

# The Impact of the Global Financial Crisis on Brazil

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Until quite recently I was among those who doubted whether we faced a major crisis in the real economy. When people said that we were in the middle of the greatest financial crisis since the great depression I did not contradict them, but I found one of the interesting aspects of this crisis to be the striking contrast between the gloom and doom prevalent in the financial sector and the buoyancy still in evidence elsewhere. This was especially evident among exporters in the US manufacturing sector, whose historic markets had been largely restored by the correction of the dollar overvaluation except versus some Asian countries, but it was a much more general characteristic. Through the first half of 2008, i.e. for about a year after the financial crisis broke, growth rates continued at historically high levels except among some of the advanced countries. To take an example close to the interests of many here this morning, Brazil reported year-on-year growth of 6.1 percent in the second quarter of 2008. There was much talk of reverse-coupling.

Not only did it seem that the spillovers from financial markets to the real economy were proving blessedly limited, but one could reasonably argue that the emerging markets were unlikely to be severely affected. There were of course a few countries that had given precedence to policies of growth during the preceding boom years—many countries in Eastern Europe plus most conspicuously Turkey and Pakistan—but most countries seemed to have taken to heart the lessons that had been repeated ad nauseum after the crises of the 1990s. Such as: that countries needed to respond to capital inflows or current account surpluses by building up reserves, moving into fiscal surplus, paying off debt, eliminating the use of foreign currencies in denominating assets, cutting the debt/income ratio, and reducing inflation, rather than by splurging. Many of us were happy to emphasize that this was conspicuously true of Brazil.

In the course of September 2008 this optimism, or maybe one should call it complacency, vanished. As the month wore on it became apparent that the financial crisis was deepening to a point where it would inescapably have major spillovers on the real economy. Housing values continued their decline, but meanwhile stock markets fell precipitously worldwide and credit markets virtually dried up, resulting in many who relied on borrowing suffering from acute illiquidity. Everyone had known from the start that a slowdown in the core of the world economy was bound to suppress demand everywhere, but until this point it seemed that the slowdown was to be welcomed rather than something that was going too far. Quite suddenly it seemed that the world was facing a real danger of a depression rather than a welcome alleviation of inflationary pressure.

Moreover, the markets decided that while many of the emerging economies might no longer have any need for an inflow of loans, many (like Brazil) are still significant net debtors to the rest of the world and therefore still vulnerable to a sudden withdrawal of foreign credit. Compounding this is the fact that one may have a balanced overall position and still be vulnerable because debts are concentrated

at short maturities. Hence one read, for example, of the Bovespa index falling by over 10 percent in a day (it has cumulatively halved in value since the peak in May). Likewise, the *real* has fallen by a cumulative 32 percent in the past month. The markets clearly do not believe that Brazil has been made invulnerable by the record cited above.

These facts compel one to reassess the probabilities of Brazil suffering seriously in this crisis. The fall in world demand is liable to impact the Brazilian economy primarily through the balance of payments. It will both diminish the prices of raw materials, which constitute roughly one half of Brazilian exports, and cut the quantity of sales of differentiated products, largely manufactures, which constitute the other half of export sales. It is the past strength of raw material prices which provides the one logical basis for the very high value of the *real* in the past three years, and quite recently the most reasonable forecast was that the price of materials, although likely to slip back from the very high levels of recent months, would remain much stronger than in the 1990s and early years of this decade. That no longer seems certain. A major worldwide recession would be consistent with a longer period reverting to weak commodity prices.

The prospects for exports of manufactures are also gloomy, though perhaps somewhat less so. The value of world financial assets is estimated to have declined by about \$20 trillion this year, and the value of housing has likewise fallen very substantially, by about \$6 trillion in the US over the last two years and perhaps as much again in the rest of the world. Applying a conventional marginal propensity to spend out of wealth of 4 percent, this implies a fall in world demand of about \$1.3 trillion, or 2 percent. To this must be added the still unknown effects of the current credit stringency. The net effect is bound to be a significant contraction in the demand for manufactures. The one bright spot is the decline in the value of the *real* on the exchange market, which can be expected to switch demand back toward Brazilian-made goods at the expense of goods made elsewhere. The demand for Brazilian-made manufactures should therefore not be expected to decline as severely as demand for such goods in general. (Of course, this assumes that the central bank will accept the decline in the value of the *real* on the exchange market, and not seek to push it back to an overvalued level by selling dollars. See Figs 1 and 2 for two market estimates of the historical performance of the Brazilian real exchange rate: even on the basis of the Citibank estimate, it is clear that the *real* was overvalued prior to its recent decline.)

There are other channels through which Brazil is likely to suffer besides the current account of the balance of payments. First, it is well known that capital inflows to emerging markets like Brazil are highly cyclical. One must therefore expect to see a diminution of the recent inflows. Two weeks ago the Institute of International Finance was forecasting an inflow to all emerging markets in 2008 only \$50 billion less than last year. Even if this figure is still realistic after the past two weeks, one would expect a further reduction next year. In part this will involve a fall in foreign direct investment and therefore in investment, but most of the fall will probably be elsewhere. One expects a reduction in portfolio equity, much (hopefully most) of which presumably has already happened and explains much of the fall in the Brazilian stock market. One also expects it to become more difficult for Brazilian enterprises to borrow in the international market: the strong financial position of the Brazilian public sector should enable the authorities to offset much of this with an expansion of domestic credit.

In short, I would expect the main channel through which the likely fall in capital inflows will impact Brazil to be via the stock market. Although maybe one-third of Brazilian shares are foreign-owned, the majority are domestically-held, and consequently there will be a wealth effect in diminishing consumption as well as some effect of the increased cost of capital in reducing investment. The ill effects from abroad will not simply come through the current account.

One should not overlook the increased demand that will come from a more competitive *real*, but neither can one doubt that there will be costs as well as benefits of the decline in the *real*. In particular, it is likely to push the forecast of inflation back up above the value of 4.5 percent being targeted by the central bank, which was almost reached prior to the decline of the *real* (described in Brazil as a strengthening of the dollar). It seems to me that the central bank should ignore this overshoot. The aim should be to avoid any *second-round effects* of the depreciation, rather than to maintain the rate of inflation at the level previously being targeted. This should enable the central bank to avoid any further increase in interest rates, which would be highly counterproductive from a global standpoint.

While a serious global recession appears inescapable at this point, there is still a great deal of uncertainty as to whether this is likely to be a short V-shaped recession similar to that experienced by Korea in 1997–98, or a protracted depression on the model of Indonesia after 1997, or Japan in the 1990s, or the world in the 1930s. The IMF has argued that the omens are bad because recessions accompanied by a collapse of the housing market have typically lasted longer than normal. However, this is not the only factor, and the collapse of the housing market is limited to certain countries rather than being a general phenomenon. In particular, I would argue that the United States (and Brazil) are likely to recover relatively rapidly due to the correction of a previously-overvalued currency, and China is likely to have a relatively brief recession as it has plenty of scope for fiscal expansion. I would expect recovery to be somewhat slower in many places elsewhere, but I do not anticipate a collapse similar to the 1930s. That was a result of ignorance from which we no longer suffer.

There may well be proposals for concerted fiscal expansion to combat the world recession. The question would then arise as to whether Brazil should join other major countries in such an exercise, similar to (but broader than) the concerted interest rate cut of 0.5 percent by all the leading industrial countries on October 8. Such an expansion would threaten Brazil's imminent move into overall fiscal surplus and reduce the rate of decline in the debt/GDP ratio. I would nevertheless favor Brazilian participation assuming (as I would hope) that it is invited, despite being much in favor of fiscal discipline. Of course I would wish the fiscal expansion to take a form that can easily be reversed and I would wish it to be strictly temporary, but the fact is that these are not normal times and we need to make some adjustments from customary behavior. The cost of not doing so would be to prolong the recession further.

