified in several parts of this recent experience and that these measures reflect a bold attempt to reestablish a route of economic growth which currently has no parallel in other countries. Managing fiscal policy to directly bust aggregate demand, however, is a lacking piece of the 'new' framework and is needed to effectively align Brazil with a sustainable route of economic growth.

Keywords: Brazil, Capital controls, Monetary Policy, Macroprudential tools, Public banks
JEL Codes: E50, E60, E61, E65, G28, O54

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1. Introduction

Macroeconomic instability is the pair of words that better summarize what happened in the Brazilian economy during the 1980's and the 1990's. Debt crises, high inflation, high interest rates, low growth, amid many institutional and structural changes, characterized our economy's day-to-day. Numerous stability plans where tried, and the economy minister was replaced 14 times between 1985 and 1994, when finally the Plano Real[1] managed to bring monthly inflation from 46.58% to 6.08%.

In this context the necessity of economic stability was urgent and spread amongst all sectors of the society. A convention around stability started to be built, shaping economic policies after the Real Plan, and was consolidated and effectively established when a new policy framework, based on three pillars, was adopted in 1999: 1) inflation targeting regime; 2) floating exchange rate, with high capital mobility; and 3) primary surplus targets (Erber, 2011; Modenesi et al., 2013a).

The so-called tripod brought with it the idea that inflation is primary a demand problem and that interest rates, through its effects on floating exchange rates and aggregate demand, are the main tool to fight against it. The fiscal policy, in its turn, was designed not to hinder the price stability – in a typical example of monetary dominance. However, the tripod does not seem to be effective and the Brazilian economy has been locked in a high interest rates, high inflation and overvalued exchange rates situation. This has had various effects in many aspects of the functioning of the economy, being the most referred ones: low growth, deindustrialization and wealth concentration.

Since the second Lula administration, started in 2007, some initial attempts to modify this situation were timidly implemented (e.g., the use of countercyclical fiscal policy and capital controls), but most recently, especially in the last two years, strong modifications were put in course as a response to the international financial crisis. For instance, the Central Bank of Brazil (BCB), for the first time, acted against the market consensus and reduced repeatedly the prime rate; public banks (Caixa Econômica Federal and Banco do Brasil), in their turn, cut drastically their spreads and administration rates, reducing their interest rates to consumers in something close to 70%, which dragged private banks to do the same; the rules of savings account remunerations were modified in order to allow further reductions of the prime rate. It is also noteworthy that capital control measures became more aggressive while financial policies aiming at the development of a long-term capital market took place.

[1] Plano Real was the stabilization plan which implemented the current Brazilian currency.

Considering these recent developments, we argue that the established convention around stability is being mined, though a new convention that replaces stability to growth is not yet in place. The basic tripod remains the same but it is being operated in a quite different manner. Active discretionary economic policies replaced the passive rule-based approach that characterized the policies in the beginning of the 2000's. So, the aim of this paper is to carefully analyze these new economic policies measures, in order to provide an understanding of what are the consequences to the economic functioning and what to expect from the Brazilian economy in the next years.

For this purpose the paper is divided as follows: beyond this Introduction, Section 2 analyzes the implementation of the tripod and its consequences, stressing the slowdown of economic growth witnessed during the last decade. Section 3, in its turn, outlines carefully the main changes in economic policies – fiscal, monetary, financial and foreign exchange – of the end of Lula's second term. Section 4 brings our final remarks. We argue that some flavors of Post-Keynesian' and structuralist' policy prescription can be identified in several parts of this recent experience and that these measures reflect a bold attempt to reestablish a route of economic growth which currently has no parallel in other countries. Managing fiscal policy to directly bust aggregate demand, however, is a lacking piece of the 'new' framework and is needed to effectively align Brazil with a sustainable route of economic growth. Lastly, Section 5 delineates topics for further research on this area.

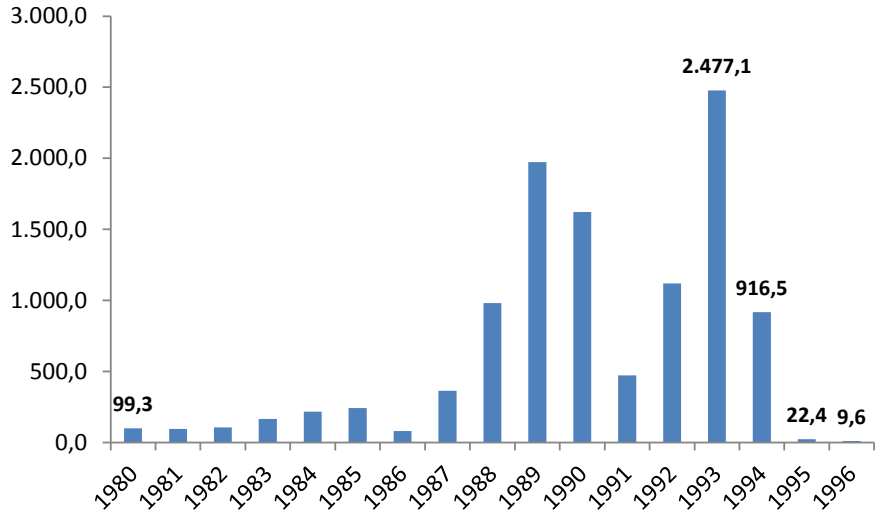
2. Stability, the tripod implementation and the slowdown of economic growth

The major problem of the decade (from the 1980's to the early 1990's), was solved, at least in its major part, with the implementation of the Plano Real, in 1994 (Figure 1). Economists at that time were relatively consensual regarding the driver of inflation. Heterodox and orthodox scholars had the same diagnosis: the evolution of prices had become inertial. Prices were too indexed to the inflation of the previous period. Tariffs, taxes, wages, capital remuneration, rents, almost everything in the economy had a contract clause that allowed prices to rise based on a basket of inflation rates. This process started in the 1970s, with the PAEG's (Government's Economic Action Programme) wages indexation, and it did not take long until the private agents perceived that they should follow the trend to maintain their margin. The population had incorporated an inflationary memory.

The Real Plan created a count unit, the URV (real unit of value), that varied in a daily basis according to real value of the Cruzeiro Real, the former currency, and forbid several indexation clauses, notably capital remuneration and wages. Besides that, the plan relied on an augmentation of the imports coefficient under an overvalued exchange rate to depress prices locally. When authorities had the impression that the population started thinking of URVs instead of Cruzeiros

Reais in their daily economic activity, they launched the new currency, the Real, as the equivalent of the URV. The inflationary memory was immediately lost:

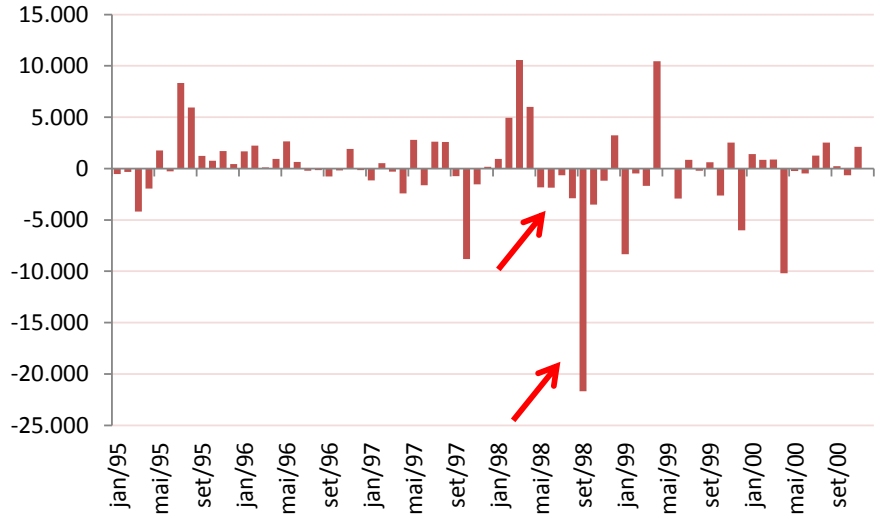
Figure 1: **Yearly Inflation Rate (IPCA)**



Source: IBGE

In the scope of the Real Plan, the appreciation of the currency was a key strategy, having in its grounds a nominal exchange rate anchor sustained by high interest rates, which attracted foreign capitals (Hermann, 1999). However the course of the events in the late 1990's, which are marked by several crises of emerging countries (Russia, Thailand, Malaysia, Korea etc.), made this strategy unsustainable. Capital outflows due to Russian and Asian crises prompted speculative attacks against Real that made Herculean any attempt to maintain the nominal exchange rate anchor (Figure 2). The lattermost speculative attack occurred in September of 1998, when the balance of payments registered a net outflow of US$ 21.8 billion (see red arrows in Figure 2) and international reserves fell 32.0%, from a level around US$ 70 to a level around US$ 40 billion.

Figure 2: **Monthly (net) result of the Brazilian balance of payments (US$ Million)**

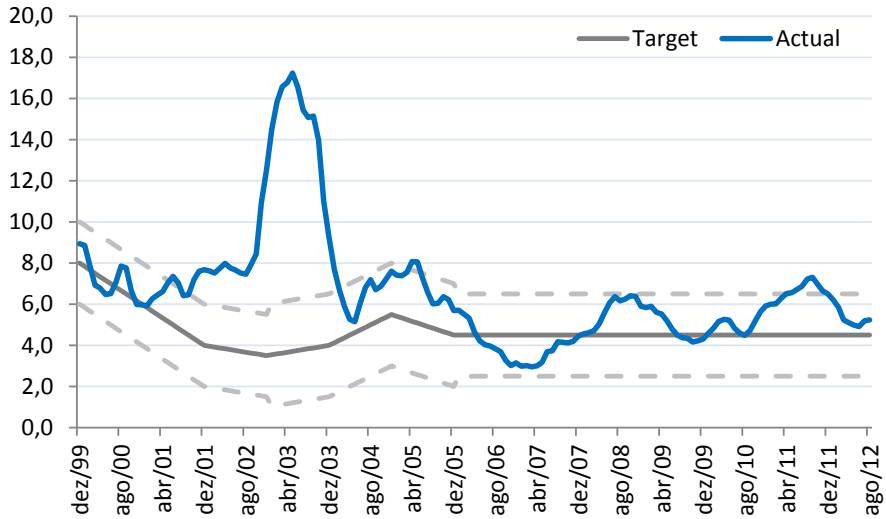


Source: BCB.

In this context Brazil abandoned the fixed exchange rate regime and a new approach to exchange policy was implemented – with a redesign of the economic policy framework as whole, though keeping the convention in mind. In 1999 the new framework entered in force, based in what was called the policy tripod: 1) inflation targeting regime; 2) floating exchange rate, with high capital mobility; and 3) primary surplus targets. In this framework, price stability was pursued by fixing the basic interest rate according to a Taylor rule (Modenesi et al. 2013b), controlling simultaneously aggregate demand and, though not directly, the exchange rate[2], in line with the so-called New Consensus on Monetary Policy. The importance of the low import prices was still part of the strategy, so interest rates should be preferably high in order to attract foreign capital. Fiscal policy, in its turn, was kept flat, not to exercise pressures on public debt and inflation (through demand). Economic growth, in this context, was left in a secondary position.

The actual performance of the tripod, however, was far from the one idealized in theory. The new framework had some fragility and has had various effects in many aspects of the functioning of the Brazilian economy (see also Arestis et al., 2011). Firstly, inflation apparently had some resilience to go below a floor limit and was kept above the central target in almost every year of the 2000's (Figure 3).

Figure 3: **Inflation (IPCA) accumulated in 12 months (%)**



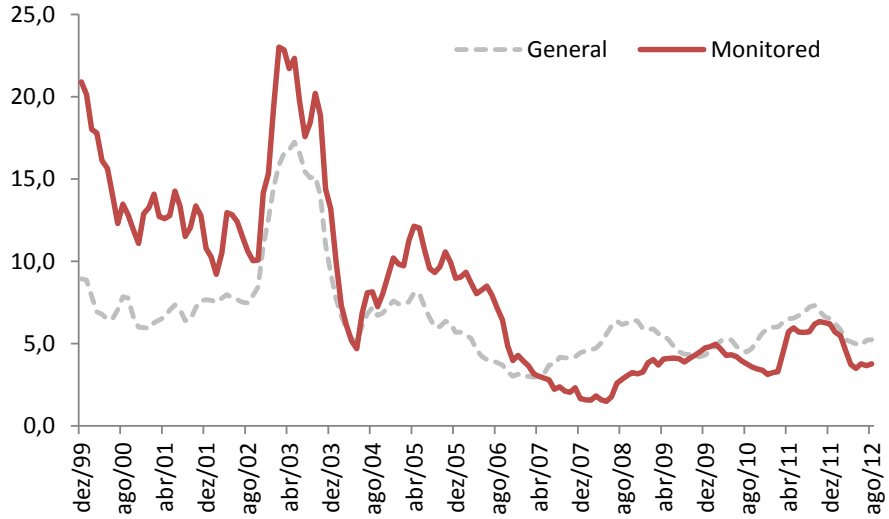
Source: IBGE and BCB.

On one hand, even if the inflationary memory was lost, the initial problem of price indexation was not completely tackled, as rents, some tariffs (public transportation, energy, gas, etc.) and other prices still had their clauses that allowed regular rises based on previous inflation rates. It meant that any eventual shock on prices (due to a crop loss, for example) would be spread

[2] As Araujo and Modenesi (2011) show, the exchange rate channel could be considered the main transmission channel of monetary policy during the 2000's.

to the rest of the economy. These indexed prices are grouped in the 'monitored' inflation index (which weighs one third of the general index)[3] that, as shown in Figure 4, drove the general inflation until the early 2007.

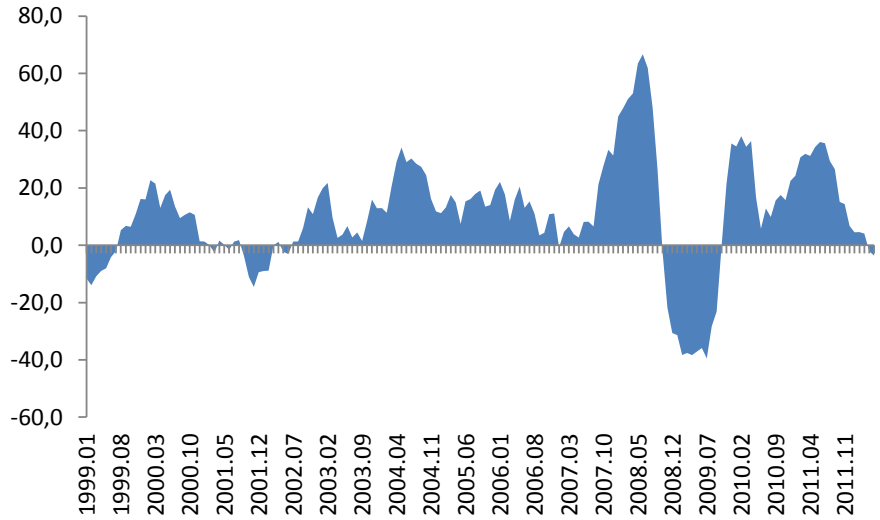
Figure 4: **Inflation (IPCA) accumulated in 12 months (%)**



Source: IBGE and BCB.

On the other hand, as a result of the financialization of commodity markets (UNCTAD, 2009; Serfati, 2012), commodity prices rose sharply in the last decade and commodity inflation was positive in the major part of the 2000's (Figure 5). International prices then contributed to higher domestic inflation. Currency appreciation, in this context, became the main instrument to fight against 'imported' inflation, compensating tradable-commodity price rises in Reais. This strategy led us to two other problems of the actual performance of the tripod: the high interest rates trap and the overvaluation of the Real.

Figure 5: **Commodity price inflation accumulated in 12 months (%)**



Source: IPEA.

[3] However not all monitored prices are necessarily indexed to past inflation.

Brazilian monetary policy during the 2000's is considered quite conservative by several authors (Nakano, 2005 and 2006; Erber, 2008a, 20008b and 2011; Modenesi, 2011; Oreiro, 2012; Modenesi et al., 2013b), as a result of the economic policy strategy designed from the tripod. Extremely high prime rates for international standards are a fundamental element of the stability convention: high interest differentials kept the Real on the track of appreciation, which could be considered the main element explaining the slowdown of inflation rates during the decade (see, for instance, Araujo and Modenesi, 2011; Modenesi and Araujo, 2011), and helped in the administration of aggregate demand, controlling 'second order' effects of price shocks on inflation (which are spread by the indexation of prices).

At the same time, from the viewpoint of political economy, this conservatism favored financial firms, institutional investors, and, broadly speaking, *rentiers*, whilst the BCB benefited from the reputation associated with it, as being conservative was interpreted as an element of actual independence. This independence was grounded on the way that BCB conducted the monetary policy, based on a strictly rigid Taylor rule in line with the New Consensus on Monetary Policy, with slightly changes on rule's parameters (see Modenesi et al., 2013b for a survey on this subject).

As a result Brazil often occupied the upper band of the ranking of prime rates – both nominal and real – around the world in the 2000's. Even when compared with its pairs, developing countries, the Brazilian prime rate presented a relevant positive spread (Table 1). It is noteworthy that the 2008's global financial crisis was not sufficient to change BCB's approach: when the crisis erupted in United States, in the fall of 2007, BCB started to raise the Selic rate, a process that ceased only after the Lehman collapse in the fall of 2008 – five days before Lehman's broke the BCB raised the Selic from 13.0% to 13.75%, event that become known as Meirelles', the former BCB chairman, mistake.

Table 1: Prime interest rates of selected countries

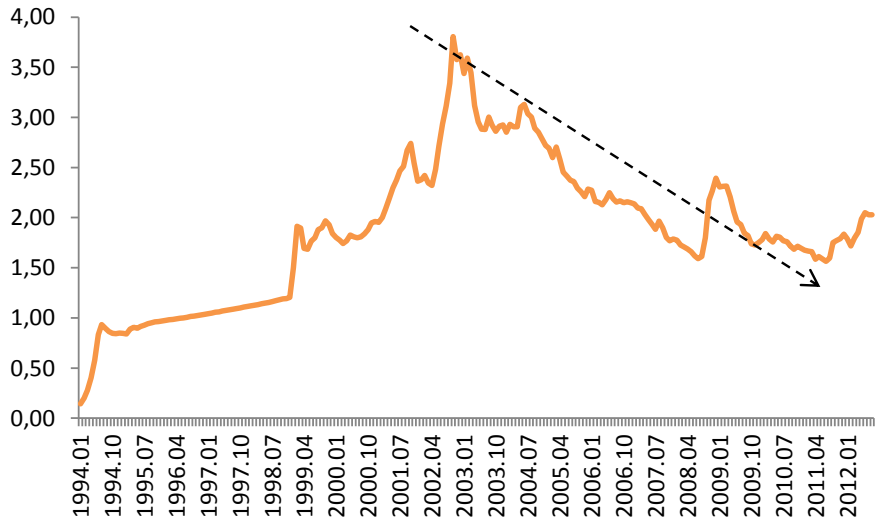
	2005	2006	2007	2008	2009	2010	2011	Latest*
Brazil	18,0	13,3	11,3	13,8	8,8	10,8	11,0	7,5
India	6,3	7,0	7,0	6,0	4,3	6,3	8,5	8,0
Russia	12,0	11,0	10,0	13,0	8,8	7,8	8,0	8,3
China	5,6	6,1	7,3	5,3	5,3	5,6	6,6	6,0
Turkey	13,5	17,5	15,8	15,0	6,5	6,5	5,8	5,8
Mexico	8,3	7,0	7,5	8,3	4,5	4,5	4,5	4,5
Euro Area	2,3	3,3	4,0	2,5	1,0	1,0	1,0	0,8
United Kingdom	4,5	5,0	5,5	2,0	0,5	0,5	0,5	0,5
United States	4,0	5,3	4,3	0,3	0,3	0,3	0,3	0,3

Source: Trading Economics. *As of September 20, 2012.

The third mentioned tripod's performance problem is an overvalued exchange rate, which, actually, was not a problem on itself: an overvalued exchange rate was supposed to be the main

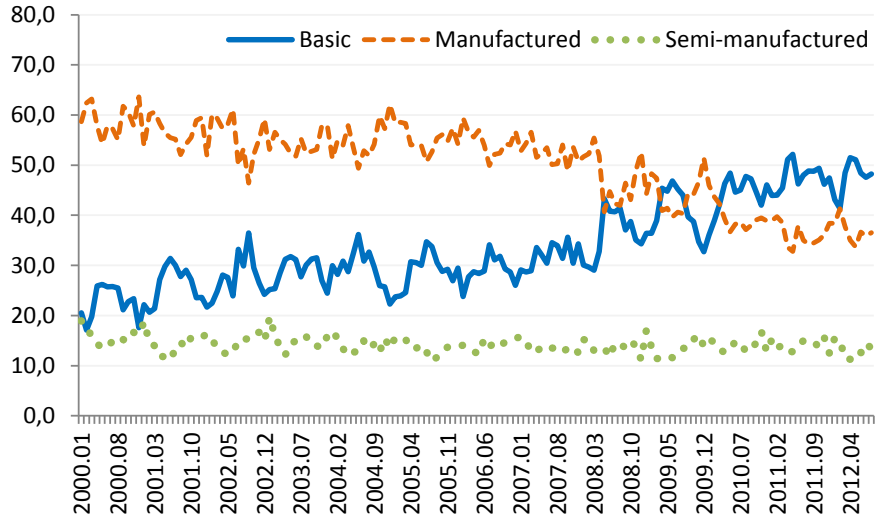
instrument in pursuing price stability. It is desirable from this viewpoint and expected. So the 50.0% appreciation of the Real between end-2002 and 2010 (Figure 6) helped to keep inflation in the broad target interval, though above the central target. However, a number of unintended (though not unexpected) consequences could be associated with the overvalued Real. The performance of Brazilian industry was jeopardized as the overvalued Real made our industry less competitive internationally (what is even worst in a context of rising costs). Figure 7 demonstrates how industrialized (manufactured and semi-manufactured) goods have been losing participation in the export basket. Many authors suggested that this situation is one reflex of a process of de-industrialization (Bresser-Pereira, 2010), whilst other highlights a premature specialization of the Brazilian industry, caused not only by exchange rates competitive disadvantages but by poor macroeconomic results (Carvalho and Kupfer, 2011).

Figure 6: **Brazilian exchange rate (R$/US$)**



Source: BCB.

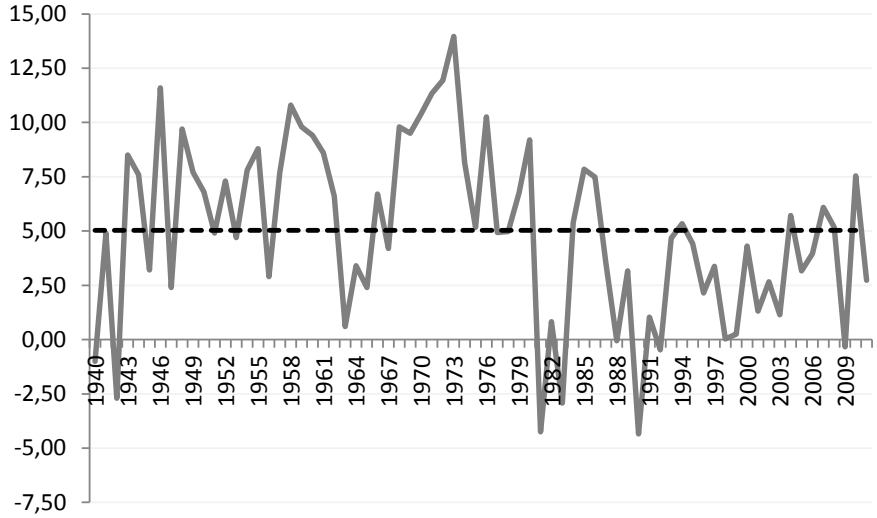
Figure 7: **Brazil Export Basket by type of goods (%)**



Source: MDIC-SECEX.

Due to the tripod established, economic policy had very little margin of maneuver, and the economy has been trapped in a high inflation (in international standards), high interest rates and overvalued exchange rates. Such situation affects strongly, through various channels, the internal investment dynamic, and consequently growth. Just to illustrate, Figure 8 shows the behavior of Brazilian GDP growth after the implementation of the tripod, which remained below the long-term average (from 1940 to 2011).

Figure 8: Brazilian GDP real growth rate (% a.a.)



Source: IBGE.

What was previously said indicates that the prospects to the Brazilian economy in this tripod framework would not be the best – a situation that the financial crisis could worsen. The costs of the strategy would be extremely high without achieving the objective of low inflation. Changes were urgent, and apparently they started to be implemented, especially in the last two years.

3. A route to recovery

The attempt to reestablish a route to economic growth started timidly in the second Lula's term. From the reactivation of fiscal policy to modest capital controls, economic policies widespread to more heterodox monetary and financial policies. The crisis acted as a catalyst of this process, which gained momentum since Dilma's election. The sections below describe the main policies – fiscal, monetary, financial and foreign exchange – carried out in this period.

a. Fiscal Policy

Fiscal policy is one of the pillars locked by the policy tripod. The primary surplus targets impede the free use of this instrument. Anyhow, since the second Lula administration, some efforts have been made to improve public investment levels. The Plano de Aceleração do Crescimento

(PAC) was first implemented in 2007, and is already in its second version. It gathers in a package infrastructure and public services investments, aiming to achieve lower costs to producers and faster growth. The program had some applicability problems, and was a success in some areas, especially in house construction, in the Minha Casa, Minha Vida[4] program that already built more than 2 million houses all over the nation, but meant a first rupture to the former conception of minimal State activity.

In August 2011, Dilma launched the Brasil Maior, which is the first industrial policy plan put in course since the end of the 1980s. It was created in a context of loss of competitiveness of the Brazilian industry, due to the rise of Southeast Asian emerging economies and the appreciation of the Real. The main measures where the following: a restitution of taxes to firms committed to export activities (0.5 of revenues from exports), a preference of 25% to Brazilian producers in government's purchases, US$ 1 billion were put available to R&D activities through Finep[5] and taxes restitutions to capital goods purchases were made automatic, instead of taking the usual 48 months.

The more aggressive measures came later. A total of 40 sectors (in two different decrees, 15 sectors benefited in April 2012, and other 25 in September), considered key to the Brazilian development, were benefited with a modification in their tax payment. They used to pay 20% of their payroll in taxes, and now they must pay from 1.00 to 2.00%, depending on the sector, of their gross revenue. This will represent a US$ 6 billion tax exemption in 2013, and will refocus tax payment to be based on revenue, not on the admission of employees. This measure is expected to increase employment and boost competitiveness on the selected sectors, which are strategic to Brazilian development, such as: bus, airplanes and ships manufacturing, capital goods manufacturing, stove, refrigerator and washing machine, railway equipment, technical assistance to informatics services, house design and IT services. Besides that, the accountability rules were modified, and capital goods depreciation was reduced in half (from 10 to 5 years), to all sectors in order to encourage the purchase of new equipment and machines. The tax exemption due to this rule modification will amount to US$ 3.4 billion from 2013 to 2017.

In August 2012, Dilma announced a plan, nicknamed by some journalists as the Mega PAC, which will invest something around US$ 66 billion in highways and railways, 40 billion in the next 5 years and 26 in the next 25 years. To manage the new and existing investments and transport systems a public enterprise was created: Empresa de Planejamento Logístico (ELP). This plan is considered the biggest in transports ever announced in the Brazilian history, and is expected to built 7,500 km of highways and 10.000 km of railways, and the bullet train between Rio de Janeiro and

[4] A government's program focused on funding the construction of low income housing.
[5] A government's agency dedicated to innovation funding.

São Paulo. The impact on transport costs is expected to be enormous. Brazil has the 4th biggest cars, buses and trucks fleet in the world, and poor infrastructure, causing constant traffic jams. With new roads, products will get faster to their final destination and reduce costs, having potential impacts on the inflation rates, if the cost cuts are transferred to prices to consumers. The case of railroads is even more expressive. By far the best choice to transport goods through long terrestrial distances, this modal is completely neglected in Brazil, the 5th largest country in the world. Since 1990, not a single railway kilometer was built, and many of the existing ones were deactivated.

Furthermore, electric energy prices, which were considered as one of the highest in the world, were significantly reduced. House consumption had a 16.2% reduction, and industrial consumption had a reduction from 19.7% to 28%. The reductions were achieved through tax exemptions and negotiations with energy suppliers, which had their concession contracts extended in exchange of the price reduction. This measure is expected to boost production, as energy represents a major part of the production costs in Brazil. A next round of reductions, similar to what happened with electric energy, is planned to happen this year with gas and the items of the "*cesta básica"* (basic goods considered necessary to every Brazilian, such as rice, black beans, pasta, toothpaste, etc.). Regarding the last, a commission was created , including the representatives from 5 ministries, the states, the Ipea (economics research institute) and the IBGE (geographic and statistics Brazilian institute), to analyze the viability of tax reductions, since the goods already benefit from federal tax exemptions, and further reductions will depend on the states.

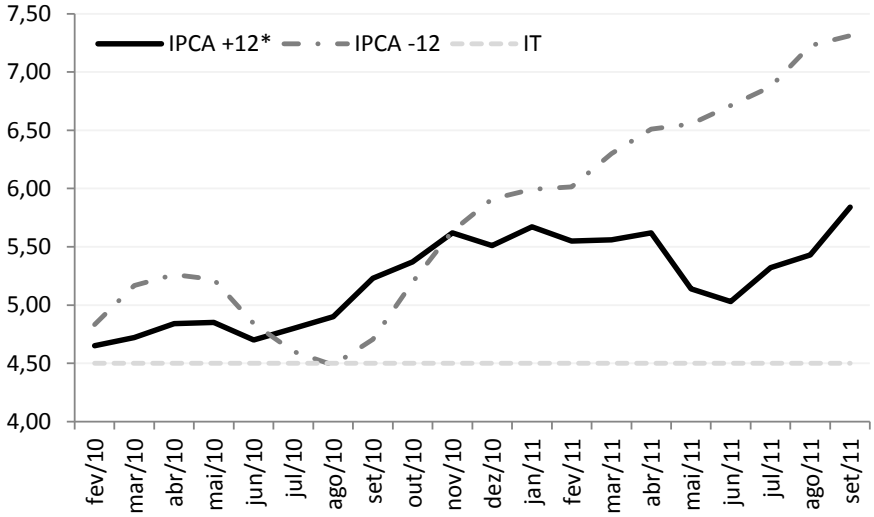
All these measures could be seen as measures that will alleviate pressures on inflation, and consequently on the inflation targeting regime, as transport costs, production costs and basic goods and inputs prices are being reduced. Demand is also expected to rise, however, considering the characteristics of the Brazilian inflation[6], this is not likely to exert pressure on prices. This ensemble of policies did not mean a fundamental modification on the policy framework, however, it shows attempts to solve the Brazilian's dilemmas that are alternative to the pure inflation targeting regime.

b. Monetary policy

The first indications of changes in the conservative conduction of monetary policy in Brazil started to be seen during the last six months of Lula's administration. Henrique Meirelles, then president of the BCB and known to be extremely conservative, got into negations of a candidacy to the Goiás state government, and gave more space to the technical body of the bank. In September 2010, the BCB opted to keep the prime rate unchanged (10.75%) while inflation expectations were in a path of deterioration, above the inflation target of 4.5% (Figure 9). This decision was repeated in October and December, when, then, BCB acted through alternative measures.

[6] For more information about this subject, see Modenesi (2011).

Figure 9: Inflation expectations for the next 12 months



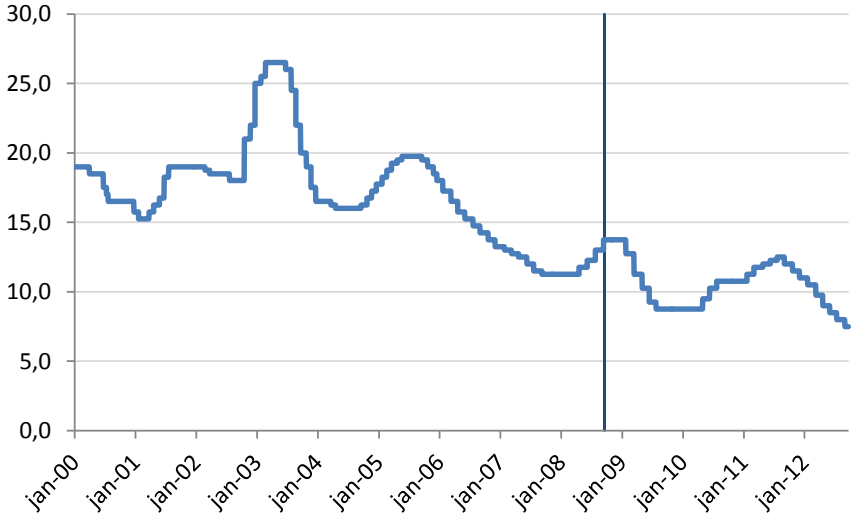
Source: Focus BCB. *IPCA (consumer price index) expectations median.

Two main measures were taken. Firstly, the BCB raised reserve requirements on demand and time deposits, seeking to reduce interbank daily liquidity[7] and control the supply of credit in order to moderate the growth of aggregate demand and its (supposed) corresponding effects on inflation (Circulars 3513/2010 and 3514/2010). It is relevant to notice that reserve requirements were usually managed by the BCB to control the liquidity of the interbank market, but not as an alternative instrument to the interest rate in controlling demand. Secondly, in an unprecedented movement, the BCB started to adopt the so-called macroprudential measures which raised capital requirements – in the context of the Basel Accord – on loans advanced to individuals, especially, those to the acquisition of vehicles (Circular 3515/2010). However the ascendant path of inflation and inflation expectations did not cease. In this context the BCB appealed again to change the prime rate, raising it five times in the first half of 2011.

Novelties on monetary policy came back only in August, with the new president of the BCB, Alexandre Tombini – and they were really hot novelties. The Copom[8] decided to cut the prime rate from 12.5% to 12.0% in a context where both inflation and inflation expectations were raising (Figure 10). This is the first time that BCB took that kind of decision since the adoption of the inflation targeting, acting against the market consensus[9]: were the Taylor rule parameters changed? Was inflation targeting being abandoned? This decision triggered a number of reactions from the market: the yield curve was sharply adjusted and public manifestations from market players on newspapers and media painted blood on the 'new' approach on monetary policy by the BCB (Modenesi et al., 2012).

[7] While exempted financial bonds (*letras financeiras*), bonds with 2-year average maturity, from reserve requirements.
[8] Monetary Policy Comitee, the Brazilian FOMC.
[9] Maerket agents were expecting a 0.5% rise.

Figure 10: Target prime rate (Selic)



Source: BCB, the bar refers to Lehman Brothers collapse.

The BCB's attitude kept unchanged since then, and the Copom cut the Selic rate 8 times more, making it to achieve its lower level since Selic was established as the prime rate, 7.5%, right in the birthday of the cut process (August 30, 2012). In this context Brazil scaled down the world ranking of prime rates from the 9th position to the 19th position, aligning its prime rate with the levels practiced by other developing countries.

In the meantime the National Monetary Council released the Resolution 4019/2011 that adopted a formal framework to macroprudential policy to be implemented by the BCB. This measure was in consonance with the FSB-IMF-BIS recommendations on macroprudential policy tools and frameworks (FSB, 2011; FSB et al., 2011a and 2011b), and sets the situations that may pose systemic risks to the financial system. Besides that, the Resolution defines the indicators that could be monitored by the BCB, the macroprudential toolkit and the institutional arrangements establishing coordination with other economic policies (ANBIMA, 2011a)[10]. Since the release of this Resolution, the reserve requirements were modified 4 times – some seeking to foster the credit supply.

Other relevant event was the change of the savings account rule (*caderneta de poupança*), which is one of the most popular financial instruments in Brazil. Changes were carried out in the beginning of May, by the provisional measure no. 567. The prior rule established a fixed remuneration of 6.17% per year plus other rate, called the interest rate of reference (*taxa referencial de juros* – TR)[11], imposing a virtual floor to the prime rate. While in the older rule, if the prime rate reached a level below 6.5-7.0% p.y., several distortions in the public bonds market and in the

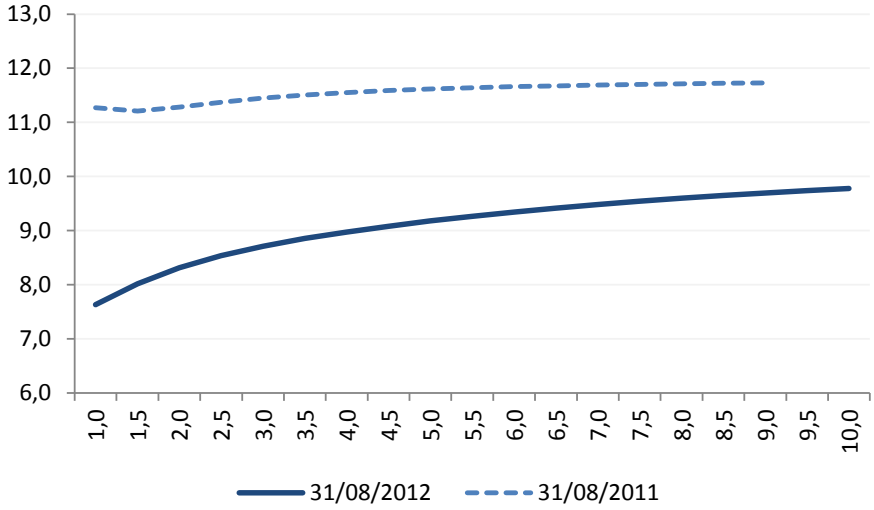
[10] BCB's staff is conducting many works in this area (Agénor et al., 2011; Agénor and Silva, 2011; Sales et al., 2012; Silva et al., 2012; Silva and Harris, 2012).

[11] TR's average was around 2% p.y. in the 2000-11 period, and 0.8% p.y. in the 2009-2011 period.

financial system as a whole would be generated – rationally, everyone would migrate to *poupança*. So, the Ministry of Finance changed the rule to avoid this problem. In the new rule the *poupança* yields a variable remuneration that changes with the prime rate (70% of the prime rate) when the prime rate gets below of 8.5% p.y.. This measure, considered a politically difficult decision (IMF, 2012a: 1), removed the Selic's virtual floor, allowing it to reach its lower levels in history.

As a consequence of this process the Brazilian yield curve changed substantially, assuming a textbook shape (Figure 11). In other words, the curve became ascendant, which means that bonds with longer maturity yields more (though not linearly), in line with what is stated by the liquidity preference theory, and longer than before – now there are vertices on 9.5 and 10 years for the pre-fixed bonds. Moreover, it is relevant to notice that the cuts on prime rate were effectively incorporated in the yield curve as the rates in each maturity decreased substantially.

Figure 11: Brazilian yield curve (rate x term)



Source: Anbima. Yield curve based on public bonds with pre-fixed interest rates.

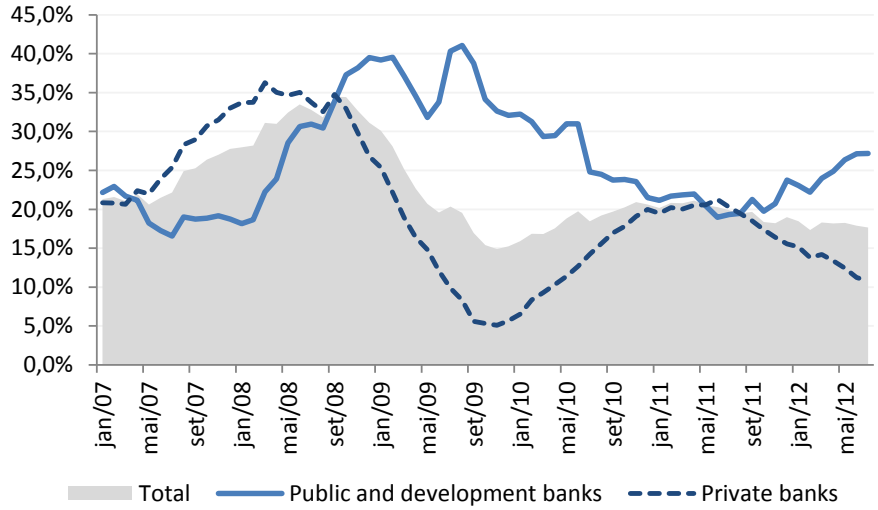
Thereby, one can state that the BCB's approach on monetary policy changed substantially after the crisis, especially after August 2011. A macroprudential framework was added to the inflation targeting, making a wider range of instruments 'available' to the BCB to pursue its goals. As Silva and Harris (2012: 49) stress: 'A combination of policies is effective involving monetary and macroprudential policies to act in a complementary fashion to ensure both macroeconomic and financial stability.' We should keep in mind that inflation targeting was not abandoned but it is undeniable that relevant changes occurred.

c. Financial policy

The 2008's financial crisis impacted heavily Brazilian financial and capital markets performance – but not the soundness of the financial system. Private banks slowed sharply the

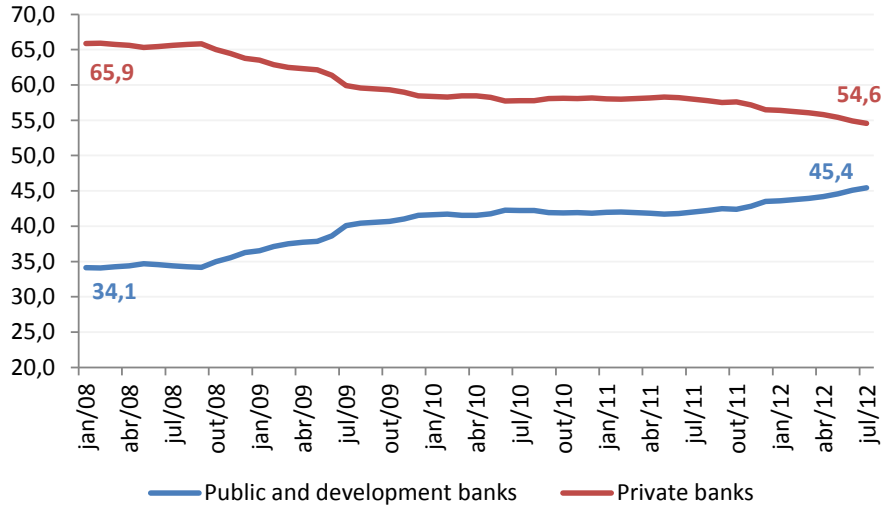
rhythm of loan concessions, as shown by the dashed line in Figure 13. At this moment, public and development banks (bold line) entered aggressively in the credit market, in an attempt to reestablish these flows of resources to corporations and individuals. At a certain moment, in the second half of 2009, while private credit was growing around 5% in 12 months, public credit was growing at a 30-35% rate. As a result, the share of these institutions in the credit market rose from 34.1% to 45.5% (Figure 14).

Figure 13: Overall loans growth rate by ownership of the bank (12 months %)



Source: BCB.

Figure 14: Loans by bank ownership (%)



Source: BCB.

It is noteworthy that during the 2000's the major public banks – Banco do Brasil (BB) and Caixa Econômica Federal (CEF) – performed a quite different role, operating like private institutions in several fronts (Hermann, 2010). Development banks, especially BNDES, in their turn, were occupied with long-term financing and not with the 'traditional' credit market. So, this

countercyclical role, though not new in Brazilian history, represents a change in the way that these banks usually operate.

A second round of countercyclical action started in the end of 2011 and gained momentum in the first quarter of 2012 (Figure 13). This new round of public credit expansion represents an attempt in restoring consumption growth and economic activity levels, amid the slowdown of economic growth.

The countercyclical role represented a more active role of public banks in other areas of the credit market and in the competition within the banking sector: BB and CEF started a 'crusade' for lower spreads since April, 2012. These institutions cut their interest rates on several credit lines, pressing private banks to do the same. After some resistance of the biggest private banks (see Annex I), spreads started to decrease as well as interest rates to clients. As shown in Table 2, BB and CEF cut around 4.0 percentage points in the spread of their main credit lines whilst Itaú Unibanco cut 8.0 p.p. and Bradesco 2.5 p.p. on loans to individuals[12]. As president Dilma said in a recent interview for Financial Times, "Brazil was the last free lunch in the world for the banks".

Table 2: Average spreads on loans to individuals and working capital

	30/Mar-05/Apr		11-17/Sep		Δ*	
	Individuals	**Working capital**	**Individuals**	**Working capital**	**Individuals**	**Working capital**
BB	26,7	12,5	22,3	9,5	-4,4	-3,0
CEF	21,3	11,3	17,1	6,4	-4,2	-5,0
Itaú Unibanco	51,4	15,7	43,4	14,6	-8,0	-1,1
Bradesco	58,0	21,1	55,5	22,5	-2,5	1,3
Santander	39,4	11,9	41,1	32,1	1,7	20,2
HSBC	54,0	24,2	57,2	25,2	3,2	1,0

Source: Authors' elaboration from BCB data. Spreads were calculated by the difference between loans rates and the prime rate. *As a matter of comparison, the prime rate was cut in 2.25 p.p. during the same period.

Financial policies however were not restrained to credit market. There is a clear attempt to create and develop a long-term capital market, especially, a long-term corporate bond market. The government published the Law 12431/2011 which: (i) sets tax incentives to foreign investors that invest in long-term bonds, and to domestic and foreign investors that invest in *infrastructure debentures*[13]; (ii) creates a special category of investment funds: *research, development and innovation investment funds*; (iii) improvements on *infrastructure investment funds*; (iv) eases conditions for issuers of debentures and financial bonds (ANBIMA, 2011b and 2011c; Freitas, 2011).

[12] These cuts were not widespread yet as other private banks cut rates on lines that are less important to the bank portfolio.

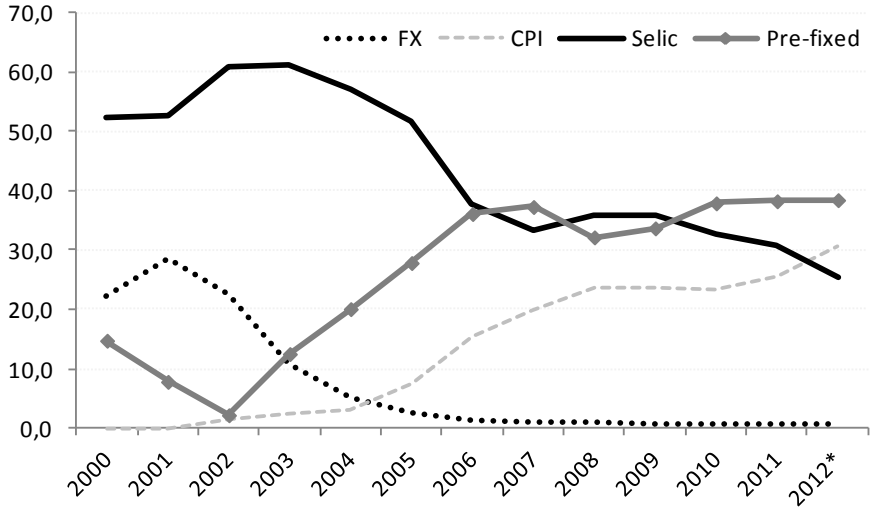
[13] Debentures issued with the special purpose of implementing an infrastructure project, regulated by Decree 7603/2011.

This measure was complemented by a joint initiative from BNDES and ANBIMA called New Market for Fixed Income (NMFI), which resembles the BM&FBovespa New Market, and establishes differentiated corporate governance levels in the bond market. The adherence to NMFI is not mandatory but adds a kind of quality stamp to bonds issued under its rules. These rules include special conditions for terms, repurchase (allowed only 12 months after the issue), remuneration (banning indexation to Selic) etc. Besides that the proposal "includes a set of measures aiming to support secondary market liquidity that include standardization of issues and the plan for a liquidity improvement fund as well as liquidity guarantee fund." (IMF, 2012b: 50).

These two measures have been showing moderate progress: first issues under NMFI took place in the first half of 2012 (Cemig and BNDESPar) and there are other issues under analysis in ANBIMA, and several projects that qualify corporate bonds to Law 12431' provisions are being approved in Ministries. In the next year, 2013, a more adequate assessment of results will be possible.

Lastly and still regarding a long-term capital market, the structure of public debt remuneration has been changing in favor of pre-fixed rates, which now is the main component and answers for 40% of the total (Figure 15). Indexation to Selic, which actually reduces the bond's duration to zero with no risk and jeopardizes private issuances, was reduced in 30 percentage points. In sum with the measures of monetary policy, this measure helps in establishing a benchmark for private long-term issues and eliminates the high-yield-no-risk condition of public bonds and the consequent unfair competition among these bonds and the private ones.

Figure 15: Public debt - Share of indexers (%)



Source: BCB.

All the measures described in this section points to a deliberate attempt of the Brazilian government in improving the functionality of the Brazilian financial system to economic

development. Lower bank spreads and tariffs facilitate the access to credit and contribute to the soundness of the system from the financial fragility standpoint. A long-term capital market helps corporations in funding their investments, improving the conditions for economic growth. However one relevant caveat applies to the strategy designed to the capital market: there is a great reliance on foreign investors in developing this market, which has proved to be problematic in other occasions – e.g., in the Brazilian stock market – due to the volatility and pro-cyclicality of foreign capital flows (Hermann and Montani Martins, 2012).

d) Foreign Exchange Policy and Capital Controls

After many years being considered something archaic and unproductive, capital control measures were once again implemented in Brazil in 2008. The context of massive entrance of short term foreign capital was appreciating the Real in a dangerous speed, and the fright of capital flights was surrounding the government's officials. In the 2008-10 period, through many different decrees, the IOF (tax on financial transactions) was put in place, for instance, raising to 2% (and after 6%) the taxes to nonresident portfolio equity and debt inflows.

The crisis came and appreciation stopped, but in 2010, with the rebound of economic growth (7.5% GDP growth) and, mainly, after monetary expansion in developed countries (e.g., quantitative easing and operation twist in U.S.), capital inflows accelerated once again, amounting to US$141 billion (6.8% of 2010 GDP). New changes in IOF were put in place but they were not sufficient to stop the appreciation path. As IMF (2011: 35) diagnosed:

> "Empirical evidence suggests that the IOF measures did not have a clear, long-lasting effect on the exchange rate—at least relative to its level at the time the various IOF measures were introduced. This may have been due to the fact that the introduction of the IOF did not trigger a significant reduction in nonresidents' positioning in the futures market." (IMF, 2011: 35).

In this context, the Brazilian Finance Ministry started to release several measures, intensifying capital controls and spreading them into several markets. The most important change, released in 26-07-2011, was the 1% IOF on exposures in FX future derivatives betting against Real (in line with IMF's diagnosis). This measure was improved and fine-tuned with three changes in end-February and March, 2012, when the Real rose to its current level, around R$ 2.00/US$. The Figure 15 illustrates the path of Brazilian exchange rate with bars indicating the days when changes in IOF were introduced and Figure 16 shows the liquid position on exchange contracts signed for financial purposes (blue bars refer to the period after the futures derivatives measure).

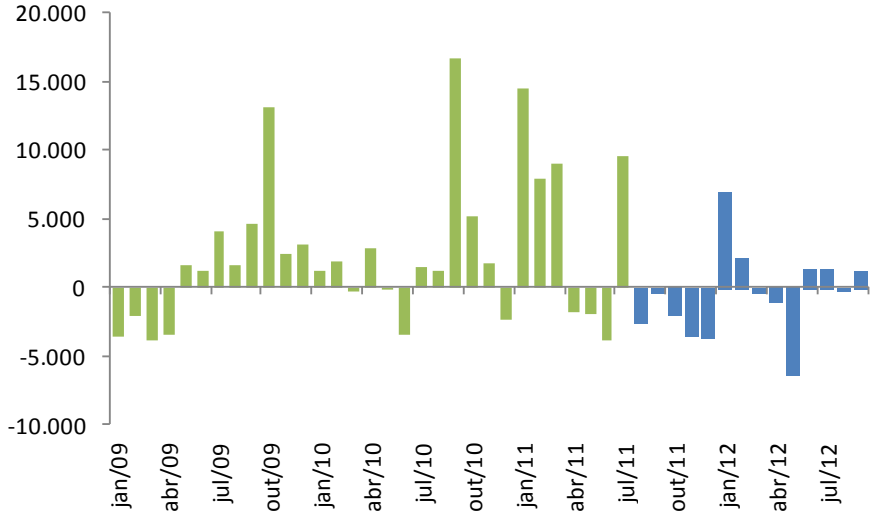
As we mentioned before, there are divergent diagnoses regarding Brazilian industry fall in the recent years. One group argues that a deindustrialization process is in force, a Brazilian version of the 'Dutch disease' (Bresser-Pereira, 2010), while other stress the premature specialization of

Brazilian industry, due to the poor macroeconomic performance and an overvalued exchange rate (Carvalho and Kupfer, 2011). However both agree that an R$ 2.00/US$ exchange rate – rather than an R$ 1.60/US$ - contributes to improve the competitiveness of Brazilian enterprises internationally.

Figure 15: Daily exchange rate (R$/US$)

Source: BCB. Bars indicate changes on financial transactions tax.

Figure 16: Liquid position on financial exchange contracts (US$



Source: BCB.

In this context capital controls were brought again to the center of the agenda. The actual Brazilian finance minister, Guido Mantega, publicly stated that Brazil is prone to use capital controls and intensify the existing controls if necessary. This statement came after the Federal Reserve announced the third round of quantitative easing, showing that new measures could arise to compensate the effects of monetary expansionist policies in a context of what he called the currency war.

4. Final remarks

An economic policy framework based on a convention around stability was formally adopted in 1999 – the so-called tripod. The tripod goals were to keep inflation low, close to the target, and fiscal policy under control, creating a stable environment that, in its turn, will have positive effects on economic growth. However these goals were far from being obtained. To achieve this price stability, high interest rates and overvalued exchange rates were used, but inflation remained high – it was above the target in most of the 2000's – and economic growth was jeopardized. The Real appreciation and the poor economic performance impacted the Brazilian industry performance. In other words, the Brazilian economy was locked in a low growth, high interest rates, high inflation and overvalued exchange rates situation.

Since the second Lula administration (2007-10), some initial attempts to get out of this trap were implemented – a process that gained momentum with the 2008's financial crisis downward effects. The fiscal policy started to have a more active role: it was used in a countercyclical way during the crisis; there was a recovery on public investment and in economic planning; and, it was used to reduce production costs to benefit industry competitiveness and alleviate pressures on inflation. The conservatism on monetary policy was left behind: a macroprudential framework was integrated with inflation targeting, making available to the BCB a wider range of instruments to pursue its goals – price and financial stability. Financial policies focused on: the development of a long-term capital market, mainly through the development of the corporate bond market; a stringent regulatory framework; and, an increase on banking competition, where cuts on spreads were the main consequences. Finally, capital controls are used to control the volatility of financial flows and to eliminate the overvaluation of the exchange rate, contributing to increases on industry competitiveness.

During Dilma's administration things got even more interesting. Monetary policy went in a different direction from the one expected by the market, huge tax exemptions were given to industrial activity, a massive public transport plan was launched, interests rates to consumers were significantly reduced, as well as bank's spreads. These measures do not make part of the usual economic policy toolkit, and surely do not accrue from the mainstream economic theory.

Some flavors of *post-Keynesian* policy prescription can be identified in several parts of this recent experience. Capital controls are being implemented and progressively intensified in the last 2 years, effectively helping in managing the exchange rate, in order to assure Brazilian industry competitiveness. Monetary policy was eased and, though not based on a proper *Keynesian* framework, is conducted in a more discretionary fashion. As president Dilma said recently: "We are returning to a place with normal levels of profitability. That means some of us will need to start looking for adequate profits in productive activities that are good for the country." Public and

developments banks are being used actively, increasing competition in the banking system and improving the functionality of the financial system to economic development. The treatment of inflation now tacitly recognizes the inefficacy of interest rates as the sole instrument to achieve price stability, using multiple instruments to 'fight back' inflation. Actually some structural characteristics of the Brazilian economy that pressure prices, such as the high energy costs, the expansive credit and the deficient infrastructure, are being attacked one by one, each one by a different method. It is relevant to note that this strategy is coherent not only with the *post-Keynesian* approach but also with a *structuralist* diagnosis and medicine for inflation: "the sources of inflation in underdeveloped countries are found on the basic problems of economic development, on the structural characteristics presented by the productive system of these countries" (Sunkel, 1958).

There is, however, a pillar of what we could call the Dilma's strategy that does not fit neither the *post-Keynesian* nor the *structuralist* analytical paradigm: the public expenditures and investments reduction, as a proportion of the GDP, in a context of low growth (for data see Serrano e Summa, 2012). Several economists suggest that this fiscal contraction is the necessary counterparty of the expansionary monetary policy but not even president Dilma herself seems to agree with this measure as she recently stated in the UN Conference: 'fiscal consolidation can only be sustainable in a context of economic recovery'. Thus, managing fiscal policy to directly bust aggregate demand is a lacking piece of the 'new' framework. To effectively enters in a sustainable route of economic growth, Brazil needs more public expenditure – and mainly public investment.

5. Further research

We acknowledge that several aspects of Brazilian economic policies were not treated in this paper but as we made you aware of before our research is ongoing. We are currently focusing on these missing aspects and we appoint the following ones as our main concerns:

- The role of financial policy as a kind of 'fourth pillar of the tripod': we are currently analyzing the strategy designed for achieve financial development in the early 2000's, which includes: the consolidation of financial liberalization and foreign capital mobility; the focus on attracting foreign investors as a strategy for corporate bonds and stock markets; and the development of a stringent regulatory framework, in order to encourage these flows to our markets;
- Till now, our analysis of fiscal policy focused on fiscal plans and less-conventional measures. A more detailed analysis of the 'day-to-day' fiscal policy, i.e., regarding primary surplus, public sector borrowing needs, and public debt, is necessary and we are currently working on it;

- The analysis of foreign exchange policy and capital controls is focused on Ministry of Finance's measures. The role of BCB on FX market (BCB operations in the spot and futures markets and evolution of international reserves) will be developed in further versions of this paper;
- Industrial policy was slightly treated in this paper and deserves more attention in a final version of this piece.

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Annex I: The ‘struggle’ for lower spreads

Date	News
02/abr	Spread in the backstage
04/abr	Ministry of Finance and banks will study spreads
04/abr	In consonance with the government, BB cuts interest rates
05/abr	BB starts offensive to lower bank spreads
05/abr	**BB cuts interest rates in offensive pressing banks**
05/abr	Caixa will anounce cuts on interest rates in next Monday
09/abr	Spread depends on better guarantees, says Lisboa from Itaú
09/abr	**Caixa anounces cuts on interest rates and promise to keep its profitability unchanged**
09/abr	After BB and Caixa, Dilma waits for cuts on private banks interest rates
10/abr	Caixa cuts interest rates in the smaller credit lines of its portfolio
10/abr	Febraban suggests measures to lower interest rates
10/abr	Debate between Febraban and the government on spreads will be held in this afternoon
11/abr	**Spreads depend on a compensation from the government**
12/abr	**Banrisul cuts interest rates, following Caixa and BB**
12/abr	**HSBC is the first private bank that cut interest rates**
13/abr	To cut interest rates and spreads is a government policy
13/abr	After public banks, HSBC lower minimum interest rate
13/abr	There is a room to banks cut interest rates' (Mantega)
16/abr	**Cuts on interest rates will come only with pressures of consumers**
17/abr	**Private banks adhere to reductions on interest rates**

17/abr	**Santander cuts interest rates for small enterprises**
18/abr	Private banks signal new cuts on interest rates
18/abr	**After HSBC and Santander, Bradesco and Itaú cut interest rates**
18/abr	**Itaú cuts interest rates for individuals and small enterprises**
18/abr	**Government wins**
19/abr	Banks urge for compensations due to lower interest rates
19/abr	After cut on Selic, BB cuts interest rates again
20/abr	After BB, Caixa promotes new cuts on interest rates
24/abr	Caixa anounces cuts in interest rates on real state loans
25/abr	Caixa cuts interest rates for realty up to $ 500,000 from 10% to 9%
30/abr	Dilma says that Caixa and BB has proved that is possible to lower interest rates
04/mai	BB promotes new cuts on interest rates and launches guaranteed credit lines
07/mai	BMG cuts interest rates for payroll-guaranteed loans
10/mai	Caixa anounces new cuts on interest rates for individuals and enterprises
14/mai	Bradesco anounces new cuts on interest rates
14/mai	Santander cuts loans rates and investment fund rates
15/mai	Bradesco and Santander cut loans rates
22/mai	BB cuts interest rates for vehicles financing
23/mai	Caixa cuts interest rates for vehicles financing
31/mai	Bradesco follows Copom and cuts interest rates from the next week
31/mai	After Copom's decision, Caixa cuts interest rates for individuals and enterprises
01/jun	BB cuts interest rates after Copom
05/jun	Caixa extends real state loans terms and cuts its interest rates
06/jun	Caixa anounces cuts in interest rates and extend loans terms
06/jun	Lower interest rates on rural, real state, and working capital loans
06/jun	Safra loans have lower interest rates
21/jun	Interest rates has dropped
22/jun	Interest rates drop amid 'crusade' against spread
27/jun	Rates of financing started to cease
13/jul	Santander cuts interest rates
16/jul	Itaú cuts interest rates for enterprises and individuals after the cut on Selic
01/ago	BB cuts interest rates on overdraft accounts
31/ago	With the new level of Selic, BB cuts interest rates, after Bradesco and Itaú
11/set	BB cuts interest rates and intensifies competition with Caixa
24/set	Bradesco anounces cuts in interest rates of credit card loans
28/set	Caixa anounces cuts in interest rates on loans for purchase of vehicles
28/set	In a new 'crusade', government decides to cut fees charged by BB