

Brazil's Perfect Storm



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Arminio
Fraga

Macro, Markets, Money with Markus

Introductory
remarks by

Markus
Brunnermeier
Princeton

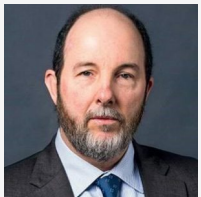
PAST AND FUTURE SPEAKERS

- Last



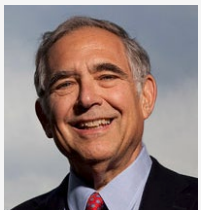
Bob Shiller
"Narrative Economics
and COVID"

- Today



Armino Fraga
"Brazil's Perfect Storm"

- Next webinar



Richard Zeckhauser
"Climate Policy: Beyond
Ostriches and Pollyannas"

- Related:



Gita Gopinath



Raghu Rajan



Hyun Shin

INTEGRATED POLICY FRAMEWORK: SAFE ASSET PERSPECTIVE

- See Brunnermeier-Merkel-Sannikov (2020)

<https://scholar.princeton.edu/markus/publications/safe-asset-perspective-integrated-policy-framework>

- EME: risk-on vs. risk-off regime Flight-to-safety
- Largely driven by US monetary policy

RISK-OFF

- Firms/banks: **Can't rollover -Rush to repay**
issue low interest US\$-debt (safe asset)
don't internalize that FX more volatile
 - Official sector: holds US\$-reserves
anti-Keynesian monetary policy
 - Citizens: hold R\$ **Rush to hold US\$ (as safe asset)**
(domestic safe asset) **Exchange rate collapses**
- 

2 MAIN EFFECTS OF CURRENCY DEPRECIATION

Export/import



Inflation

Mario Simonsen: *"Inflation hurts but the foreign exchange rate kills."*

\$-debt burden



balance sheet impairments

■ *Brazil then:*

anti-Keynesian MoPo → GDP volatility
defend currency in crisis

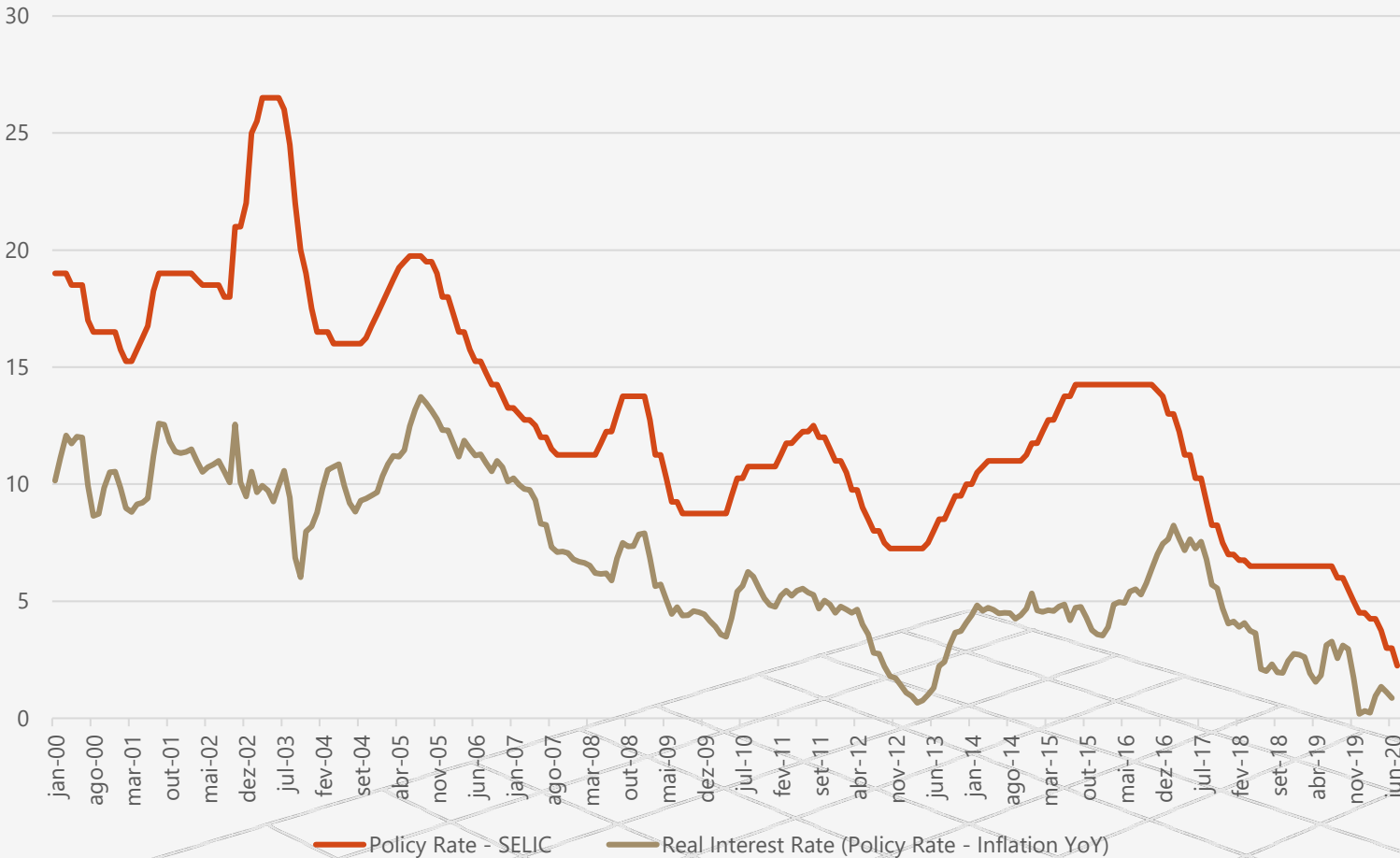
■ *Brazil now:* low inflation (so far) firms repaid US\$-debt

banks long US\$

official sector US\$-reserves

citizens hold R\$ gov. bonds

NOMINAL AND REAL INTEREST RATE IN DECLINE



FLIGHT TO SAFETY IN US-\$

■ Fiscal debt structure

- Inflation indexed ($\approx 35\%$) Less inflation temptation or not?
- Floating interest rate ($\approx 50\%$)
- Short maturity ($\approx 2-3$ years)

■ Flight to safety by citizens

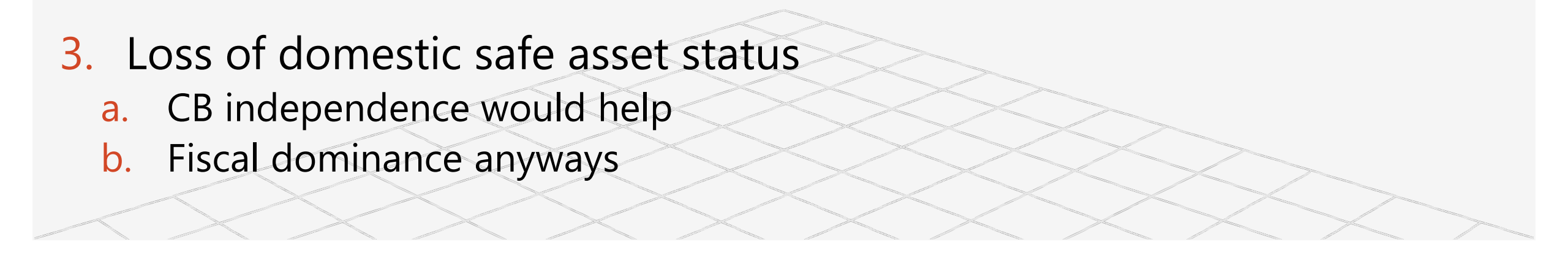
- Loss of domestic safe asset status
- Run into money/reserves US\$ (depends on \$-interest rate and FX-rate)
- Defend currency domestically (off-equilibrium credibility)
 - Monetary dominance \rightarrow hike interest rate \rightarrow fiscal consolidation
 - Fiscal dominance \rightarrow have fiscal plan in place

■ Capital controls (outflows) – financial repression

POLL QUESTION

1. Brazil is economically in a better situation in this crisis
 - a. Reserves holdings
 - b. Less \$-debt
 - c. Same problem, due to "original sin redux" (BIS)

 2. Low real interest rate is
 - a. Good and a big benefit to manage economic crisis
 - b. Bad, e.g. secular stagnation

 3. Loss of domestic safe asset status
 - a. CB independence would help
 - b. Fiscal dominance anyways
- 

Brazil's perfect storm

(why Brazil is falling behind)

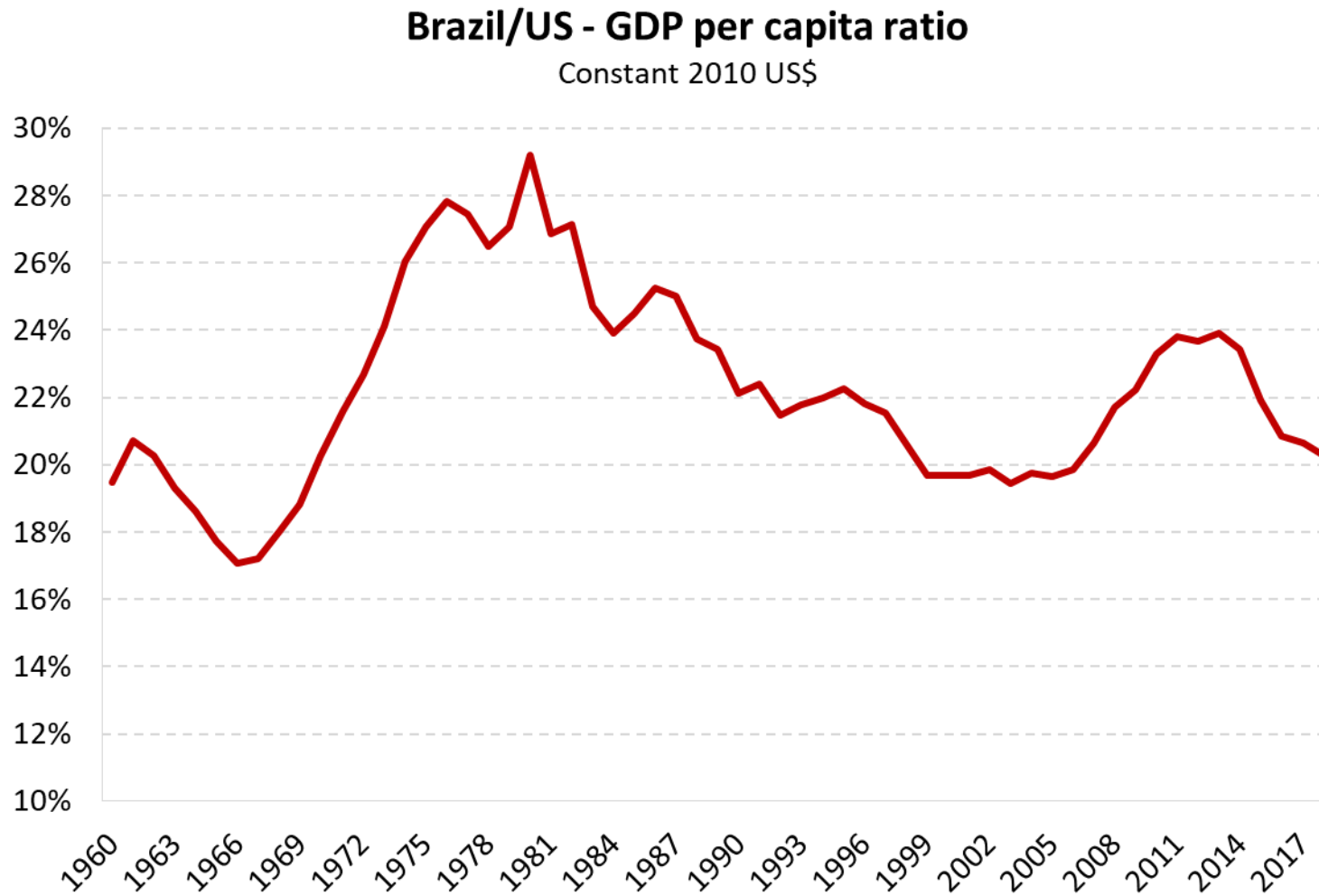
Arminio Fraga



July 13th, 2020

CONFIDENTIAL

1. DIVERGENCE since 1980



2. WHY? WRONG MODEL

- Closed economy
- No focus on education
- No focus on structural inequality
- Excessive presence of the State in the economy
- Macroeconomic instability

=> Blew up in the 80s

3. Progress since the 90s

- Macro stability
- More open economy
- Focus on education (most kids in School)
- Focus on Health (SUS, important successes)
- Privatization + regulation

=> Reduction in poverty (“inflation tax” Plano Real)

=> Reduction in extreme poverty (Bolsa Família)

=> Some reduction in inequality

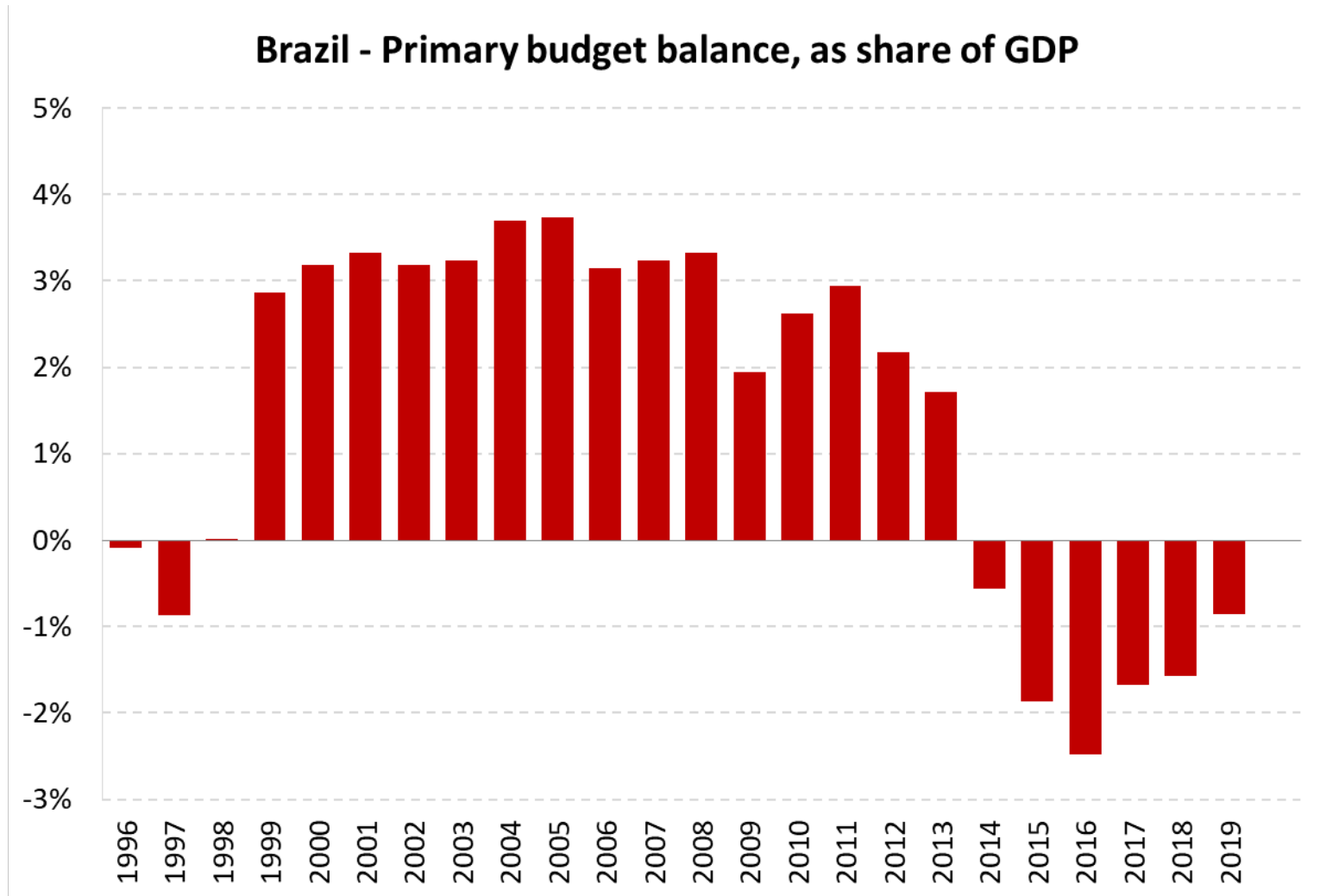
=> Some growth, looking good

4. But it was not to last

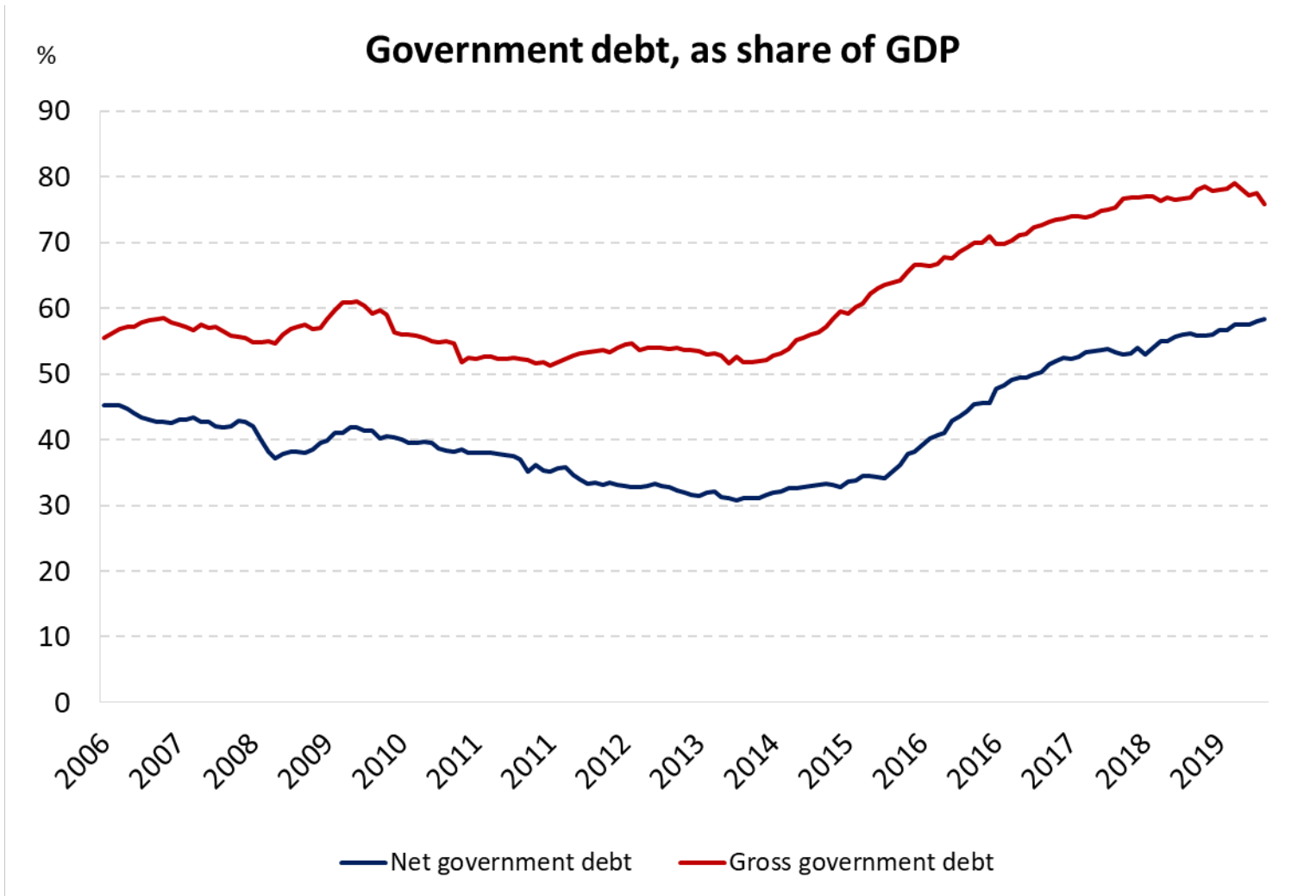
- Dilma Rousseff: “spending is life”
- Massive credit subsidies and tax breaks
- Growing indebtedness of states and municipalities
- Return to a failed model...

=> **Massive fiscal collapse** starting in 2014

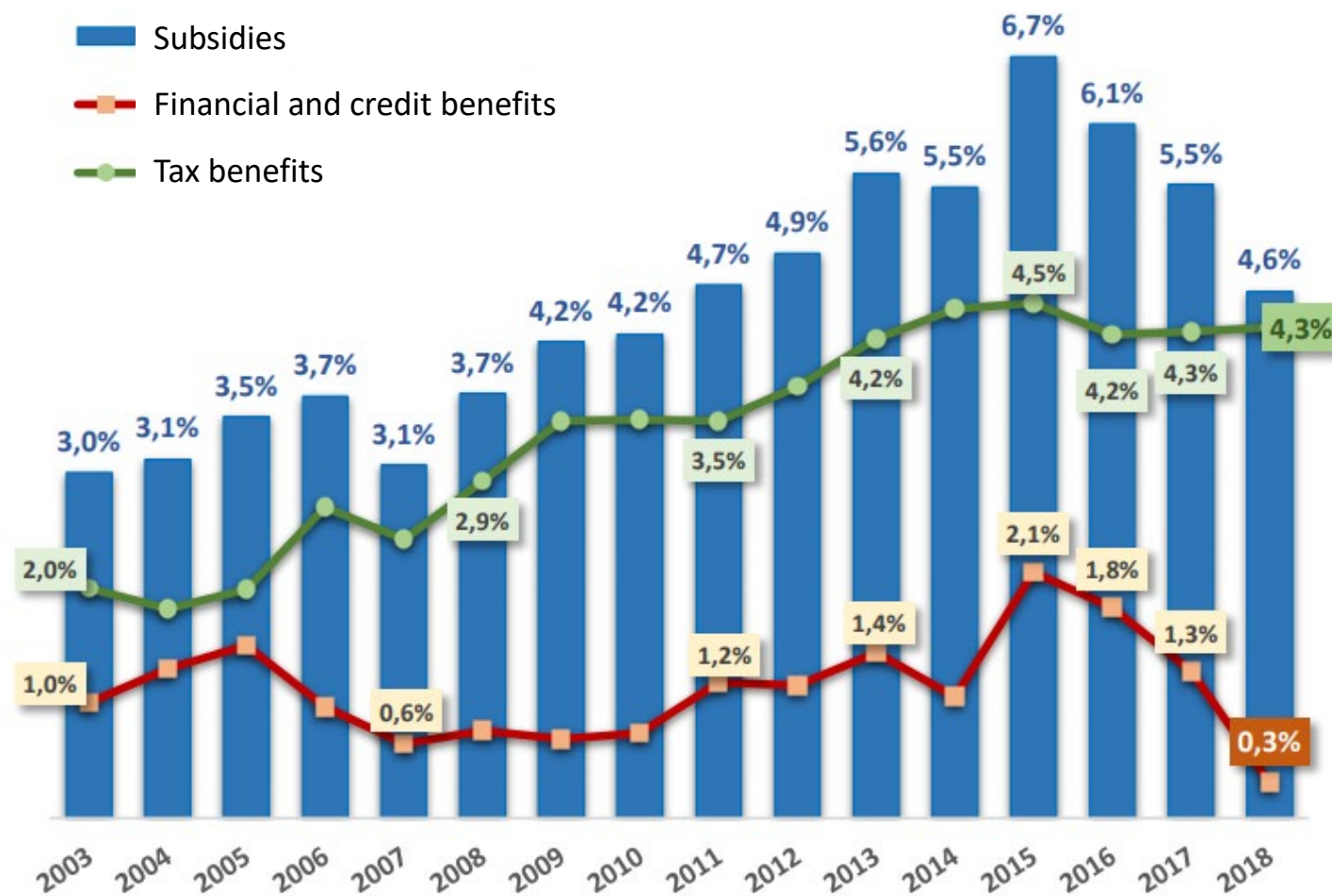
Government spending & Tax breaks



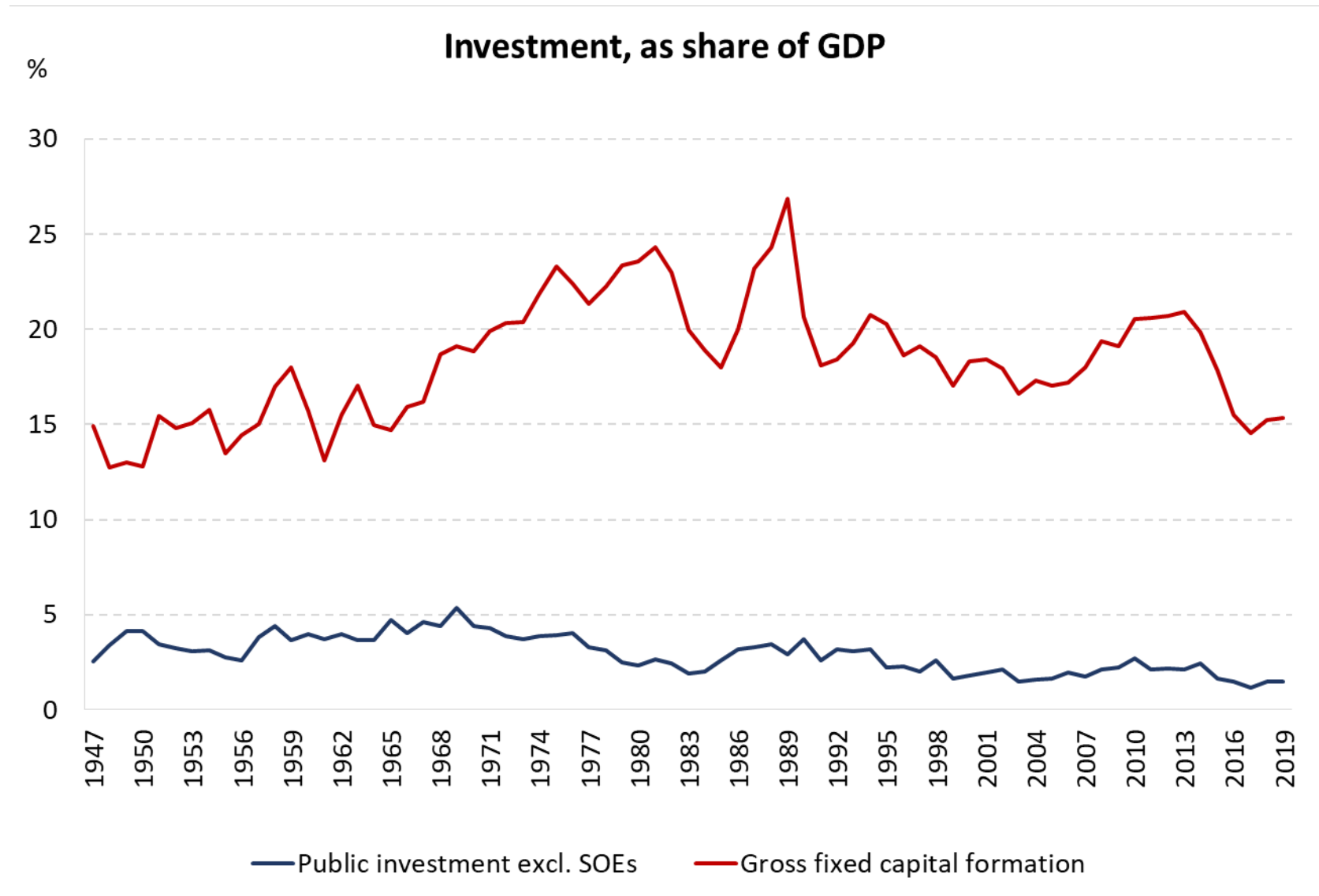
Government debt



Brazil - Evolution of federal subsidies, as share of GDP



Investment



GDP growth: Brazil vs. LatAm

GDP Growth - Brazil and Latin America

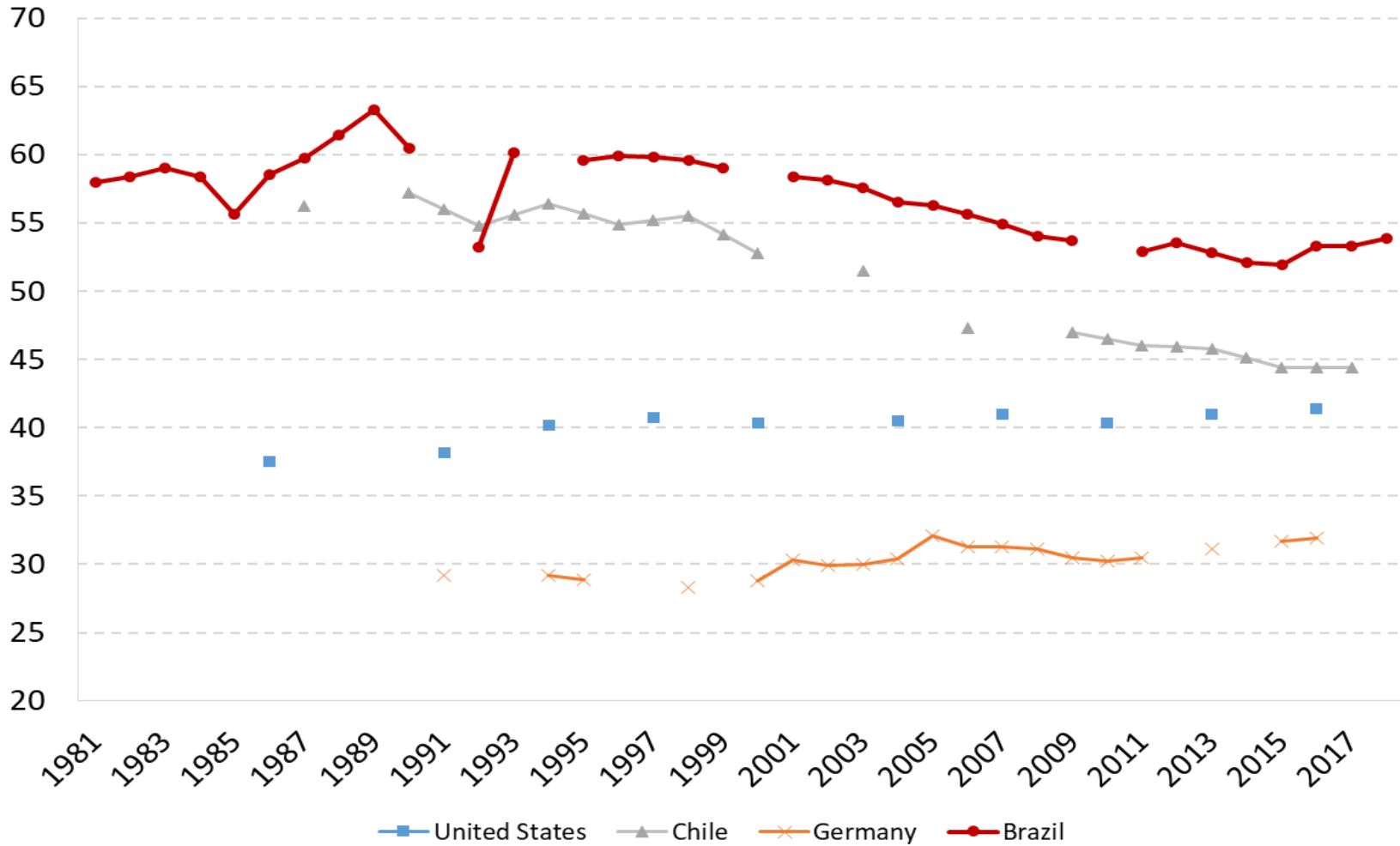
	<i>Average Growth</i>		
	Brazil	LATAM Ex-Brazil	Differential
1995-2002	2.2%	2.1%	0.04%
2003-2010	4.1%	3.7%	0.43%
2011-2016	0.4%	2.6%	-2.24%
2017-2019	1.6%	1.7%	-0.11%

6. Brazil just before Covid-19

- Low productivity
- High inequality
- Vulnerable macroeconomy

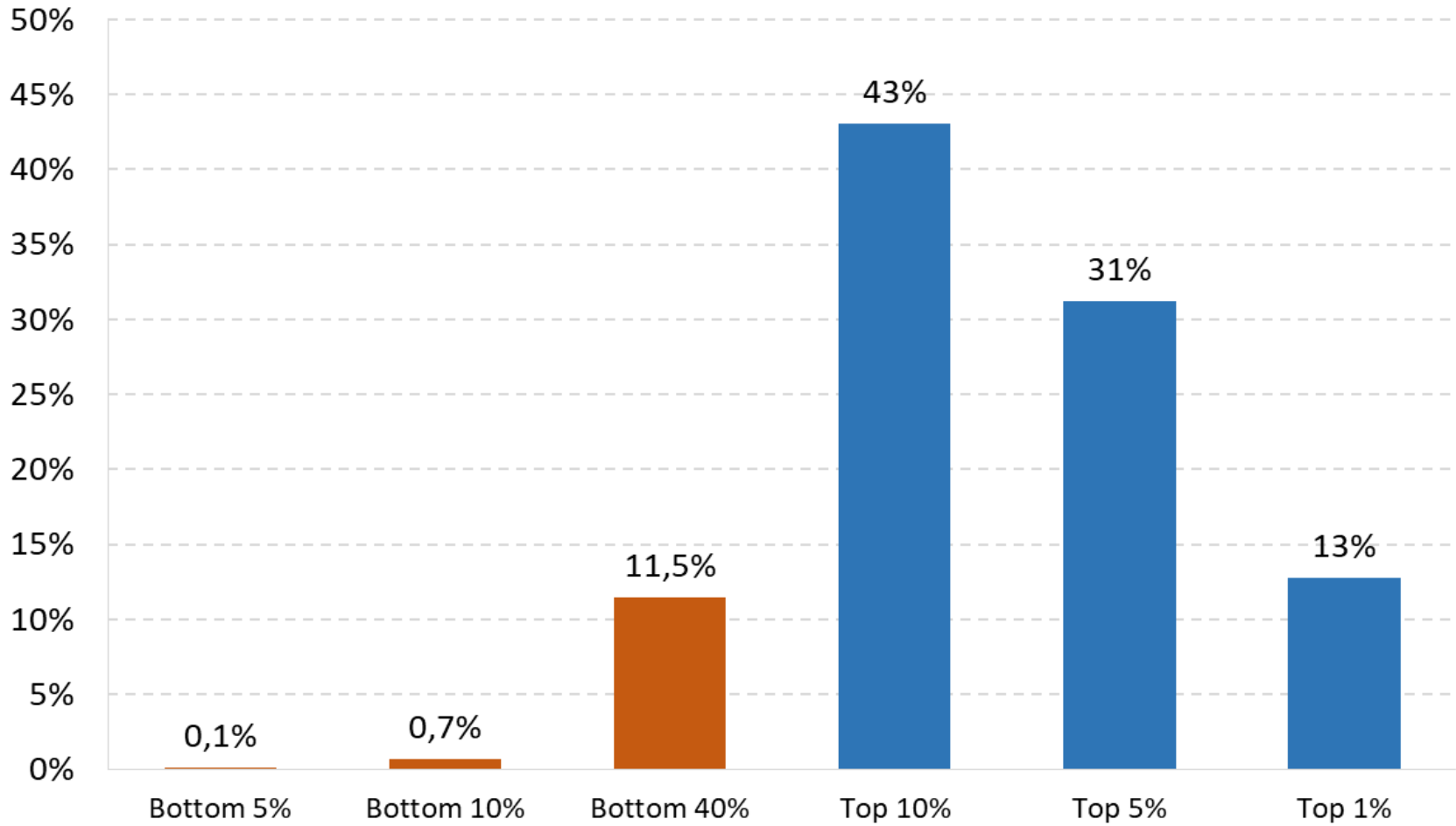
Inequality

Gini Index

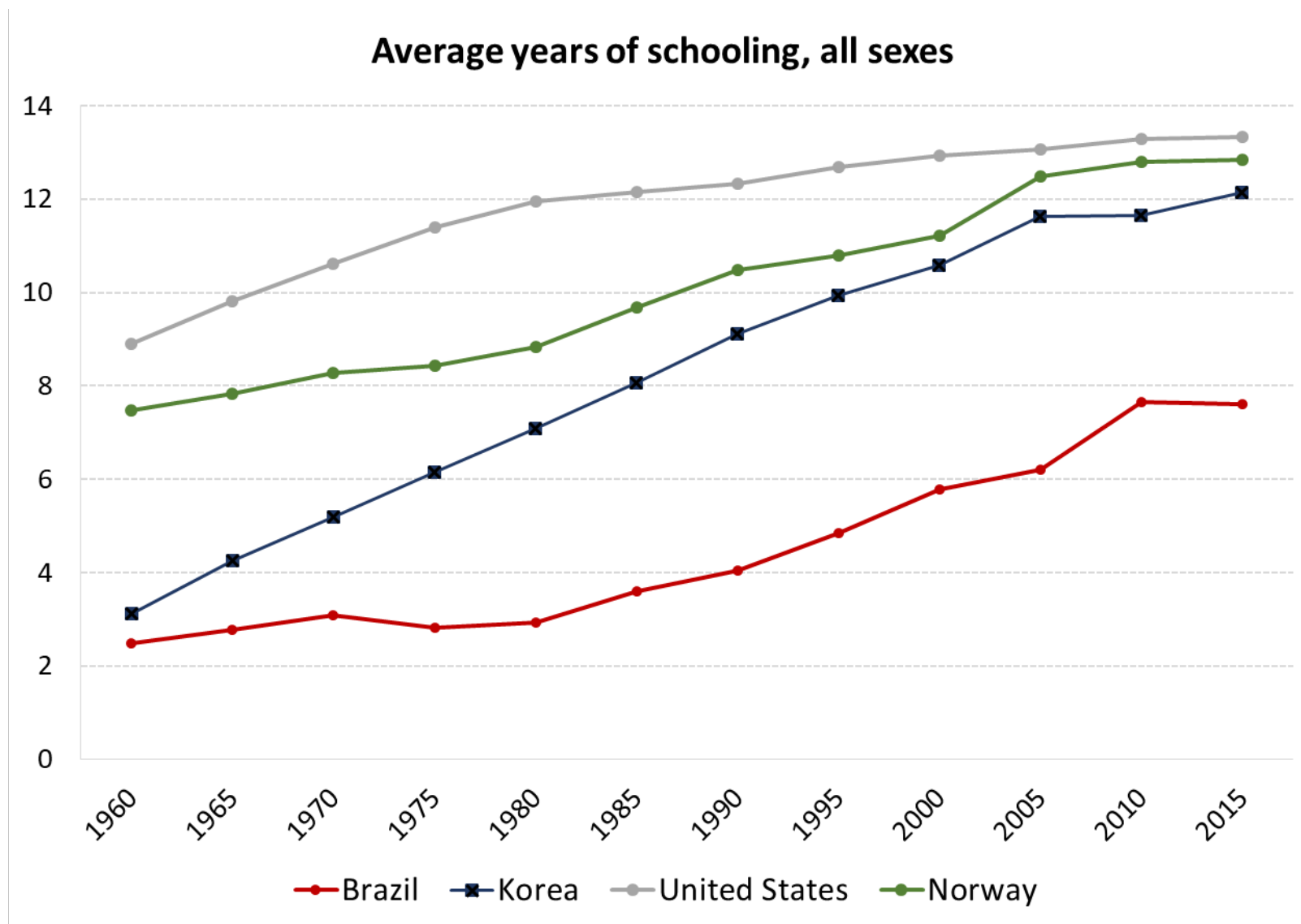


Inequality: income distribution

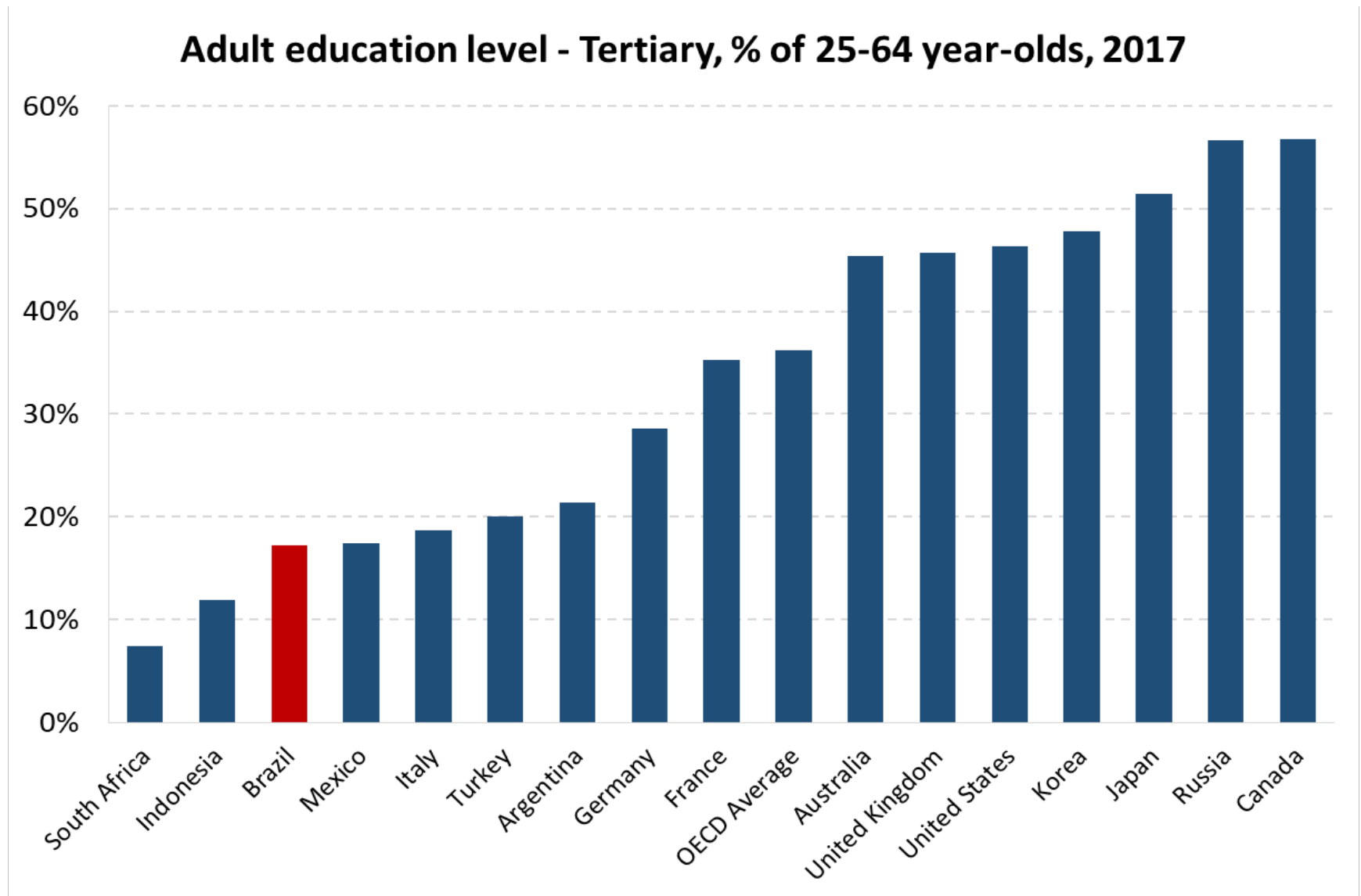
Brazil - Share of average monthly earnings, by income



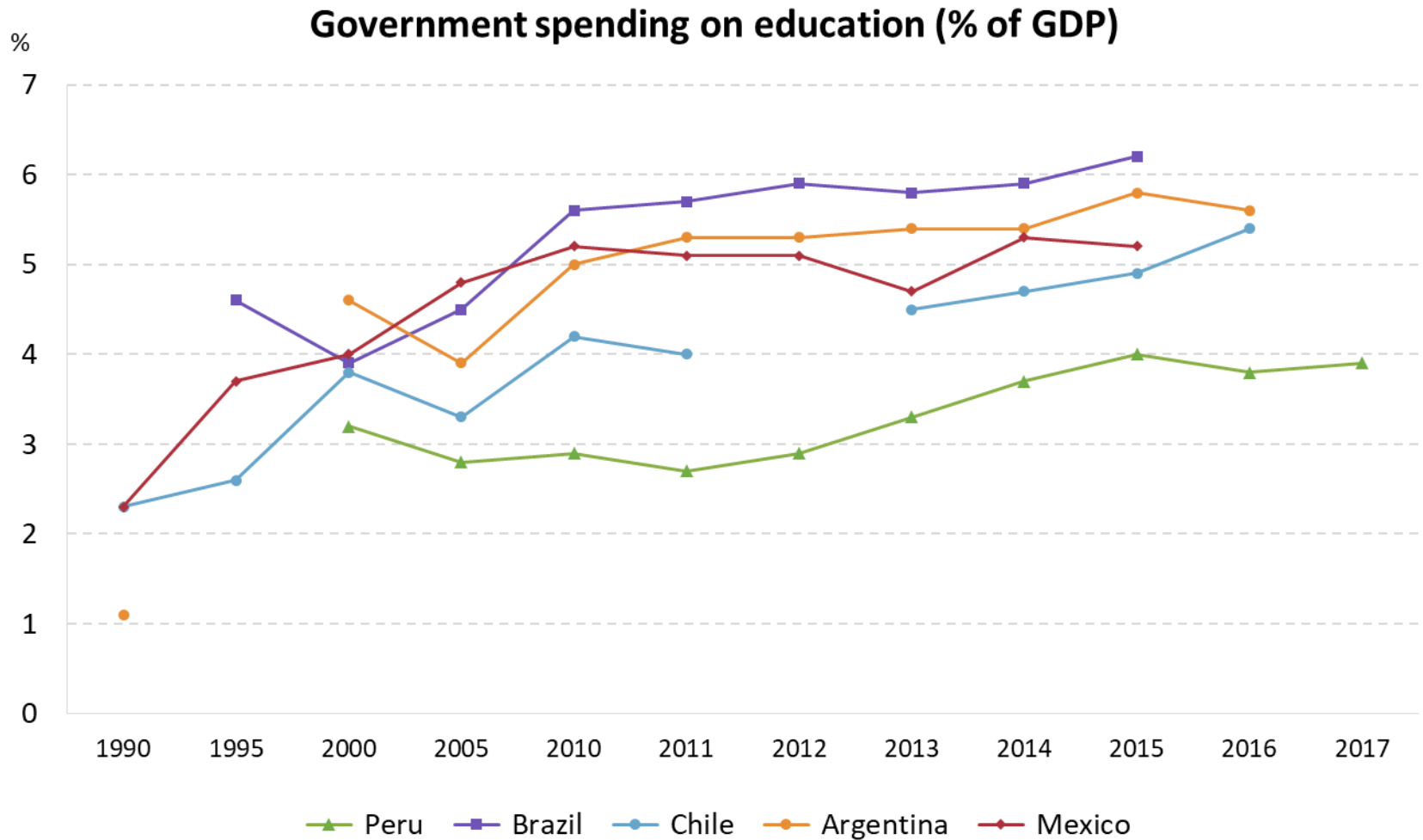
Education



Education

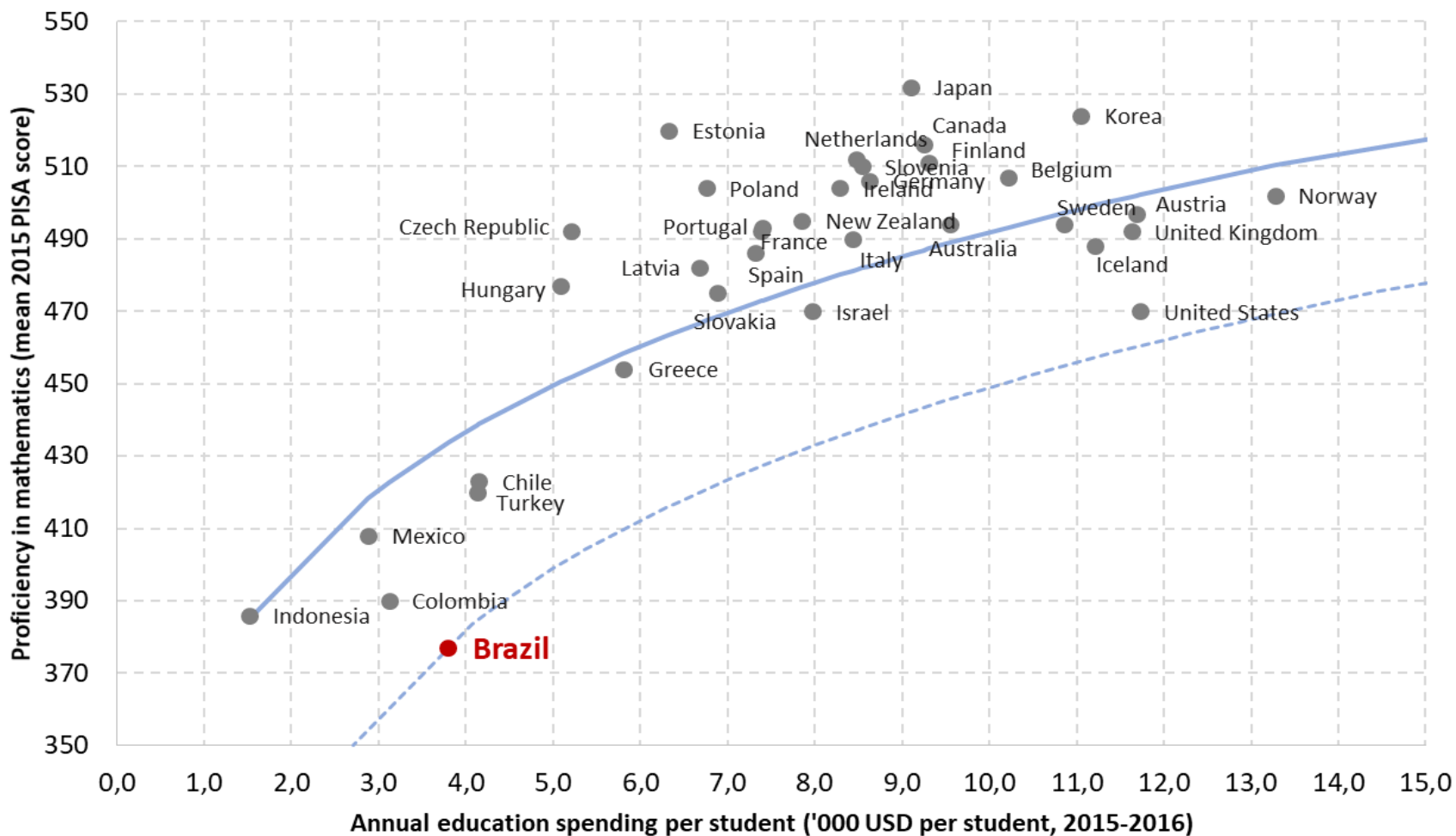


Education: government spending vs. Latam



Education: proficiency vs. spending

Proficiency in mathematics vs. education spending, 2015-2016

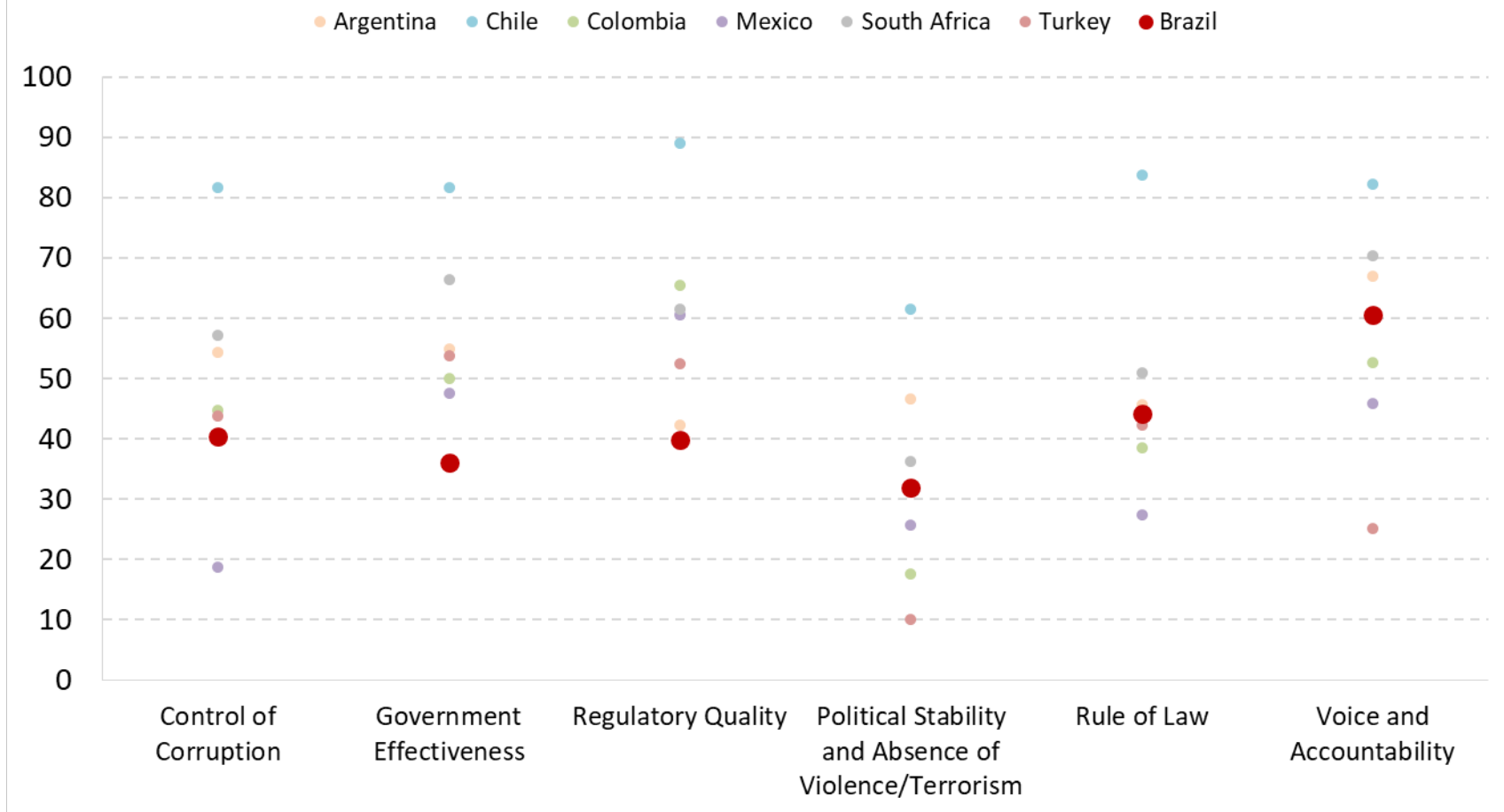


Ease of doing business: Brazil vs. other EM



Governance

Percentile rank in Worldwide Governance Indicators



Global competitiveness index (GCI)

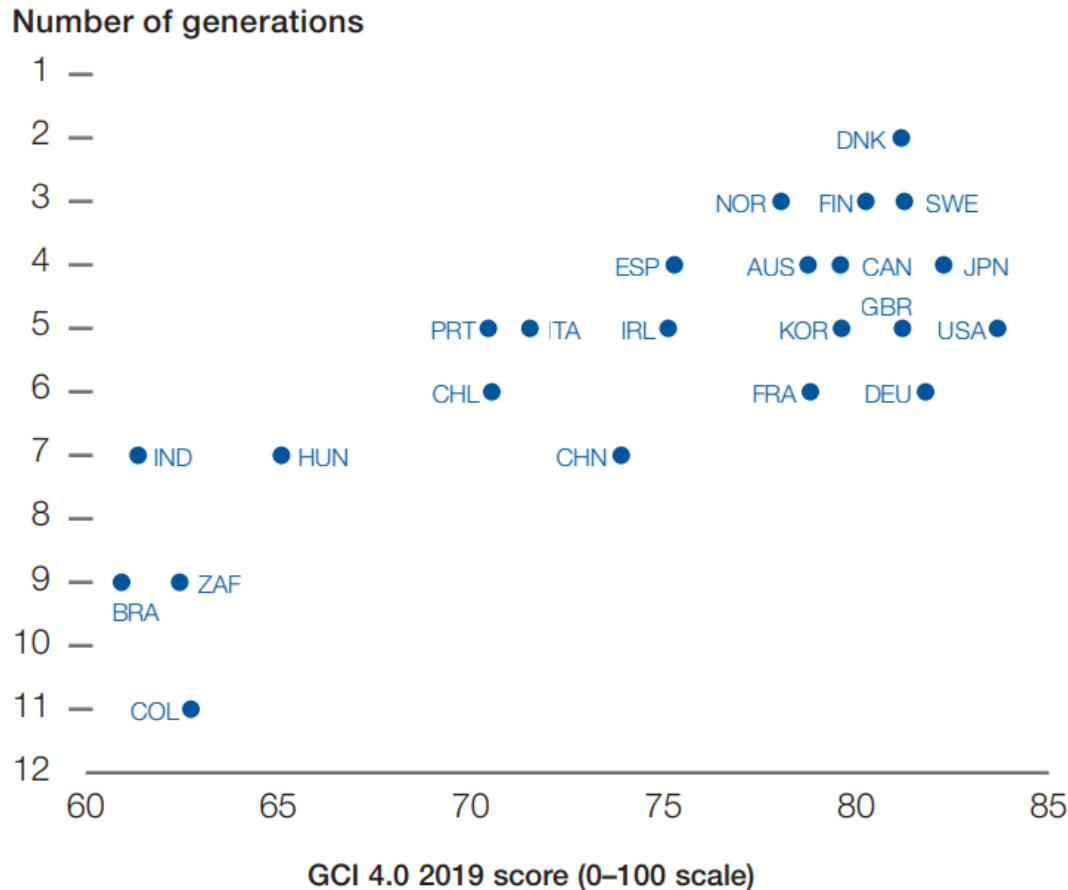
Brazil

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Performance Overview 2019 Key ◇ Previous edition ▲ Upper-middle-income group average □ Latin America and the Caribbean average



Figure 1: Competitiveness and intergenerational mobility, selected countries



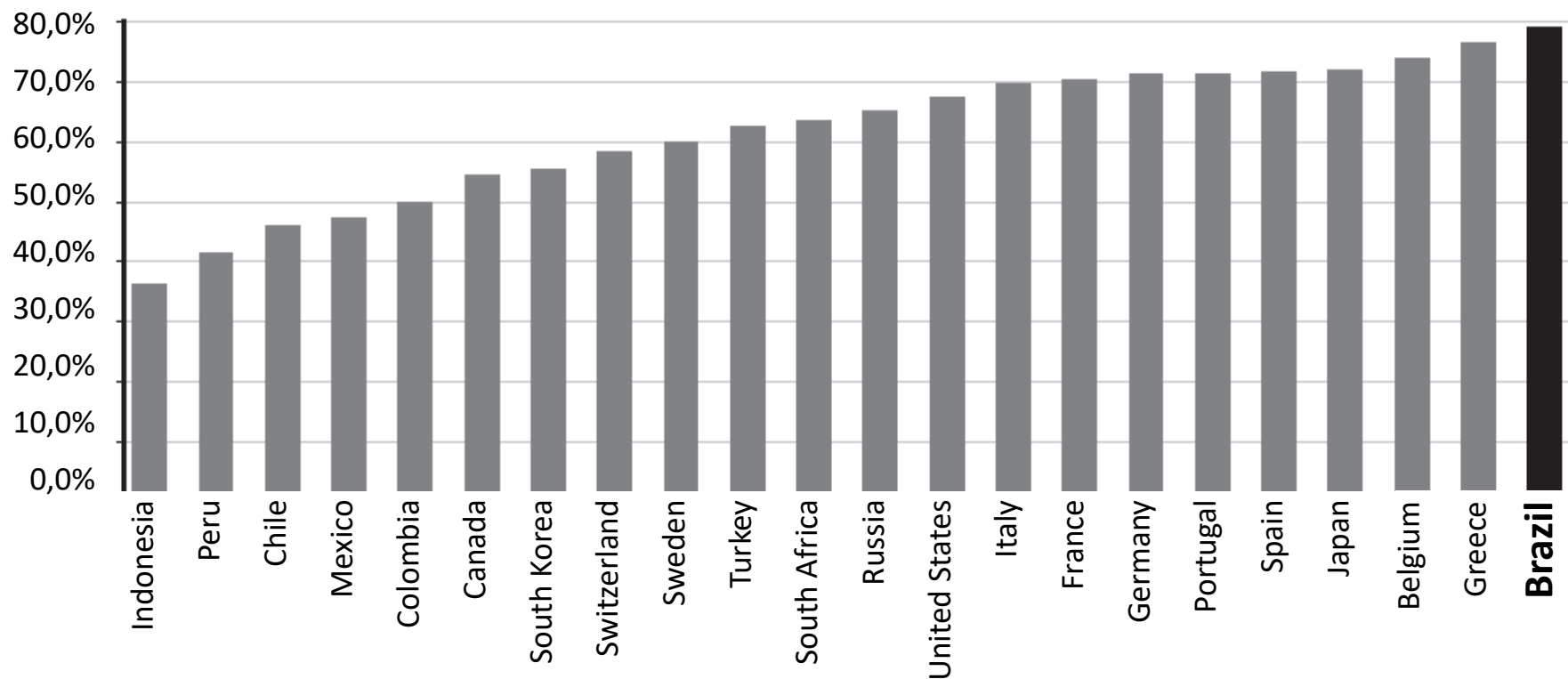
Source: World Economic Forum and OECD, *A Broken Social Elevator? How to Promote Social Mobility*, 2018.

Notes: Number of generations refers to the number of generations needed for those born in low-income families (bottom 10% of the income distribution) to reach mean income in their society.

AUS = Australia; BRA = Brazil; CAN = Canada; CHL = Chile; CHN = China; COL = Colombia; DEU = Germany; DNK = Denmark; ESP = Spain; FIN = Finland; FRA = France; GBR = United Kingdom; HUN = Hungary; IND = India; IRL = Ireland; ITA = Italy; JPN = Japan; KOR = Korea; NOR = Norway; PRT = Portugal; SWE = Sweden; USA = United States; ZAF = South Africa.

Government spending

Government spending on pensions and civil servant wages, as share of primary spending



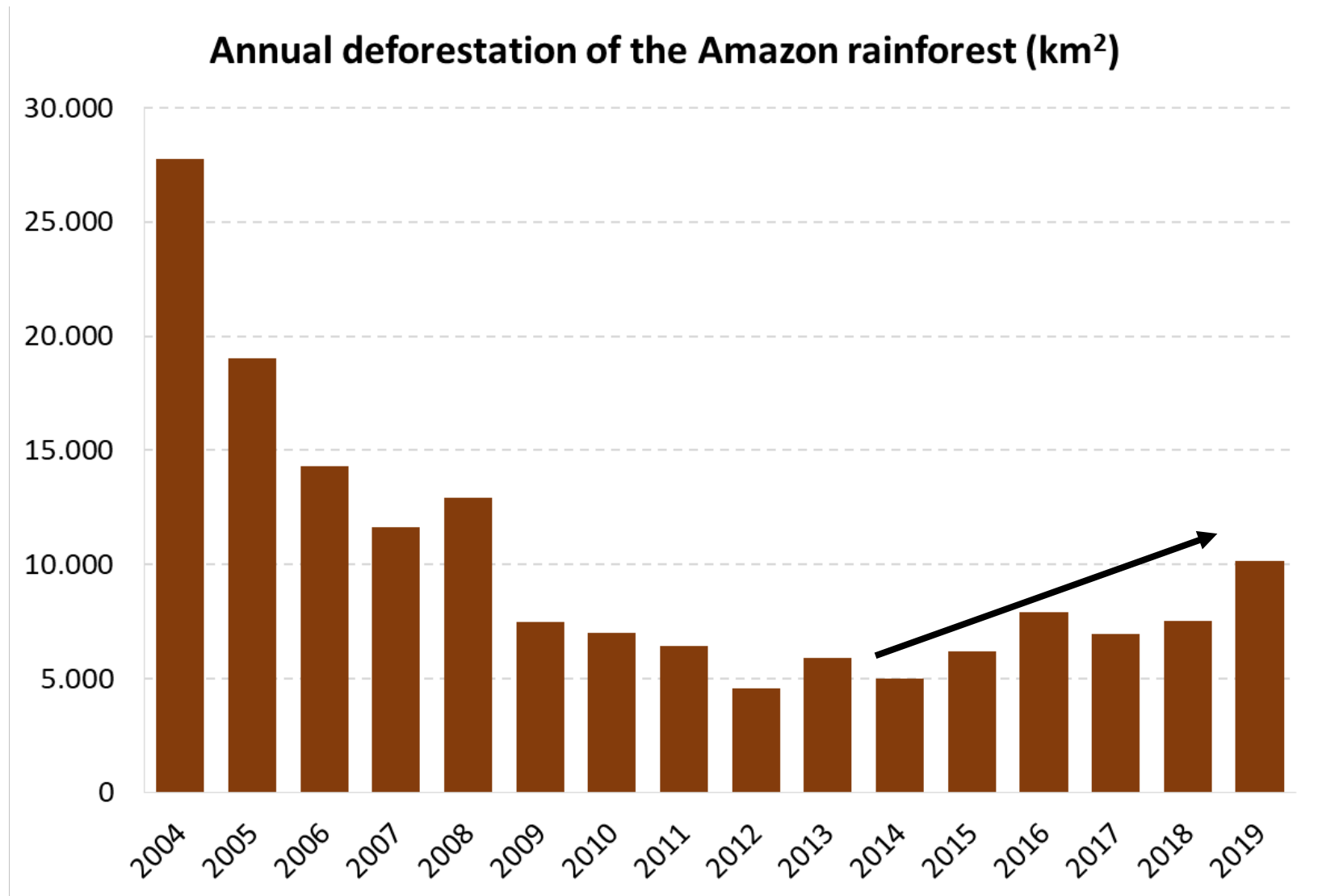
Perfect storm

- Health crisis
- Another massive recession (two 7% drops in 7ys)
- Political crisis (three branches at war)
- Weak leadership

Major risks

- Debt dynamics
- Slow growth, social tensions
- The quality of Brazil's democracy

Deforestation



A picture is worth a thousand words



Ato realizado em Brasília com bandeiras a favor da intervenção militar e do AI-5 | Agência O GLOBO

Caption: “Act in Brasília with flags in favor of military intervention and AI-5”.

Source: O Globo, <https://blogs.oglobo.globo.com/bela-megale/post/pf-vai-apurar-quem-bancou-trios-eletricos-em-atos-antidemocraticos.html>.

Picture source: Agência O Globo,

“Shut down Congress and the Supreme Court”



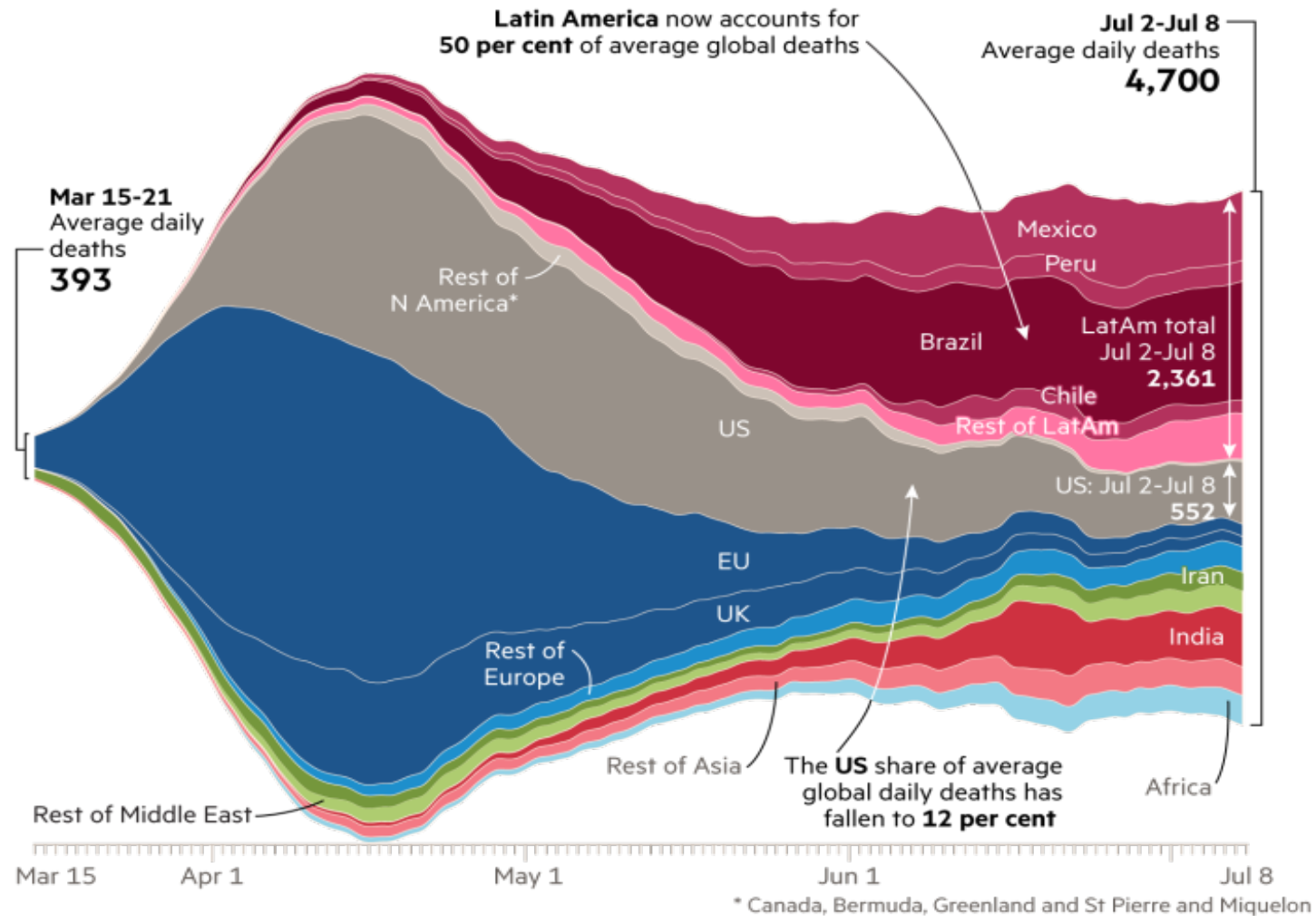
Source: CNN Brasil, <https://www.cnnbrasil.com.br/politica/2020/04/20/pedido-de-inquerito-sobre-atos-pro-intervencao-cita-deputados-mas-nao-bolsonaro>.

Picture source: Gabriela Biló/Estadão Counteúdo,

Covid-19

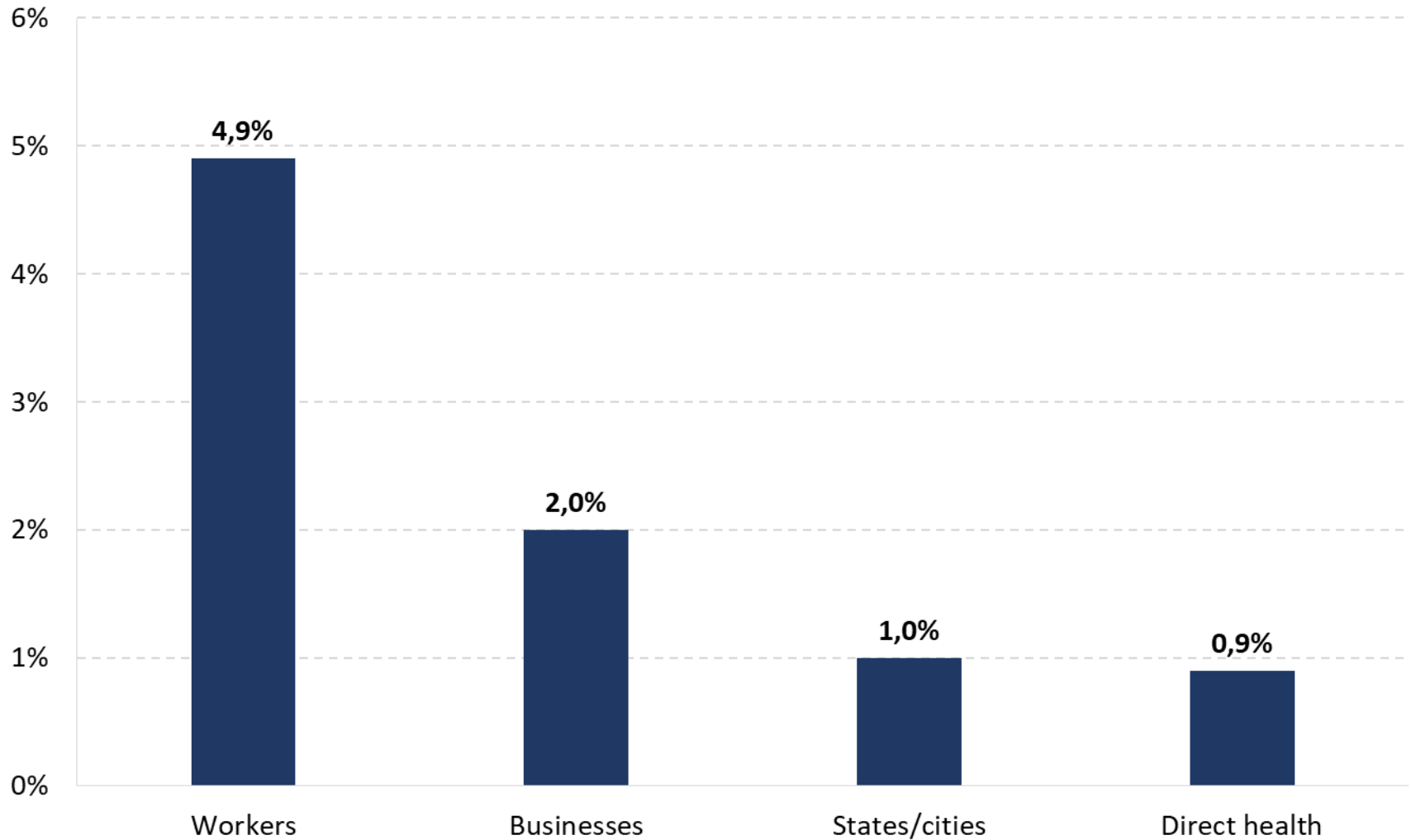
Surge in Latin America means global daily death toll on the rise once again

Daily deaths of patients diagnosed with coronavirus (7-day rolling average)

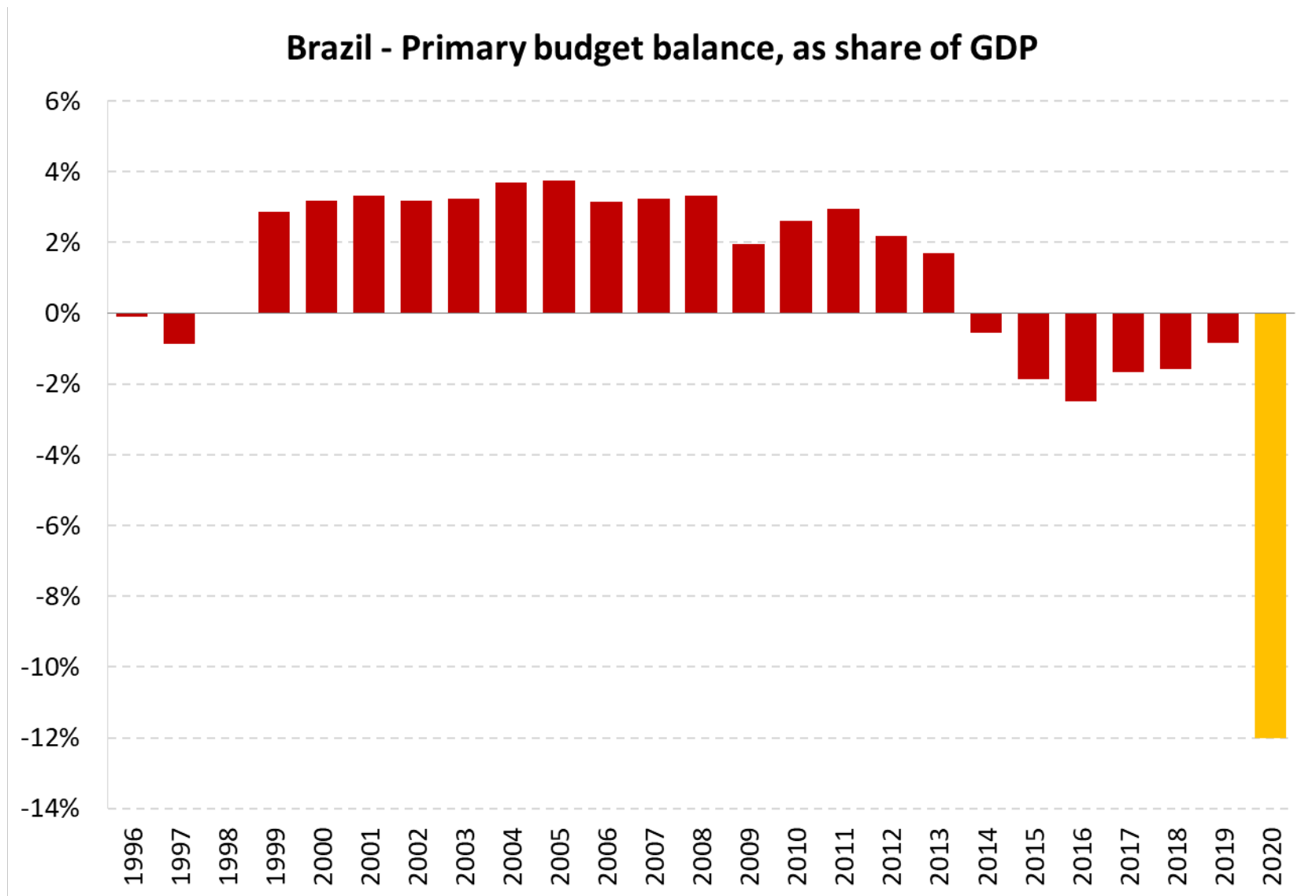


Covid-19

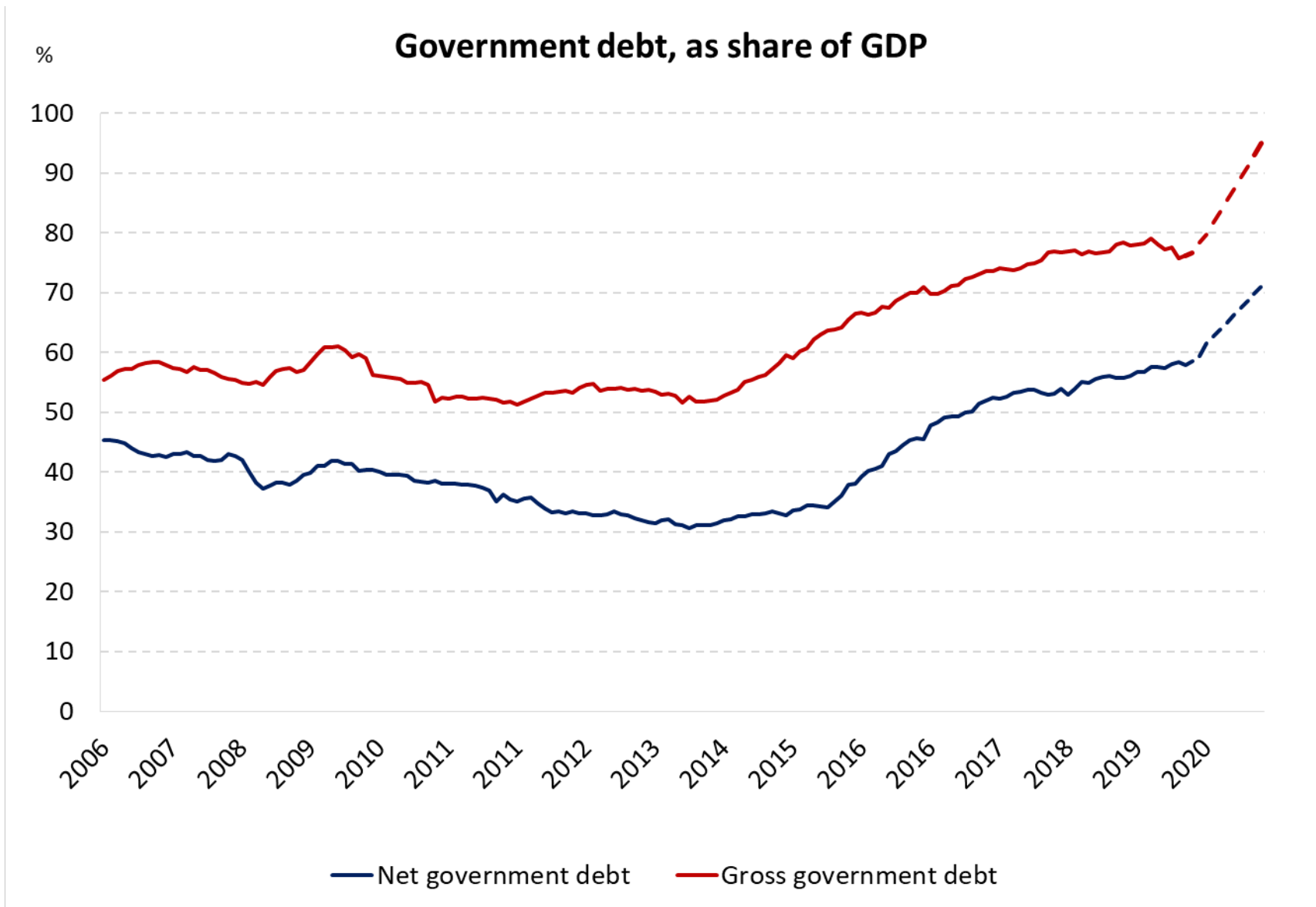
Projected crisis spending, as share of GDP



Government spending



Government debt



Hope and resistance

- Institutions responding
- Free press / media
- Young people engaging in politics
- Reform agenda has been alive since Temer
- Labor, BNDES, Social Security, Sanitation
- Needed: Tax (VAT and Income), Fiscal (again), State (HR)
- Above all: politics