Changes in financial regulation and the Brazilian economy: comments on 'The evolution of financial regulation before and after the crisis'

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The paper by Carlo Panico, Antonio Pinto, Martín Puchet Anyul and Marta Vazquez Suarez brings us with a thorough analysis about how the instruments of regulation have been implemented by economic authorities in developed countries in order to deal with financial activities since the Great Depression in the 1930s. The authors emphasize the changes in perception by economic authorities about how to deal with financial institutions, and, in their opinion, the 2008 financial crisis has in a great deal been the result of the move from a structure of financial regulation which was 'discretionary based' to one 'rules-based'. As Hyman Minsky has pointed out long ago, all economic constructs are not natural systems, but exist and develop through legislation and permanent innovation. In this sense 'Economic policy must reflect an ideological vision: it must be inspired by the ideals of a good society (Minsky, 1986, p. 9). The ideological vision that pervade the 'contemporary era' was one that the world 'worked well' with less regulation assuming that markets forces would operate more efficiently. According to the authors, this has proved to be a misleading reasoning, not considering, among other things, the extraordinary expansion of the world trade following, mainly, the boom of the Chinese economy. This expansion had important positive impact on commodity prices, which in turn had a positive impact on exports of both emerging and developed countries.

The 2008 financial crisis interrupted the international growth cycle, affecting differently developed and developing economies. If the first impact of the financial crisis hit most badly developed economies, the emerging economies also had their momentum of increased instability. A point to highlight is that emerging economies had learned with successive exchange rate attacks in mid 1990s to build defensive mechanisms against balance of payment crisis. The main instrument had been the accumulation of reserves (Aizenman *et al,* 2010).

This is the case of the Brazilian economy that since 2000 had increased its international reserves over 1000%. Even with an extraordinary level of international

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reserves, for how long can the Brazilian economy support the free flow of capital, without this implying in reducing national income and rising unemployment? Can accumulation of international reserves be a substitute for capital control? Therefore, for the Brazilian economy, the aftermath of the 2008 crisis had not been as dramatic as the exchange rate attacks in mid 1990s, but economic policy still now had not been able to prevent pessimistic expectations and so to induce the recovery of high and sustainable rates of growth. The rather robust growth trajectory initiated in 2003 ended up not holding up after 2010[1].

Panico *et al* 's paper helps us to shed some light on the issue why the Brazilian economy does not resume its growth potential. One conclusion we can reach from their contribution is that sustainable growth for developed and developing economies will only be possible after the restoration of the state of confidence on positive expectations, leading business decisions to move away from towards less liquid and volatile investments. This moment will be reached when a new international monetary order, following the appropriate institutional reforms, becomes consolidated, as it happened in the 'Breton Woods era'. However, the time horizon for this to turn out is not predictable yet.

According to the authors, until mid 1970s, the financial and institutional arrangements created by the New Deal and, after the Second World War, the Breton Woods agreement, had enabled a period of continuous economic growth, expansion of international trade and reduction in social inequalities for most of capitalist economies. In Brazil, the period after the War until the end of the 1970s had also been a period of great economic progress, with accelerated industrialization process induced by the State. Nevertheless, rapid industrialization relied heavily on foreign capital. With the breakdown of the Breton Woods agreement in the early 1970s (but still without affecting international liquidity), the Brazilian economy continued to access international capital markets. With the sudden interruption of autonomous capital flows in the beginning of the 1980s, due to the Mexican default, the Brazilian economy started a long period of slow growth and rising inflation. During this phase the Brazilian economy 'decoupled' from international financial market.

Therefore, the new international institutional arrangement that was shaped after the non-convertibility of the dollar in 1973, and the financial deregulation process that began in the 1980s in the United States, had relatively little impact on Brazilian's economic performance until early 1990s. During this period, when the

1 It is worth noting that Brazilian economic authorities misjudged the gravity of the financial crisis in USA and the Brazilian Monetary Committee of the Brazil's Central Bank, differently of most central banks in the world, kept unchanged the SELIC in 13.75 per cent per year between September 2008 and December 2008, despite the sharp drop of commodity prices and strong downturn in the Brazilian monthly manufacturing production (Nassif, 2011).

'discretionary-based' structure of financial regulation was gradually being replaced by 'rules-based' regulation in developed countries 'speculative capital advanced its control over productive capital bringing severe negative impacts on income distribution and social inequality', according to Panico *et al*'s paper.

The return of the Brazilian economy to the international financial market occurred with the Brady Plan in the early 1990s, which brought relief to the country's international commitments and enabled the return of external capital flows. This was followed by the change in the domestic economic policy agenda, based on the opening of the economy. Economic liberalization process came with the proposal of structural reforms, ultimately aimed at creating a stable economic environment with an emphasis on market forces. It was believed that the introduction of structural reforms would 'naturally' encourage growth and attract foreign capital. (Erber, 2002). Trade and capital liberalization would promote a virtuous circle of growth as a result of structural reforms, designed according to the Washington Consensus.

One of the consequences of the return of the Brazilian economy to the international financial market, under the neoliberal policy agenda, has been the de-nationalization of the Brazilian industry. Hence,in the Brazilian case, although we do not have studies on the issue about advances of speculative capital to control over productive capital, de-nationalization brought up different issues in the administration of macroeconomic policies, industrial ones in particular. During the mid 1990s, domestic manufacturing firms faced increasingly effective import competition caused by the rising value of the Brazilian currency. In many cases, the option for Brazilian entrepreneurs was to give up managerial control in favor of foreign take over. In this sense, the flow of foreign investment did not result in an increase in capital accumulation in the same proportion, as a great part was assigned to the acquisition of existing firms, many of them in the privatization process launched by the government[2].

Another consequence of the new policy orientation has been the impact on real exchange rate. The neoliberal policy agenda pursued by the Brazilian government in the 1990s and 2000s had inflation control and primary fiscal surplus as the main pillars. Inflation targeting regime, relying mostly on the interest rate to control inflation, was adopted in January 1999, after the succession of speculative attacks against the domestic currency that forced governmental authorities to abandon fix exchange rate. One of the consequences of this policy orientation is that Brazil

2 In fact, Brazil, as other emerging countries, was one of the economies that received large amount of foreign investment in the second half of the 1990s, even after the Asian and Russian crisis. During the privatization period (second half of the 1990s), foreign investment went mostly to services industries such as telecommunications, electric energy, and financial services. After 2005 foreign capital went most to agriculture and mining sectors, due to the export boom. See Laplane and Sarti (2002) and Laplane et al (2001).

presents, still nowadays, one of the highest interest rates of the world[3]. High interest rates differential, on its turn, has contributed to keep real exchange rate appreciated[4]. The long overvaluation trend of the real exchange rate has been playing a role to reduce the share of manufacturing industry in total value added and to concentrate exports in products of low value added[5].

Therefore, the appreciation trend of the Brazilian currency stimulated the acquisition of liabilities denominated in foreign currency. In addition, it encouraged the import of capital goods as well as more technologically advanced consumption goods, and thus it has contributed to deter the development and consolidation of an industry more intensive in technology. Moreover, as Brazil is endowed with a large diversity of natural resources, trade expansion in the 2000s until 2008, reinforced productive specialization in the production of natural resource-based products.

In short, an overall picture of the way the Brazilian economy has been performing in the 'contemporary era', of de-regulated financial markets, can be that its degree of external vulnerability - evaluated by the degree of volatility in the real exchange rate, for instance - is still high, in spite of the high level of foreign reserves and the low level of foreign debt[6]. The policy of accumulation of reserves has been pursued since the first decade of the 2000s, and it has contributed to allow the economy to create better conditions to withstand sudden movements of capital outflows. However, this policy might not be a perfect substitute for more interventionist policies in order to avoid excessive exchange rate fluctuation, such as capital controls, considering the high volatility in the international capital flow.

Therefore, if it is clear that for precautionary reasons a high level of reserves may work as an insurance to protect the economy from sudden changes in the value of its domestic currency, it should also be observed that the evaluation of how safe the level of reserves should be depends on the composition of the external liability position of the country. The issue that stands out in the Brazilian case is that a large fraction of assets hold by non-residents is in highly liquid assets (stocks, bonds and derivatives) that can very quickly be converted into foreign currency. This means to say that changes in expectations about the composition of portfolios by agents may

3 Several authors interpret that the formation of interest rate in Brazil is based on a 'convention'. Bresser-Pereira and Nakano (2002, p. 169) for instance, state that , "After the persistent maintenance of interest rates at very high level, it is natural that there is a fear of reduction and so that level becomes a convention in the Keynesian sense of the term, and also a trap. Therefore, there will not be easy to escape the perverse equilibrium of the interest rate that we got ourselves into many years ago".

4 About this, see Nassif et al, 2011.

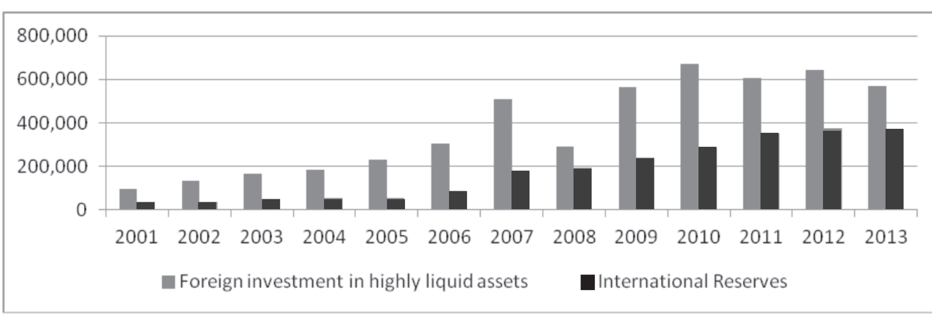
5 About this, see Feijo and Lamonica, 2012.

6 For a discussion about indicators to identify vulnerabilities in the external sectors of emerging economies, see Araujo et al, 2013.

induce the exchange of domestic assets (money and bonds) for foreign assets, what would lead to a massive flight of capital. The immediate reaction by governmental authorities, in order to deter such a movement, implies measures such as increase in interest rate and the use of reserves in an attempt to prevent a large depreciation of the domestic currency. If these actions are not enough, a depreciation trend of the currency should follow.

In order to illustrate the point we are making about the composition of Brazilian liabilities vis-à-vis international reserves, in Figure below we compare the amount of the most liquid domestic assets held by non-residents with the level of Brazilian reserves in the 2000s. As we can see, the amount of reserves is insufficient in case of a flight of capital. A policy of accumulation of reserves would be a 'perfect' substitute to capital controls measures if international reserves were in the same volume as the total net external liabilities, at least the most liquid type. If this is not the case, in the upsurge of external turbulence in international financial markets, exchange rates and interest rates will vary sharply. Sudden changes in the exchange rate have immediate inflationary impacts in the domestic economy, what induces increases in interest rates, reinforcing deflationary results. Very often, both changes in these macroeconomic prices occur simultaneously leading the economy to stagflation.

Figure 1: End of period position of foreign investment in highly liquid assets and the level of International Reserves - (US$ million) - 2001-June 2013



Source: Brazilian Central Bank.

As mentioned before, a 'new era' of sustainable growth for developed and developing economies will emerge when trust in future expectations will be rebuilt. However, the slow pace of international reforms in the direction of establishing a more cooperative environment among central bankers and other multilateral financial

7 See, for instance, Carvalho, 2009, and Cruz and Walters, 2008.

institutions and the still timid initiatives to establish control over capital flow suggest that we may not have seen all the negative economic consequences of the long period of de-regulation of the 'contemporary era' yet. The relevance of the contribution of the paper by Carlo Panico, Antonio Pinto, Martín Puchet Anyul and Marta Vazquez Suarez, in line with Minsky's recommendation, stands to show that, since the inadequate performance of the economic and social order becomes evident, the time for a 'thorough-going institutional reform.... has arrived' (Minsky, 1986, p. 8).

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