# Strategies for Bringing Down Long-Term Real Interest Rates in Brazil

by Kenneth Rogoff, Harvard University

Central Bank of Brazil, August 30, 2005

Brazil should be growing much faster given extraordinarily benign global environment at the end of the “Greenspan era”.

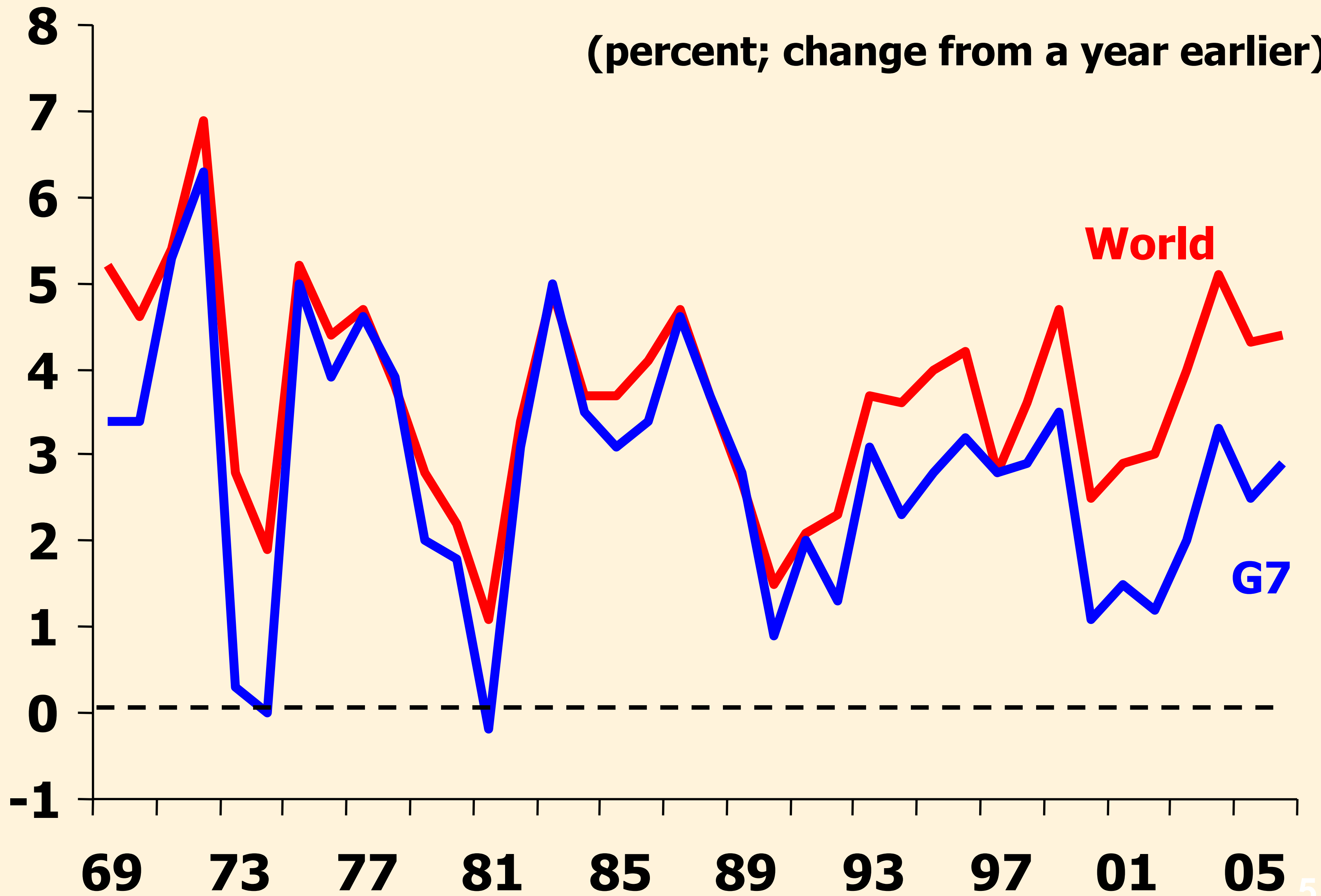
# Late Greenspan Era

- Rising trend global growth
- Falling global output volatility
- Inflation at historic lows
- Long term real interest rates at historic lows in much of the world

# Many Positive Factors

- Technology boom (slow to Europe)
- Globalization of trade and services
- Deeper financial markets
- Better policies, esp. developing countries.
- Improvements in Monetary Policy
- PAX AMERICANA?

# GDP Growth: World and G7

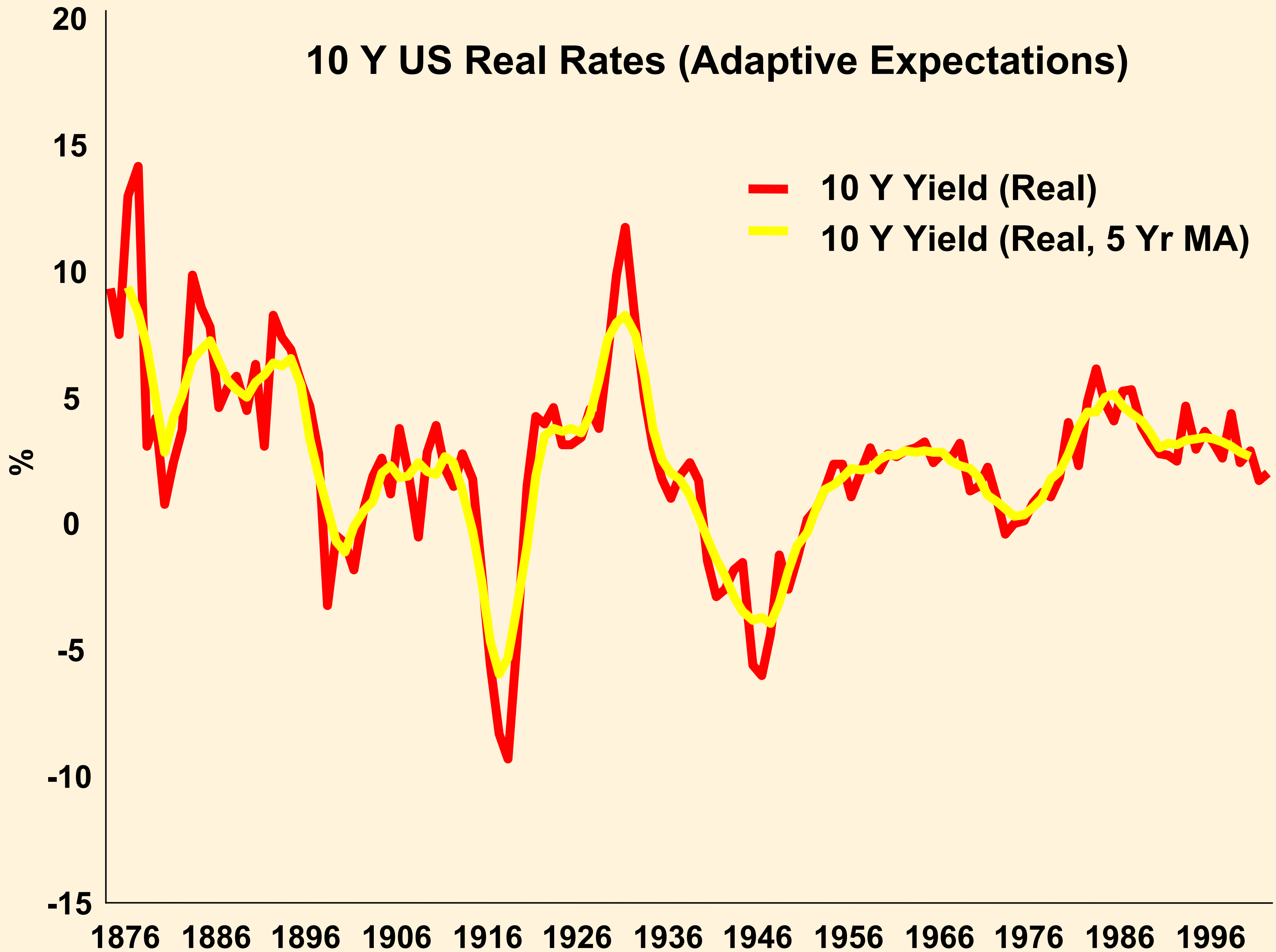


# World CPI Inflation

| | 80-84 | 85-89 | 90-94 | 95-99 | 00-04 | 2005 |
|---|---|---|---|---|---|---|
| World | 14.1 | 15.5 | 30.4 | 8.4 | 3.8 | 3.6 |
| Industrial economies | 8.7 | 3.9 | 3.8 | 2.0 | 1.9 | 2.0 |
| Developing countries | 31.4 | 48.0 | 53.2 | 13.1 | 6.3 | 5.5 |
| Africa | 16.8 | 17.9 | 39.8 | 20.6 | 10.6 | 7.7 |
| Asia | 9.0 | 11.5 | 10.5 | 7.3 | 2.7 | 3.9 |
| Central and Eastern Europe | 20.8 | 31.6 | 84.5 | 36.5 | 14.4 | 5.2 |
| CIS and Mongolia | 2.8 | 1.4 | 383.9 | 66.8 | 16.1 | 11.4 |
| Latin America | 82.4 | 185.9 | 232.6 | 17.2 | 7.7 | 6.0 |
| Middle East | 18.6 | 22.5 | 30.4 | 29.6 | 6.6 | 8.6 |

(Source: WEO data base)

# Long term real interest rates near 1950s levels



# But real rates remain high in a few countries

# 2004 Short-term Real Interest Rates for Selected Countries

| | |
|---|---|
| Brazil | 9.6 |
| China | 0.5 |
| Georgia | 6.2 |
| Mali | 8.1 |
| Mexico | 2.5 |
| New Zealand | 3.5 |
| Poland | 2.5 |
| South Africa | 5.8 |
| Turkey | 11.0 |
| United Kingdom | 3.0 |

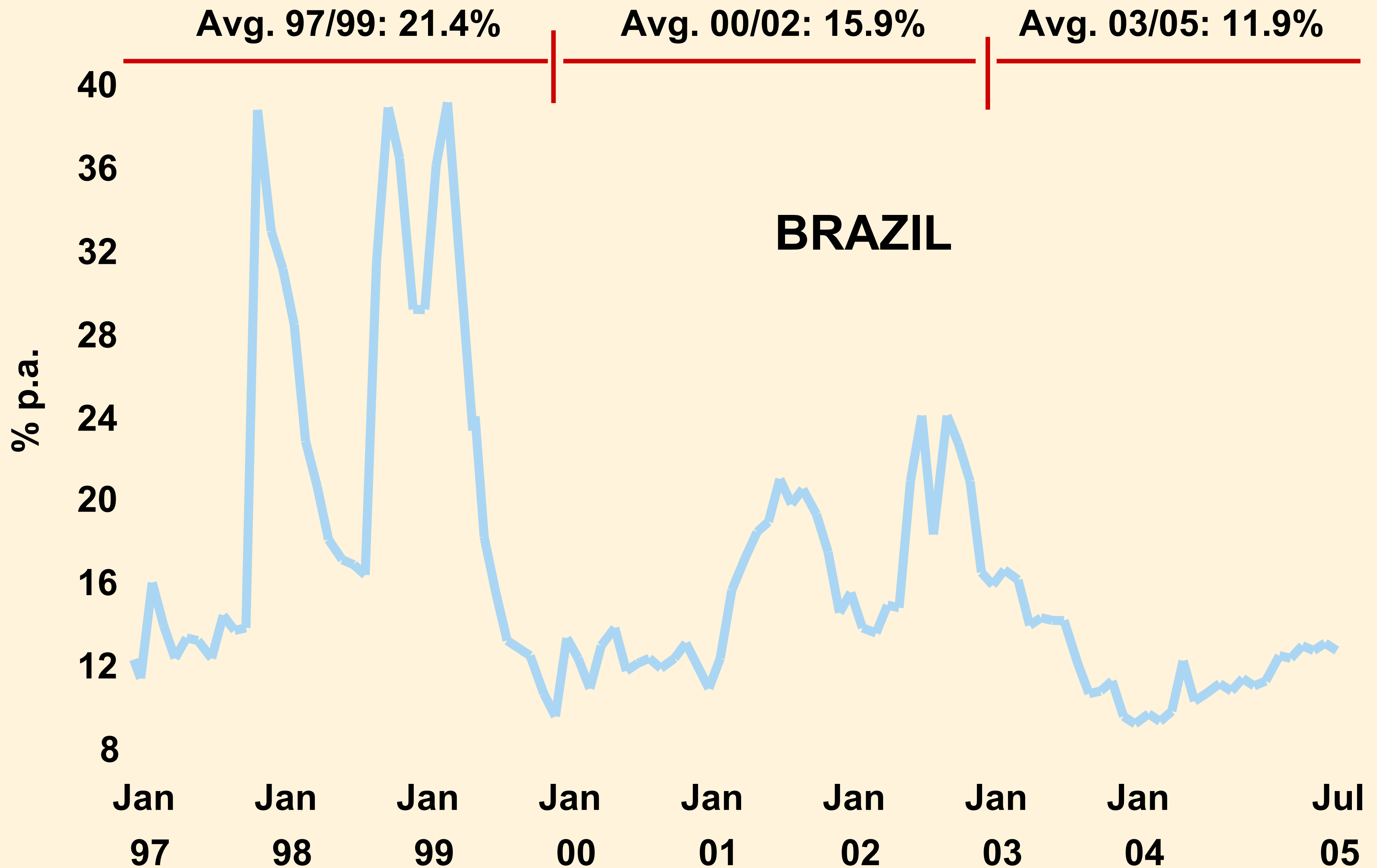
Source: WEO for inflation, national sources for money market rates

# 2005 Short-term Real Interest Rates for Selected Countries

| | |
|---|---|
| Brazil | 12.0 |
| China | -0.9 |
| Dominan Republic | 10.4 |
| Korea | 0.4 |
| Mexico | 4.8 |
| New Zealand | 3.6 |
| Poland | 3.4 |
| South Africa | 2.4 |
| Turkey | 7.8 |
| United Kingdom | 3.1 |

Source: WEO for inflation, national sources for money market rates

# High real rates familiar problem in Brazil

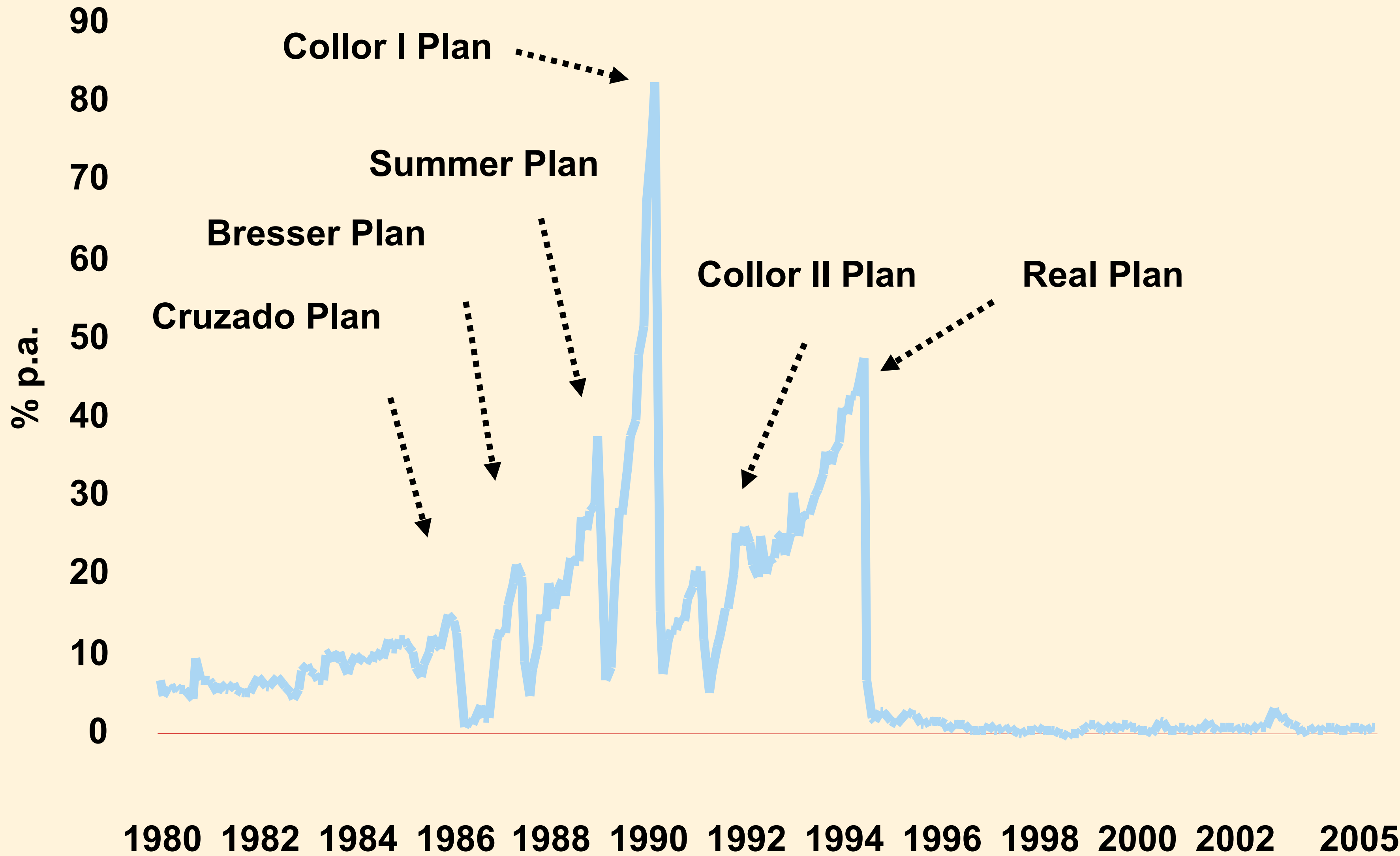


# Why are rates so high in Brazil: several elements conspire

- Brazil's external debt to GDP ratio is nearing investment grade levels, but public debt is still very high (over 50% net)
- History of Default and High inflation
- Technical factors (tax rules that limit market for long-term bonds, etc.)
- High tax and spending levels
- Failure to achieve sustained take off in GDP growth

# History of high inflation and serial default

# Inflation



# External Debt Defaults in Emerging Markets 1824-2004

| | *Number of default or restructuring episodes* | *Percent of years in a state of default or restructuring* | *Number of years since default* |
|---|---|---|---|
| Argentina | 4 | 26.1 | 0 |
| Brazil | 7 | 25.6 | >10 |
| Chile | 3 | 23.3 | 20 |
| Colombia | 7 | 38.6 | 60 |
| Mexico | 8 | 46.9 | 15 |
| Philippines | 1 | 18.5 | 13 |
| Turkey | 6 | 16.5 | 23 |
| Venezuela | 9 | 38.6 | 7 |
| *Group average* | *5.2* | *27.4* | *18* |

# An Aside: The Early History of Default

*Number of defaults*

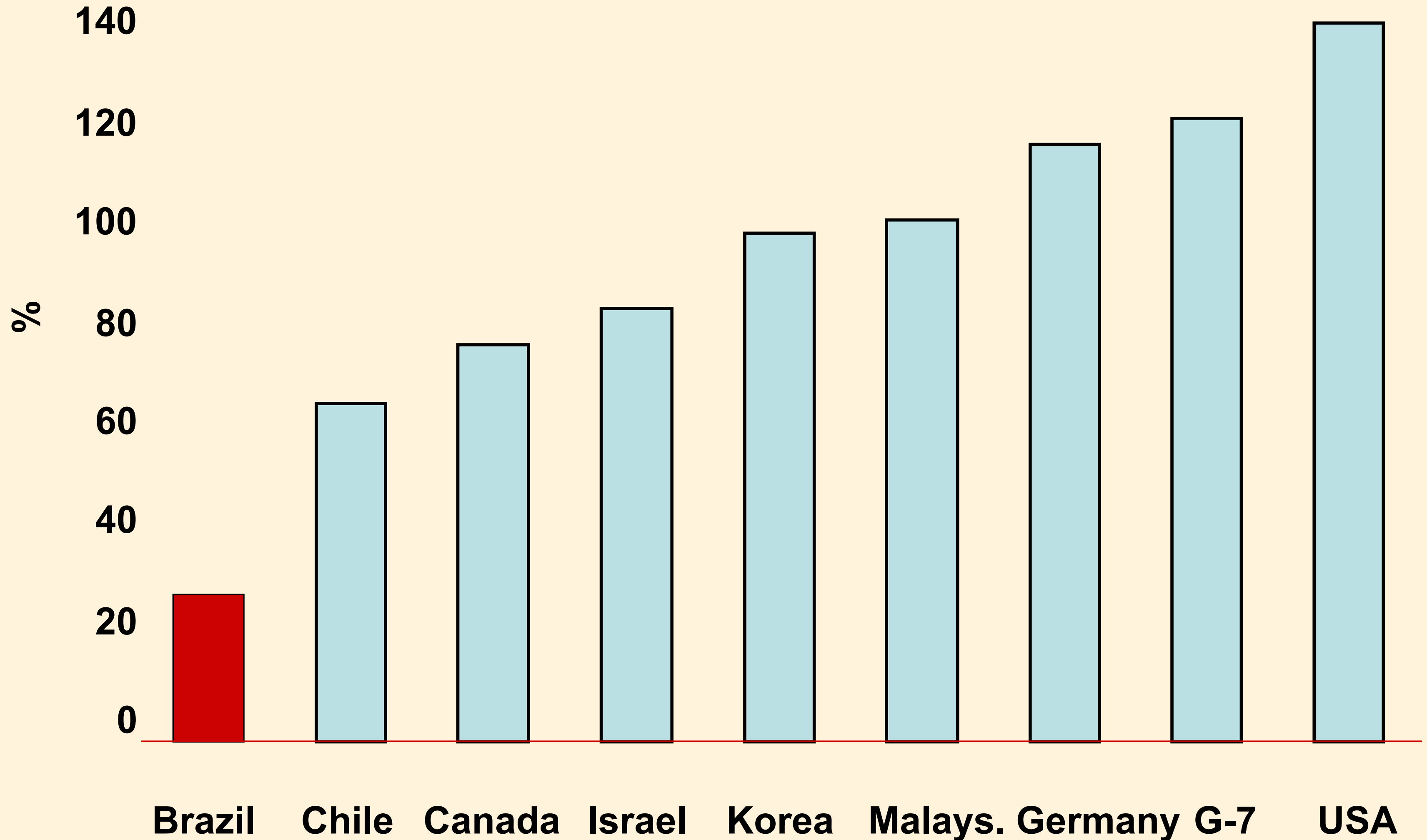
| | *1501-1800* | *1801-1900* | *1501-1900* |
|---|---|---|---|
| Austria | n.a. | 5 | 5 |
| France | 8 | n.a. | 8 |
| Greece | n.a. | 4 | 4 |
| German | 1 | 5 | 6 |
| Portugal | 1 | 5 | 6 |
| Spain | 6 | 7 | 13 |

*Repeated rape of financial sector*

….has left it very thin and weak

…even though Brazilians remain at the forefront of innovation in finance.

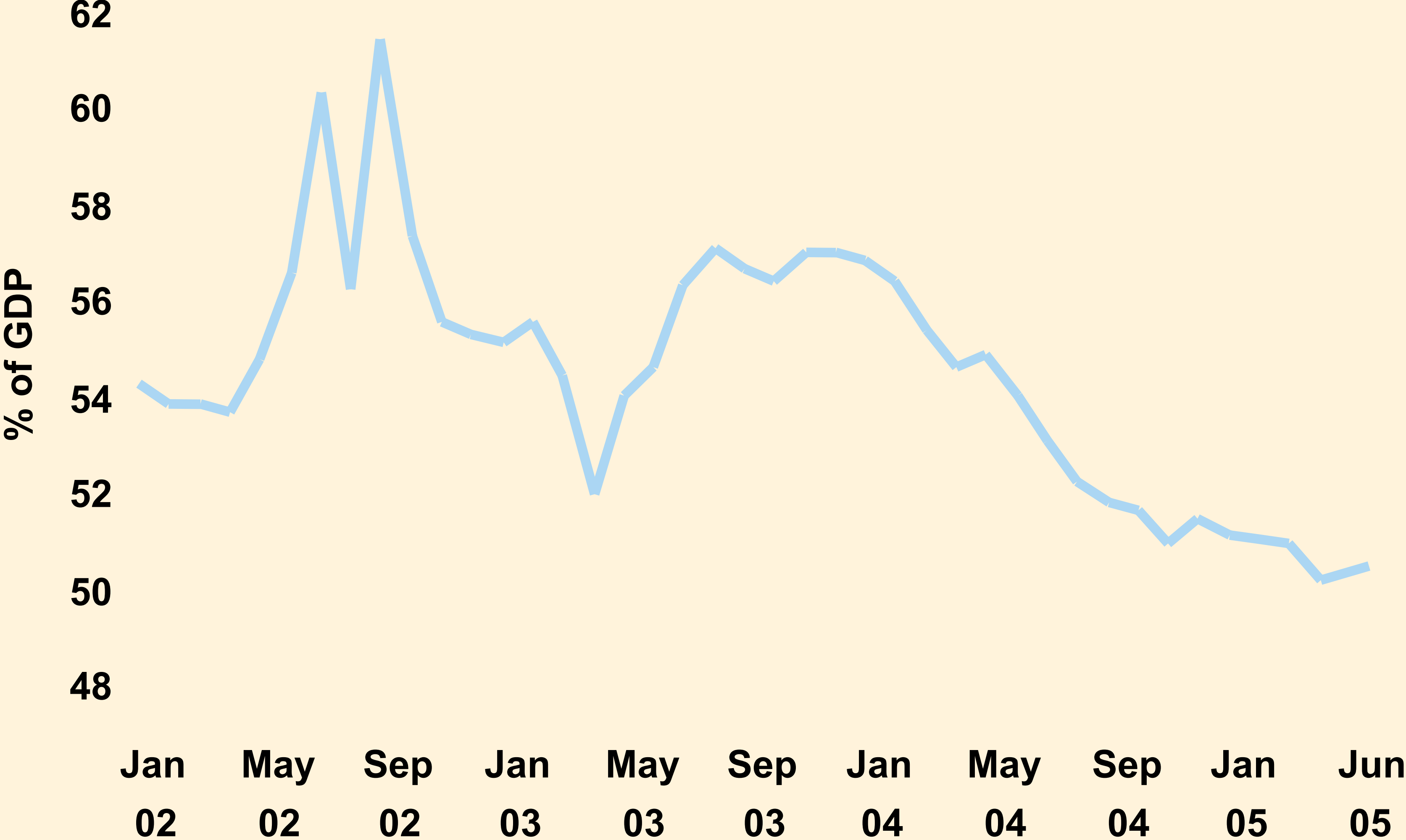
# Credit/GDP Ratio: Selected Countries



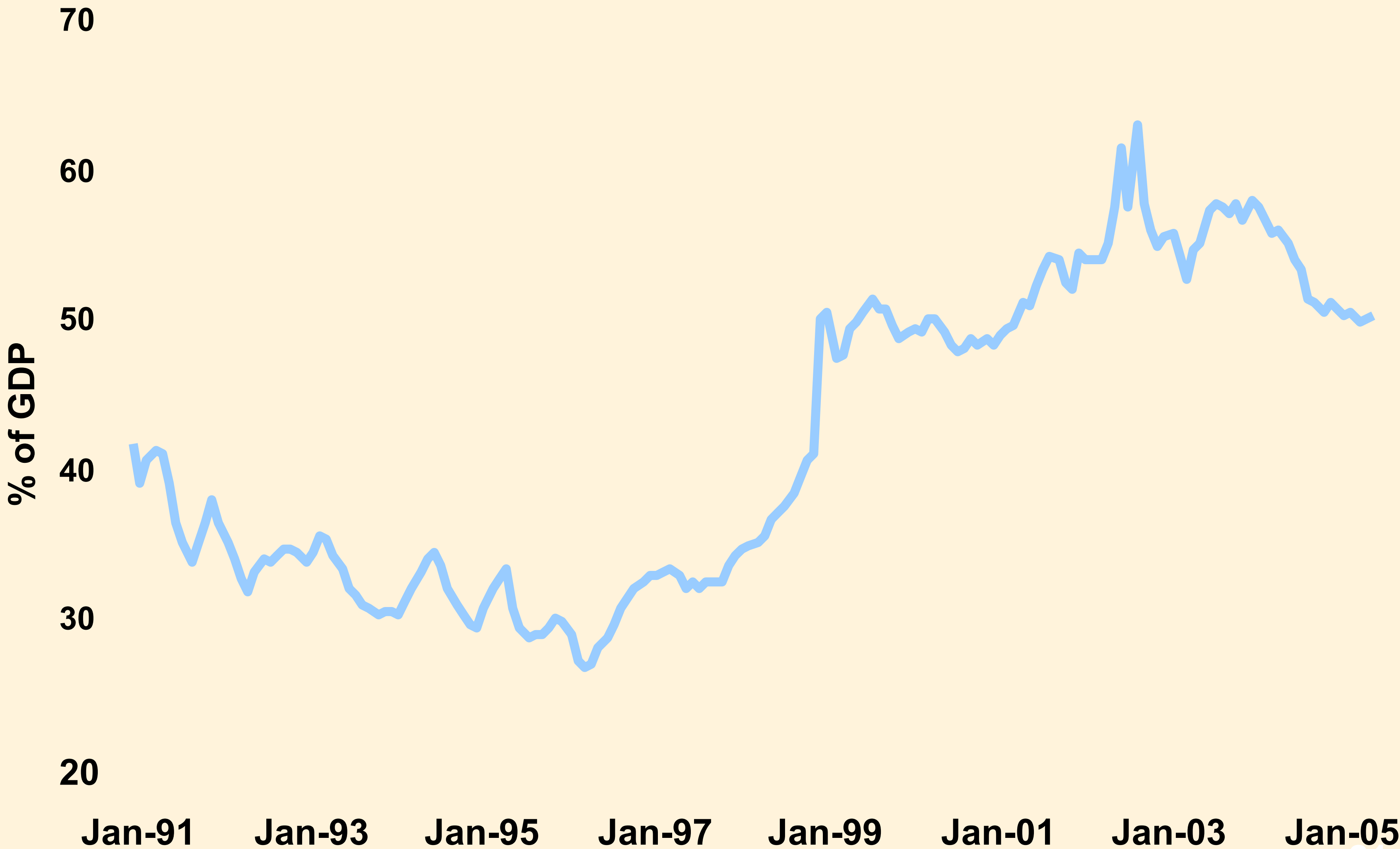
# History hurts: Debt intolerance

- Reinhart, Rogoff and Savastano (Brookings, 2003), Reinhart and Rogoff (American Economic Review, 2004). History of serial default and high inflation implies that Brazil starts paying a significant default risk premium even at relatively low levels of debt. Debt levels need to come to down below 25-30% to be safe

# Net Public Debt/GDP Ratio Improving



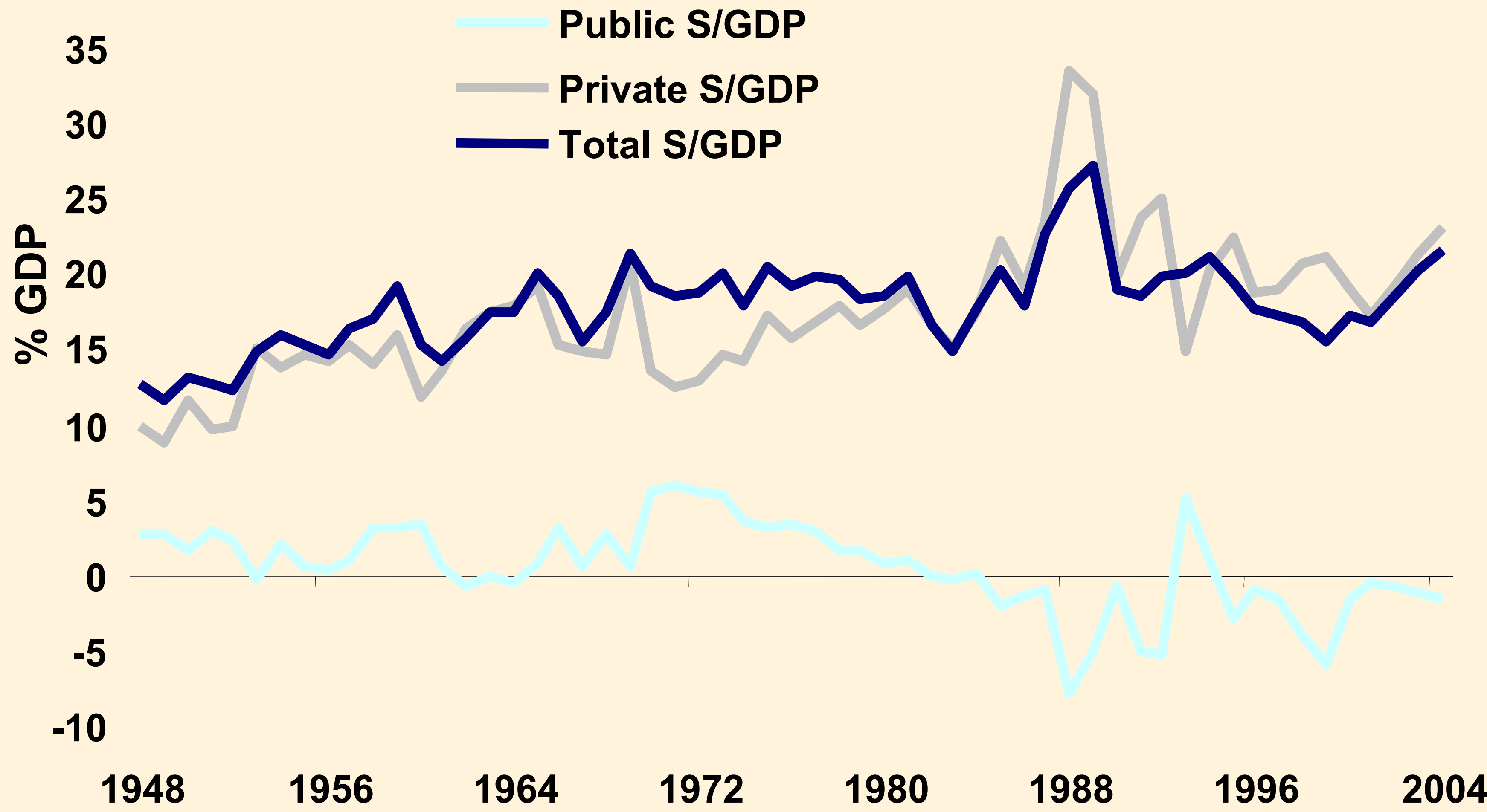
# But still high relative to longer term



Adjustment made difficult by already high tax burden

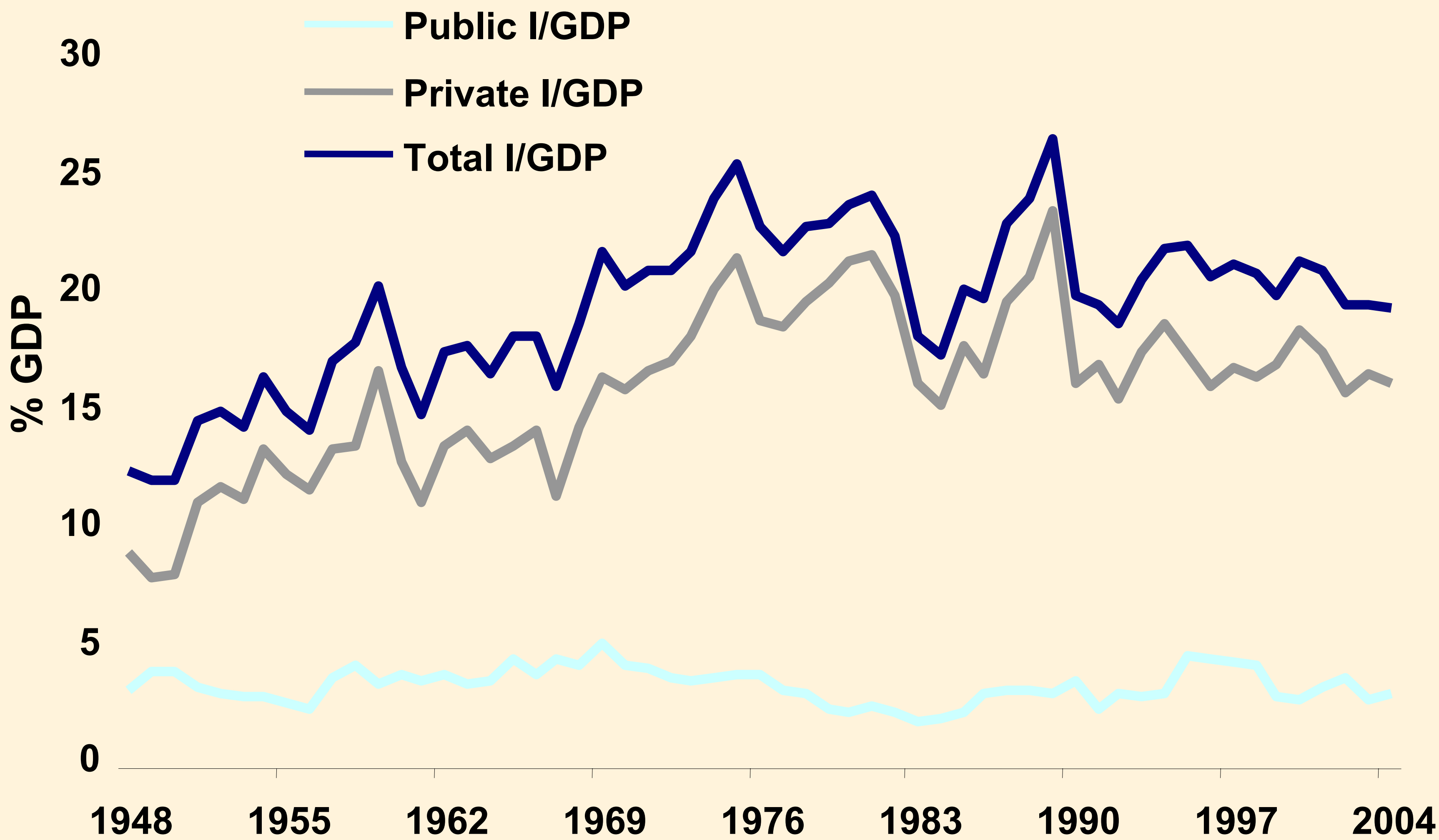
# Tax Burden: Selected Emerging Markets

# Brazil - Private Sector Always Pays Adjustment Burden




Source: Goldman Sachs based on BACEN.

# Even though Private Sector Drives Investment

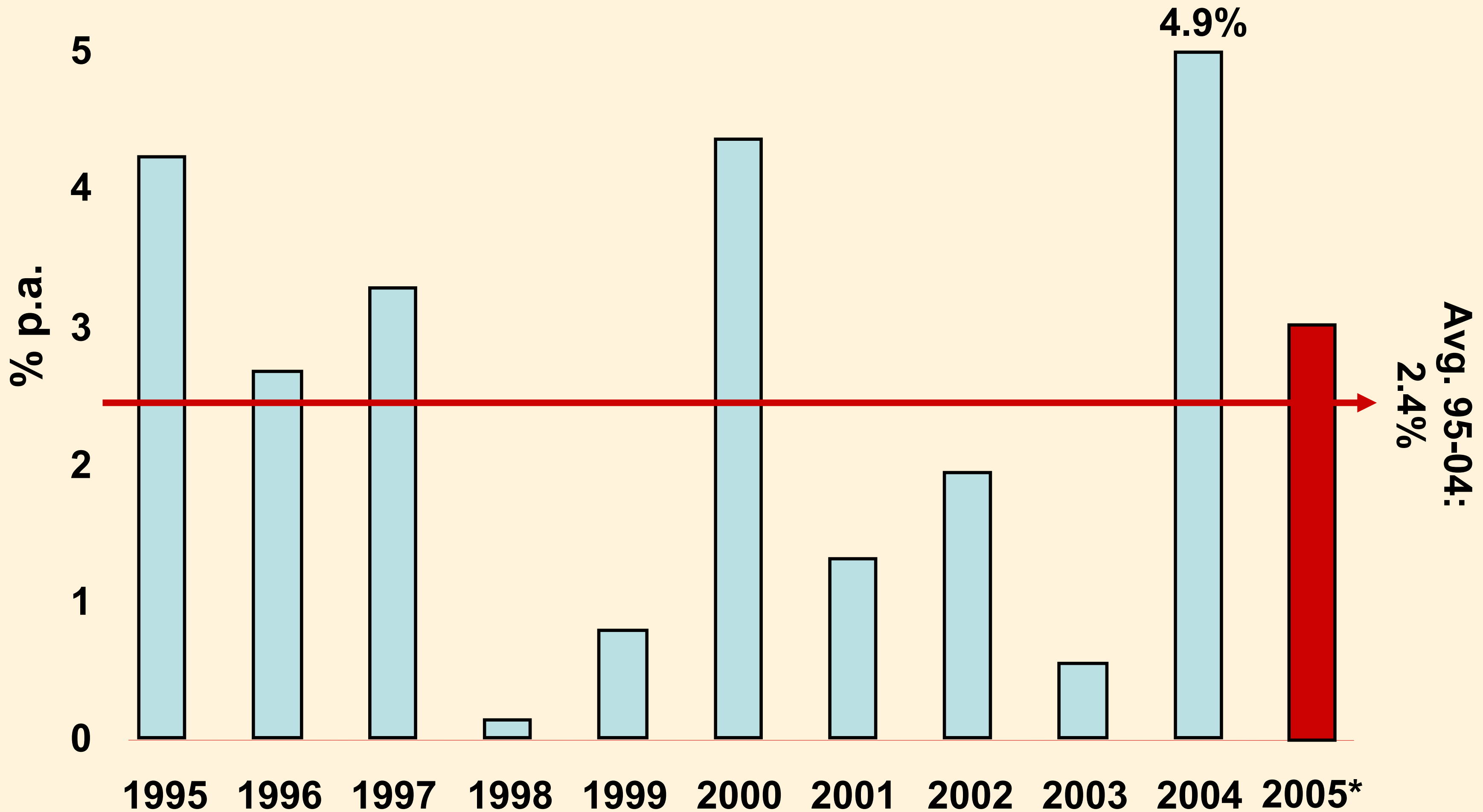



Source: Goldman Sachs based on BACEN

# Ideally, Brazil would grow its way out of debt…

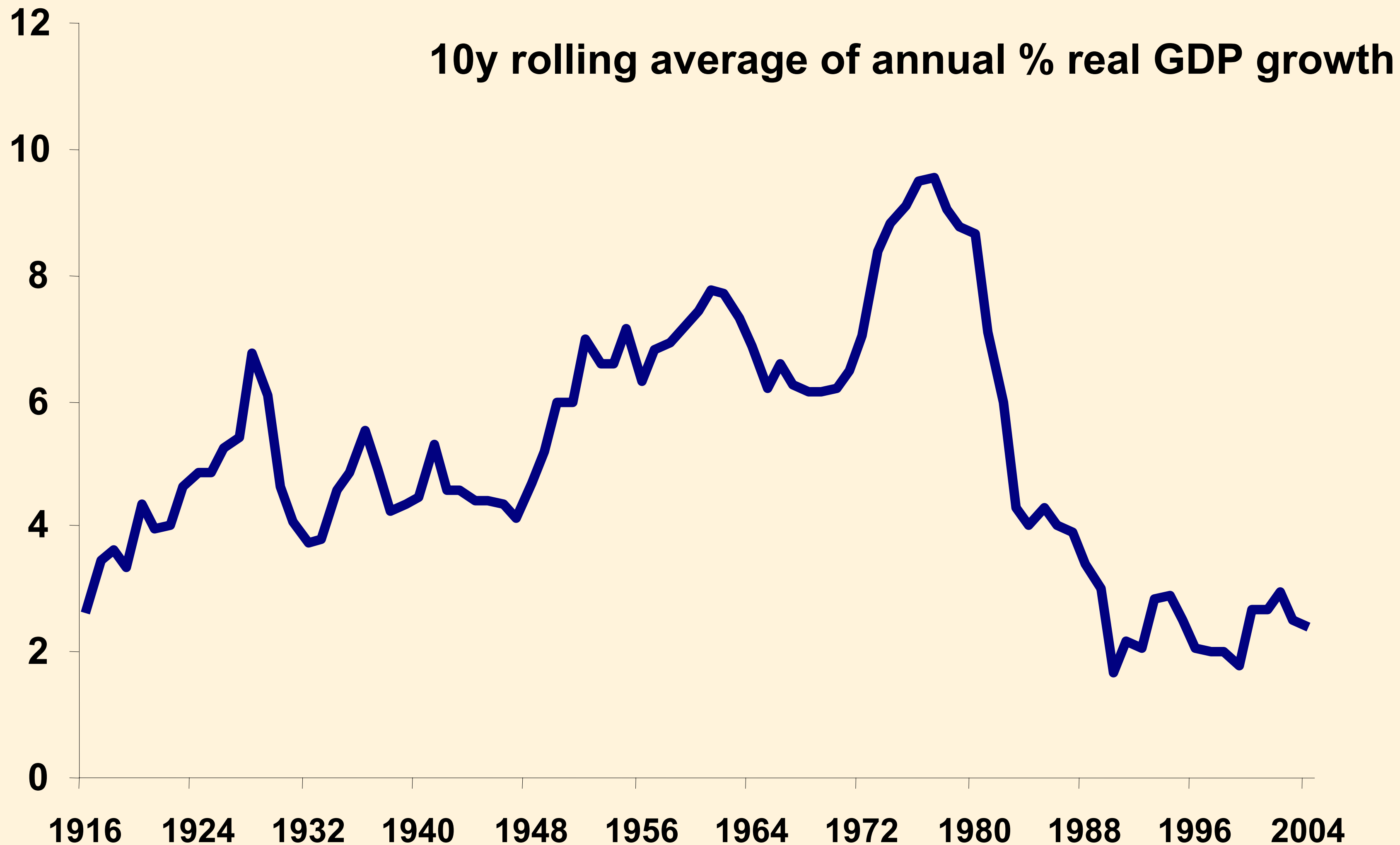
- But this may not happen until years of microeconomic reform and economic liberalization take place…

# GDP Growth is lackluster



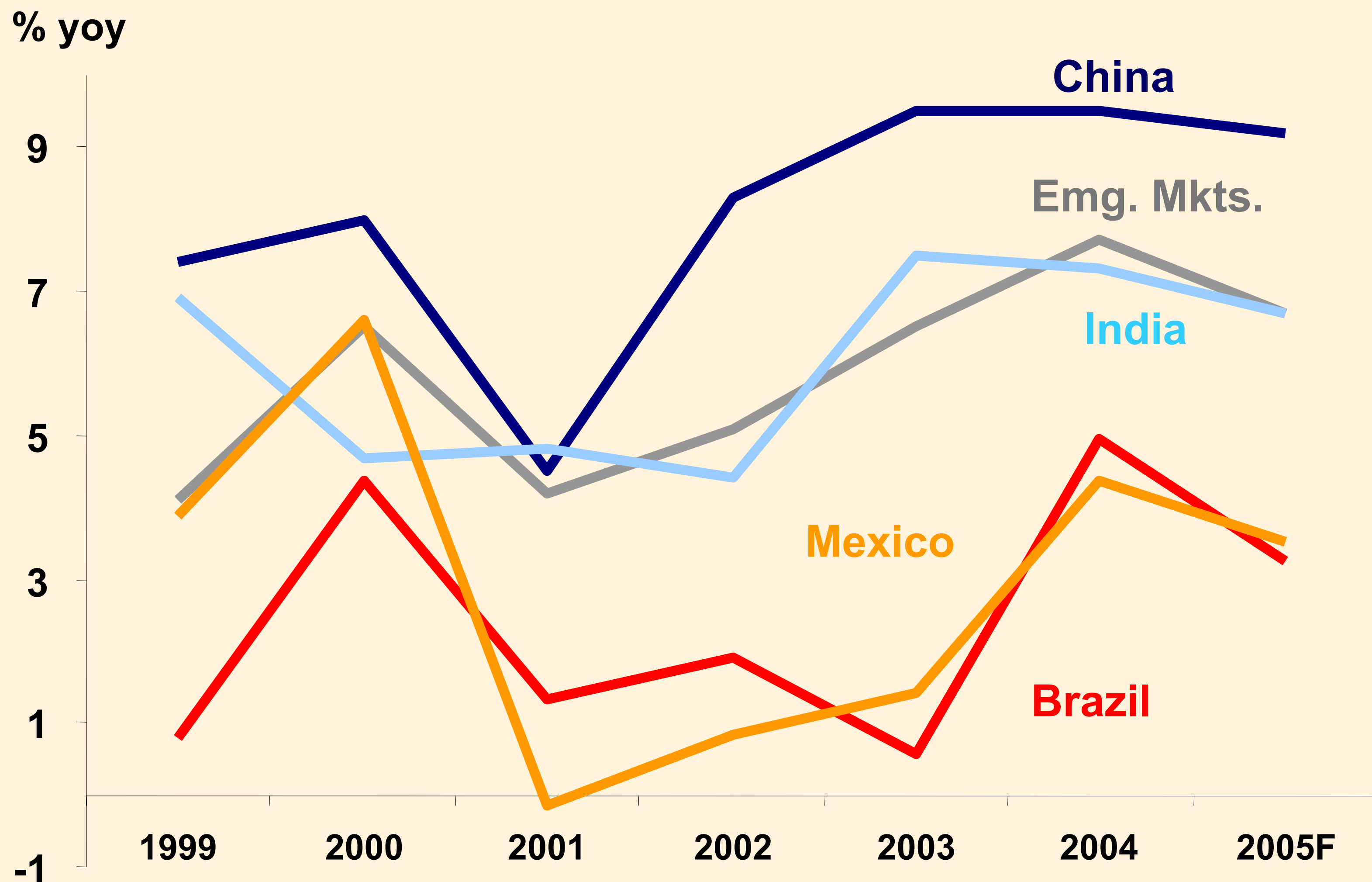

* Market Consensus

# Trend Decline in Growth



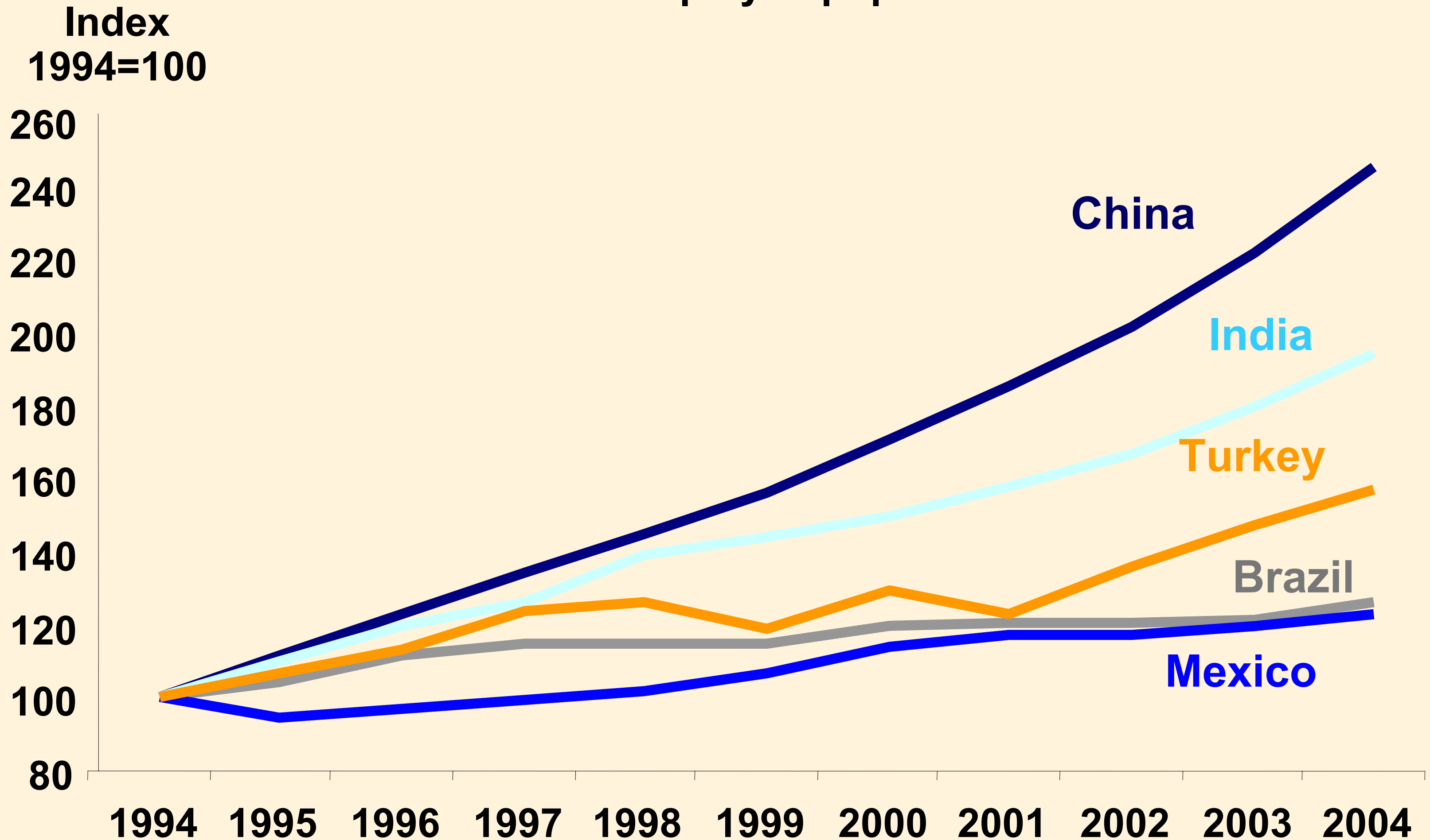

Source: Goldman Sachs based on BACEN

# Why does Brazil lag its peers?



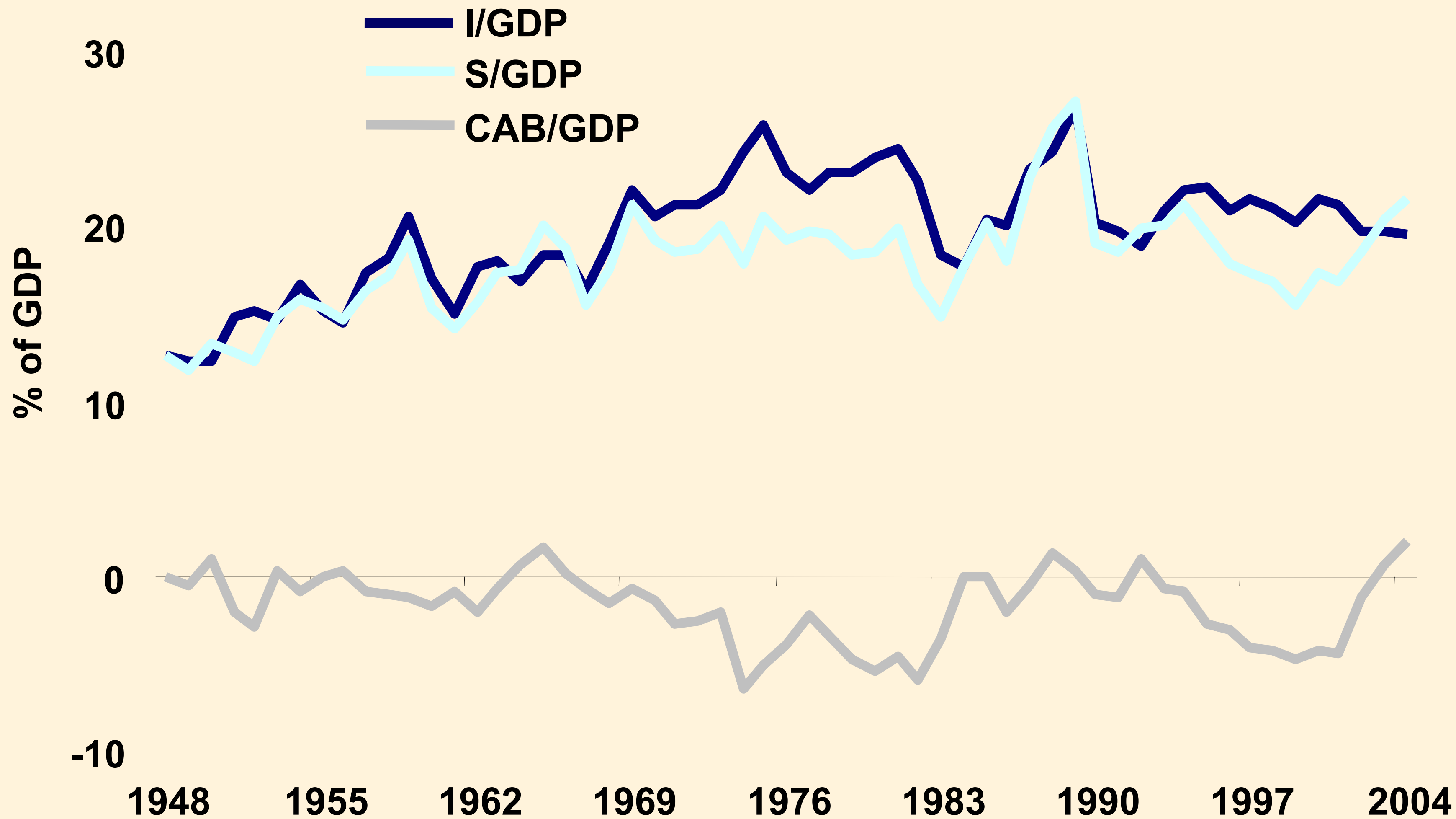

Source: Goldman Sachs.

# Brazil - Labor Productivity Lags



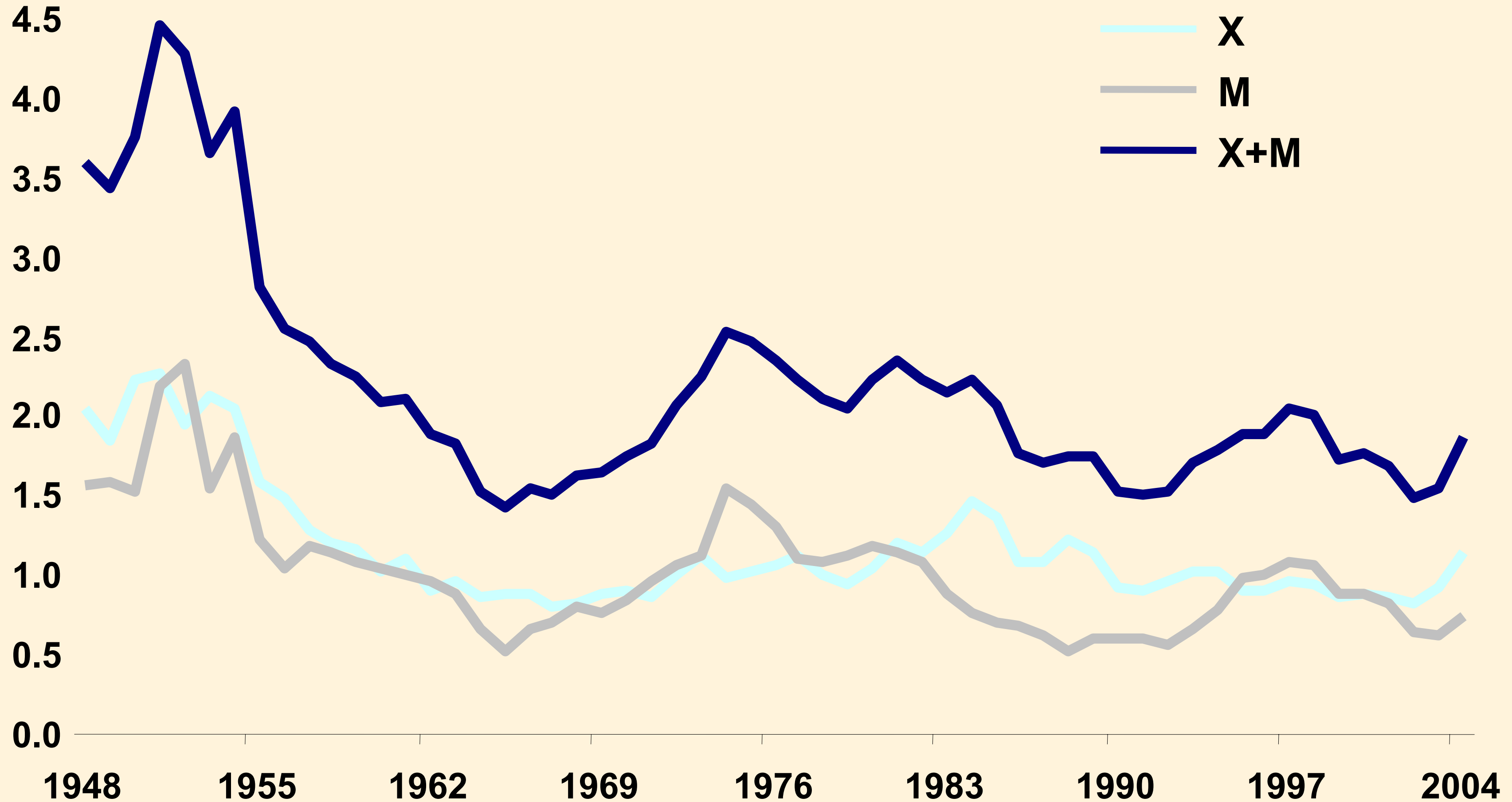

Source: Goldman Sachs based on IMF and ILO

# Investment is too low




Source: BACEN, IBRE.

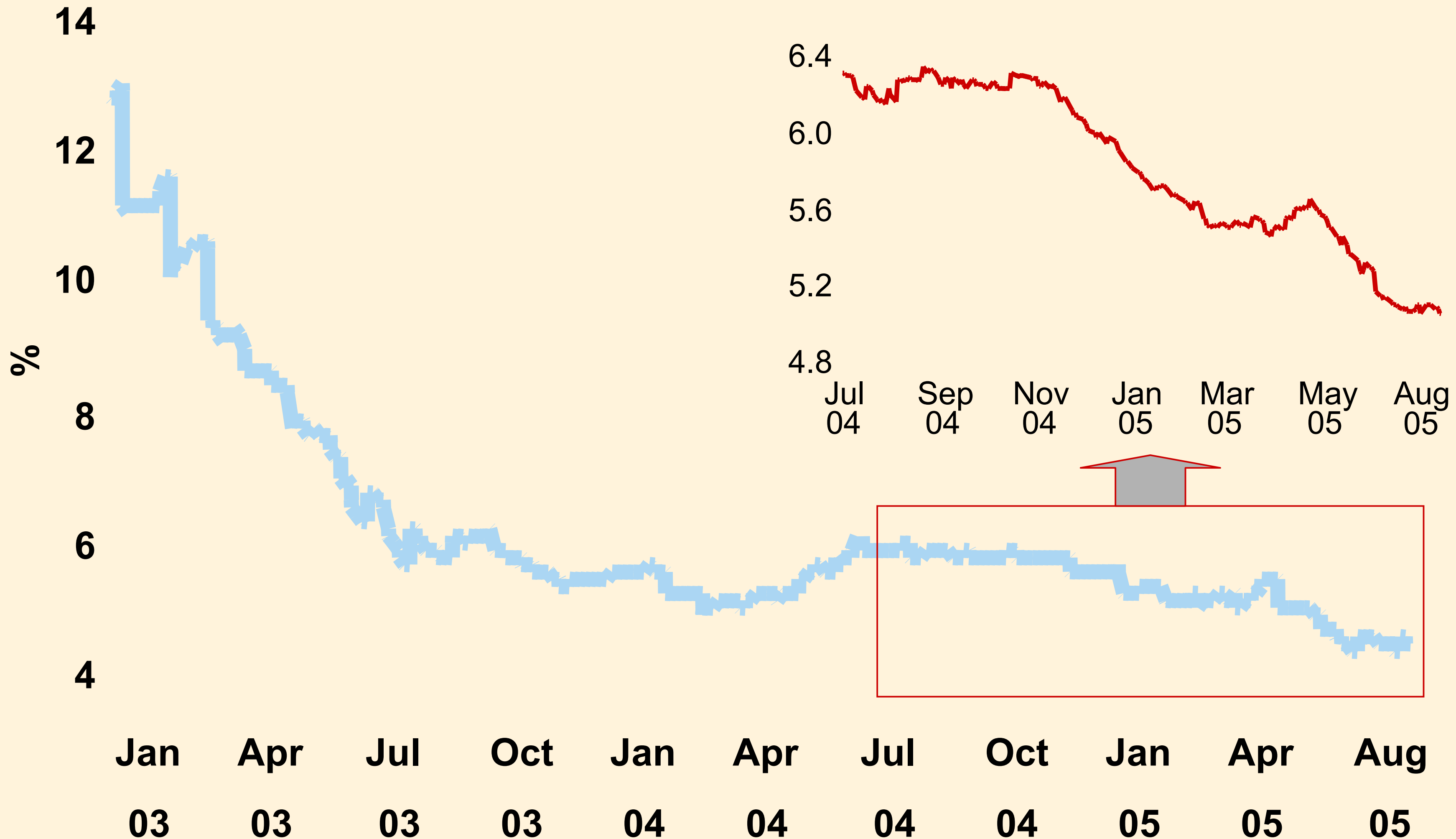
# It is alarming that Brazil's share of global trade is declining



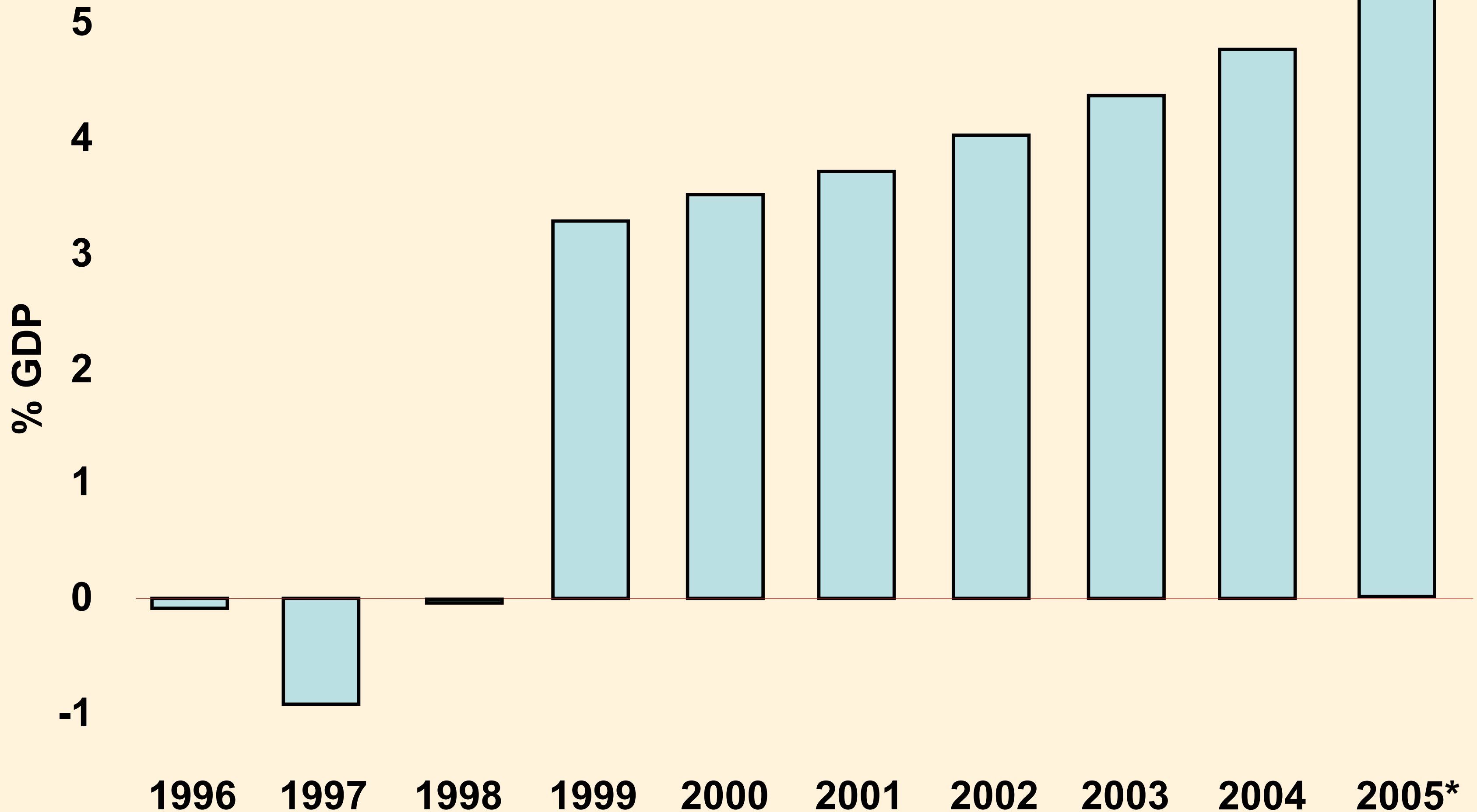

Source: BACEN.

Nevertheless, it must be acknowledged that Brazil continues to achieve enormous progress

# Inflation Expectations for next 12 Months

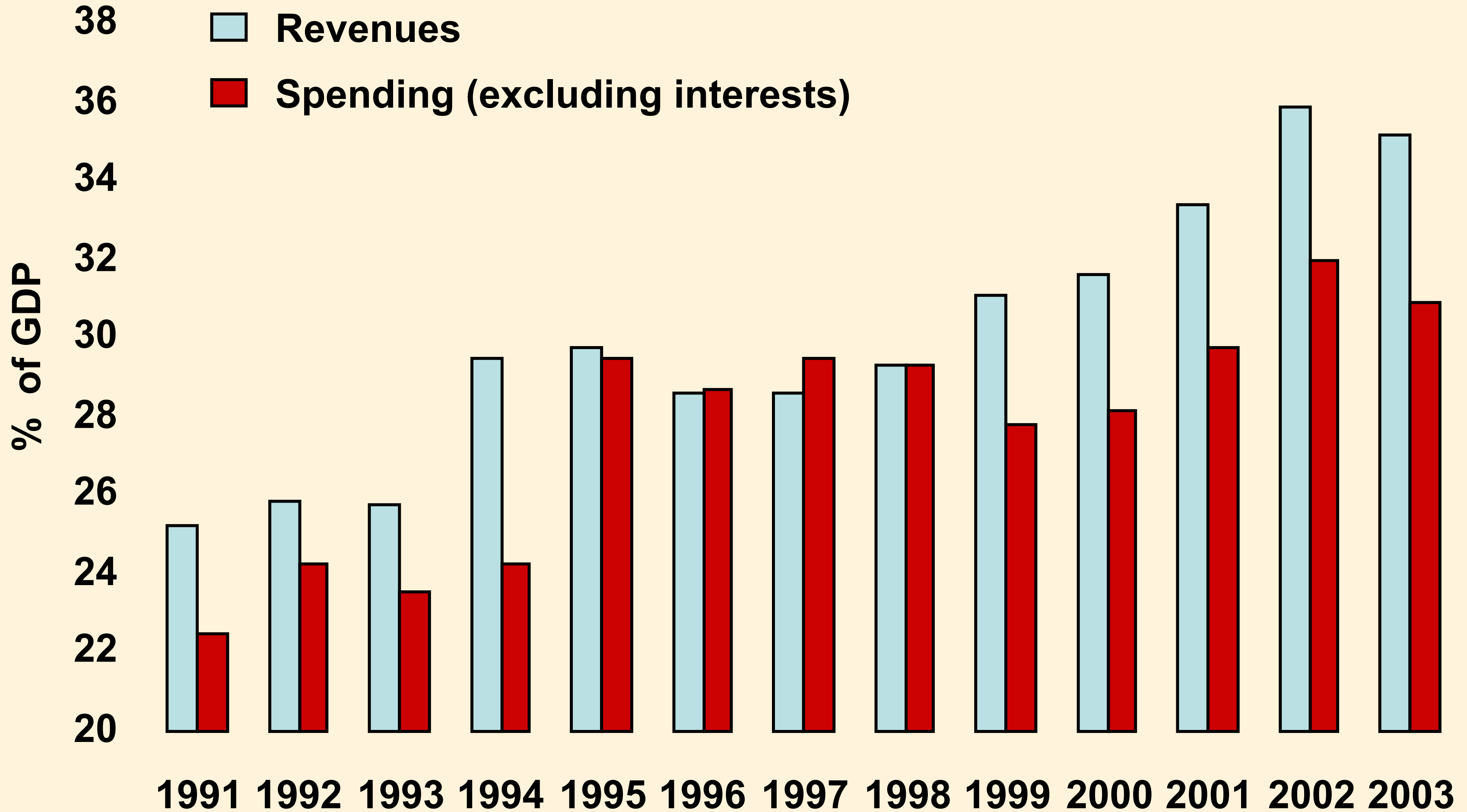


# Consolidated Public Sector Primary Surplus

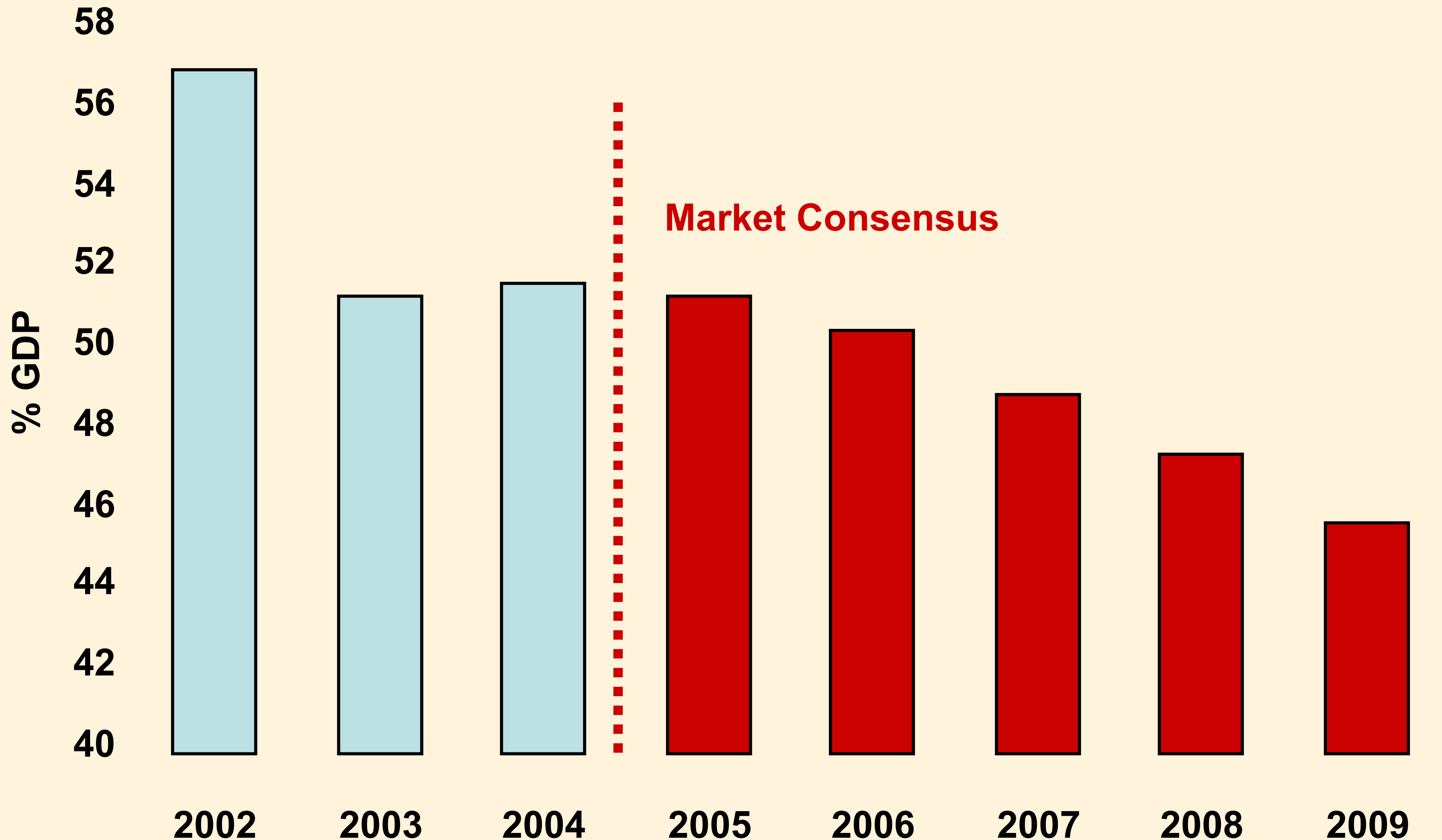



*** 12 months through June 2005**

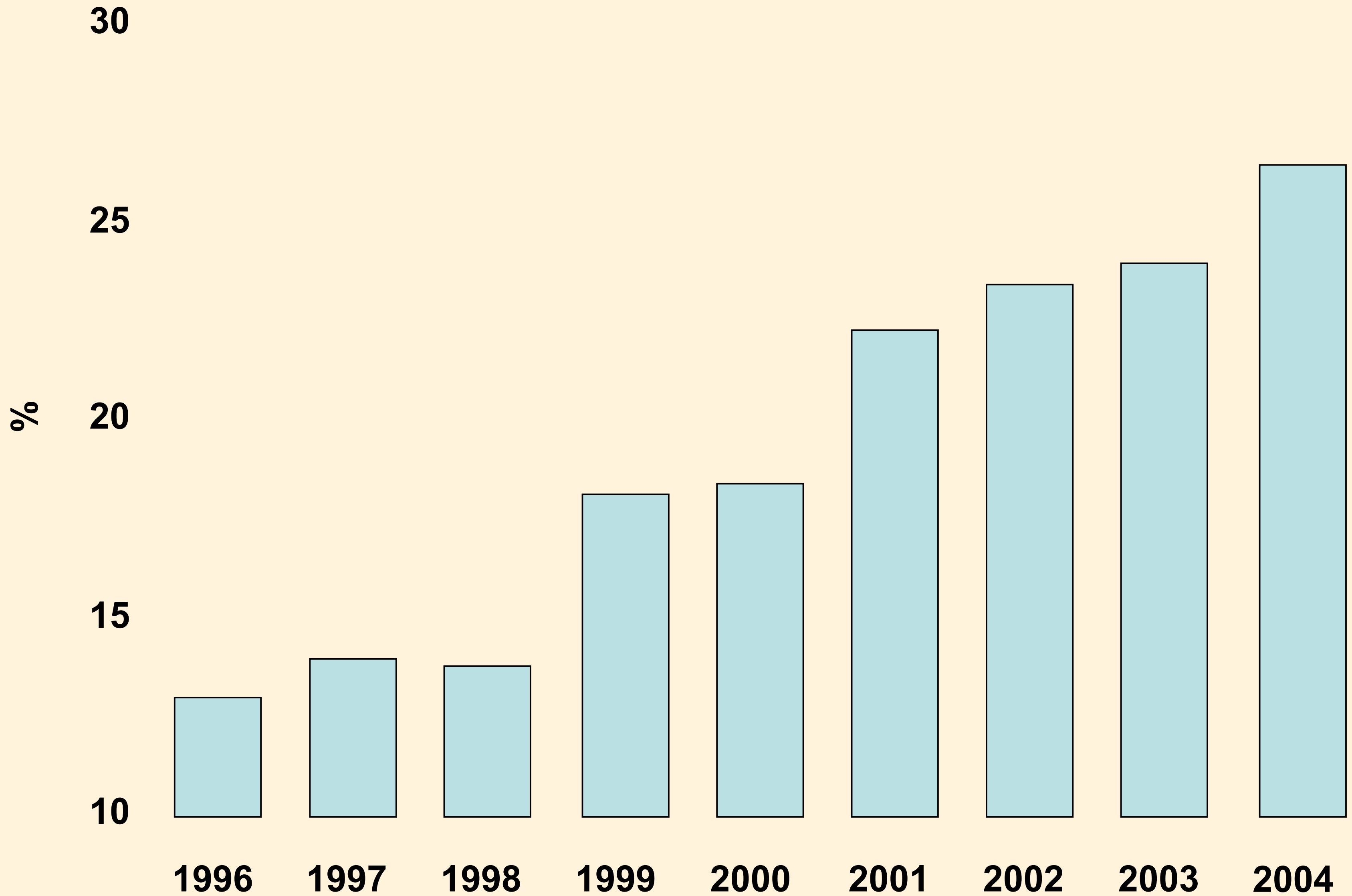
# Public Sector: Total Revenues and Primary Spending



# Market Expectations for Public Sector Net Debt/GDP Ratio

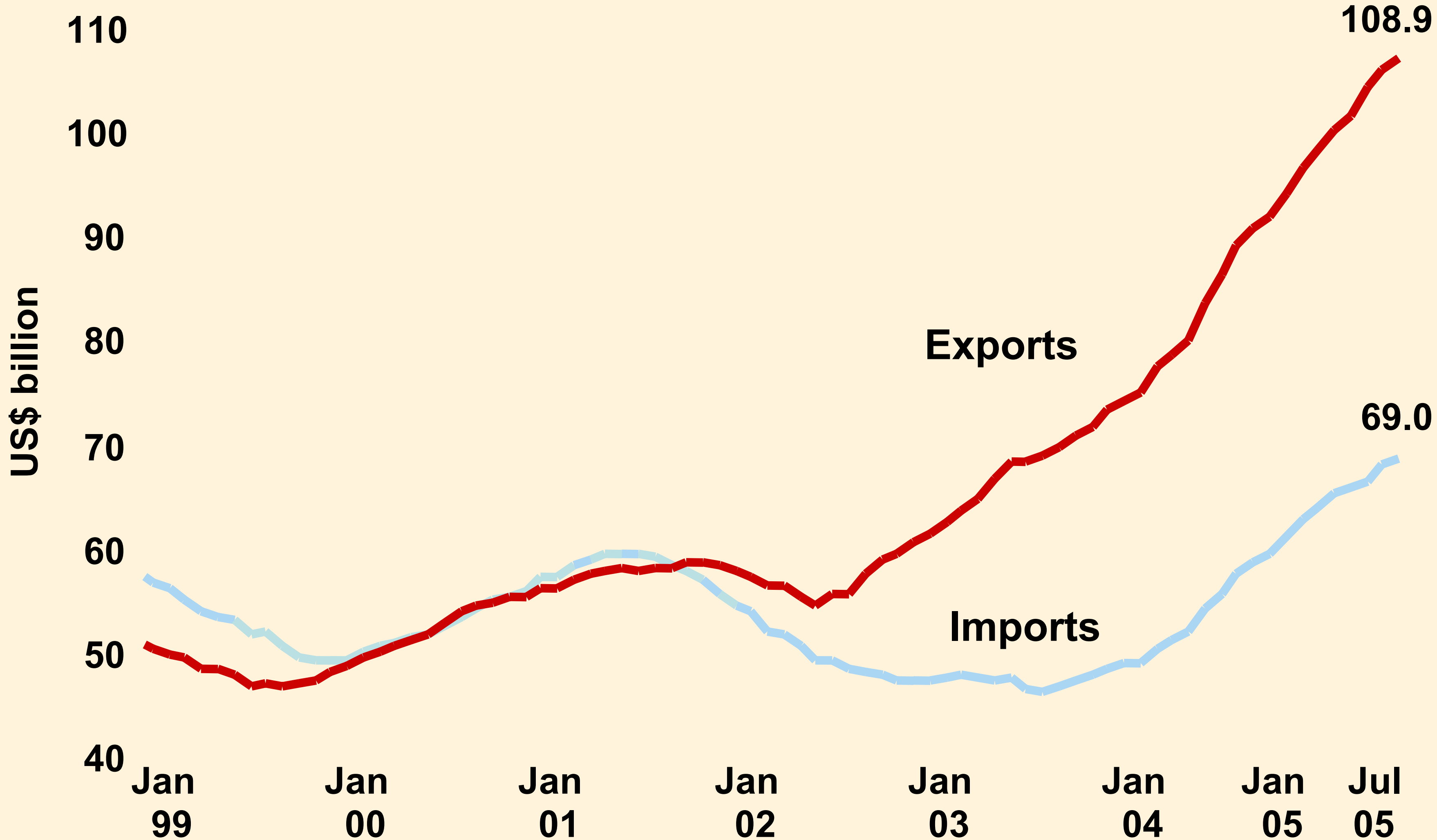


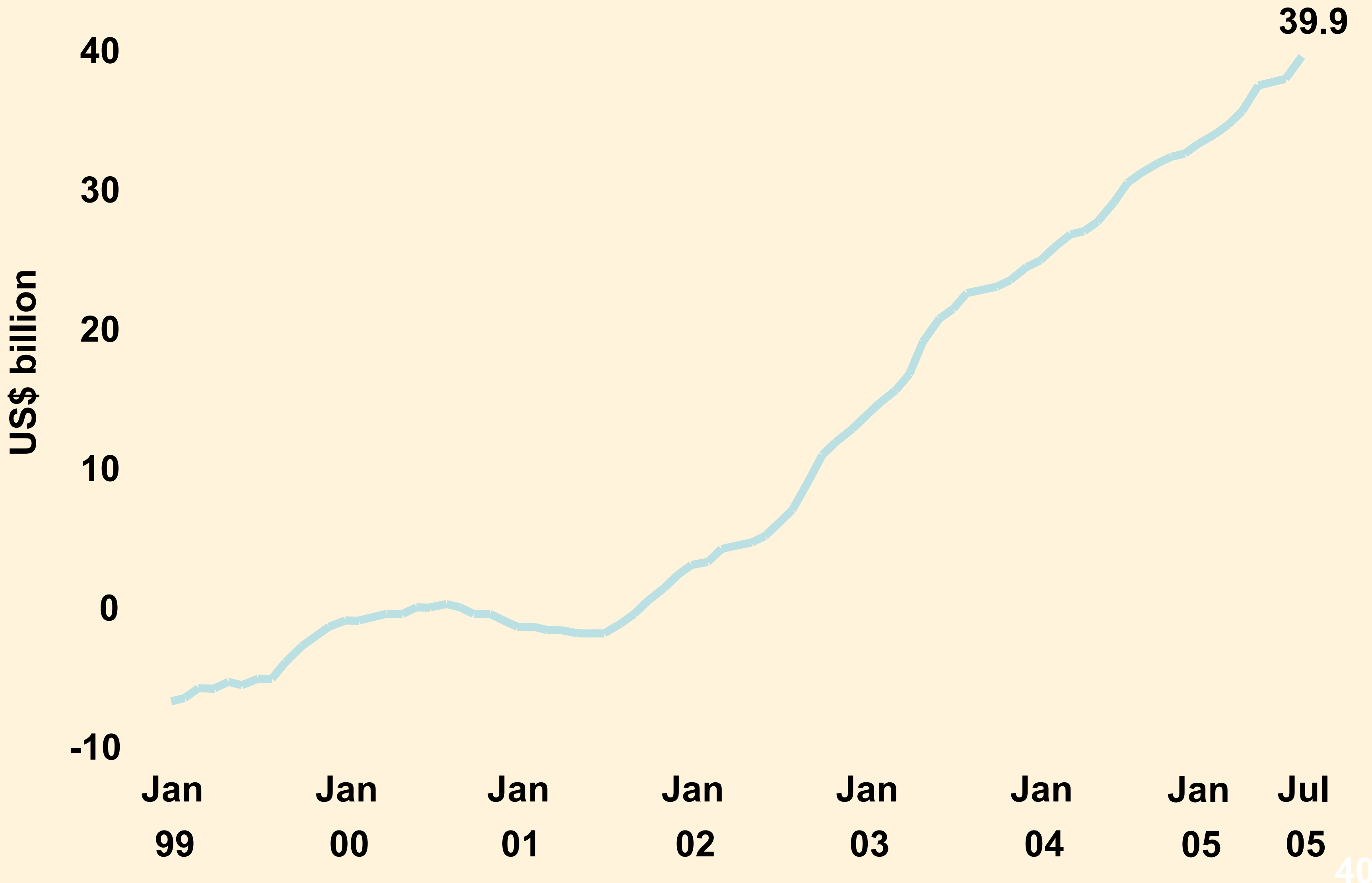
# Total External Trade/GDP



# Exports and Imports

## Accumulated in 12 months

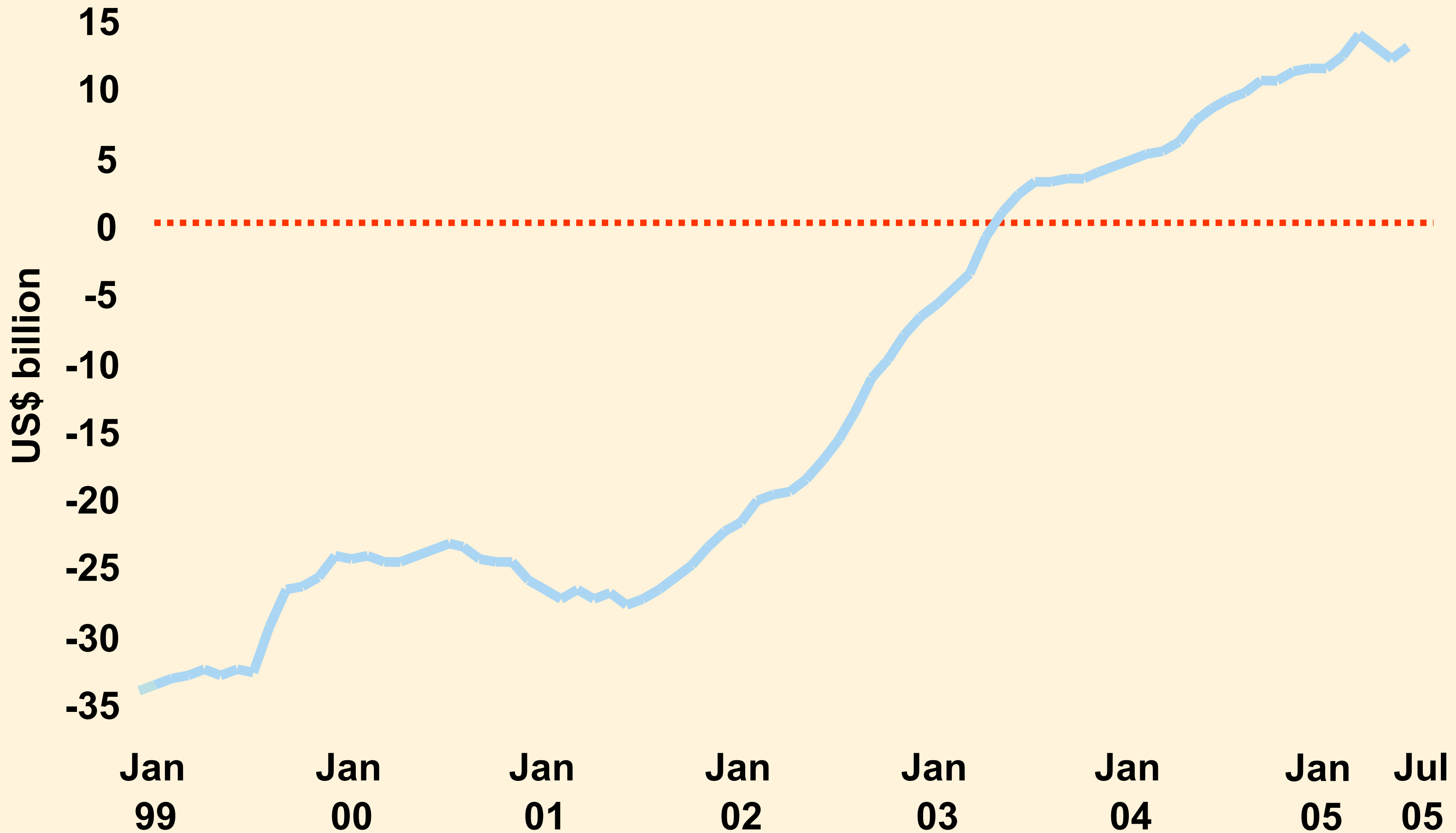




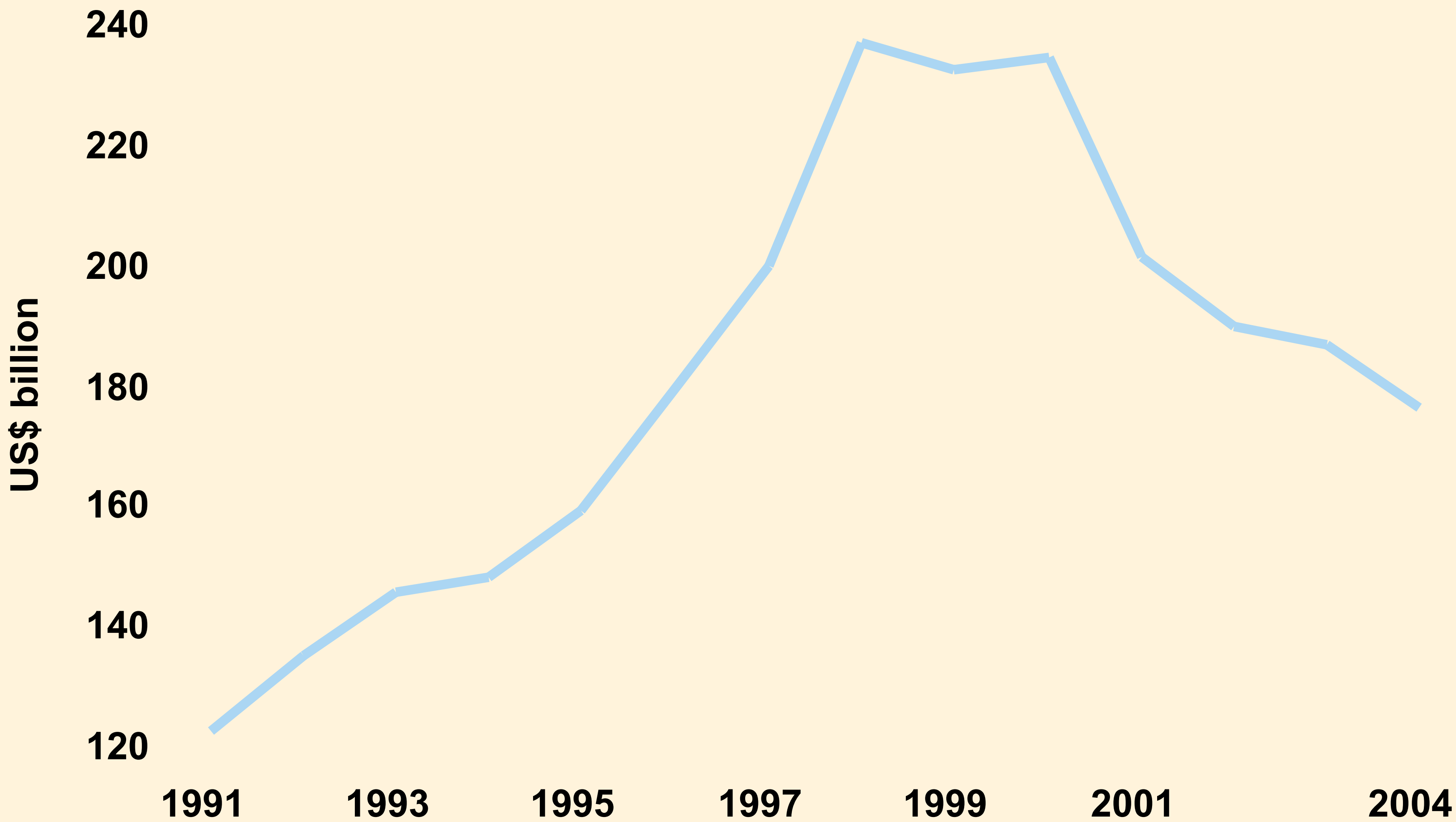
Trade Balance
Accumulated in 12 months
39.9
40
30
20
10
0
-10
US$ billion
Jan 99
Jan 00
Jan 01
Jan 02
Jan 03
Jan 04
Jan 05
Jul 05

# Current Account

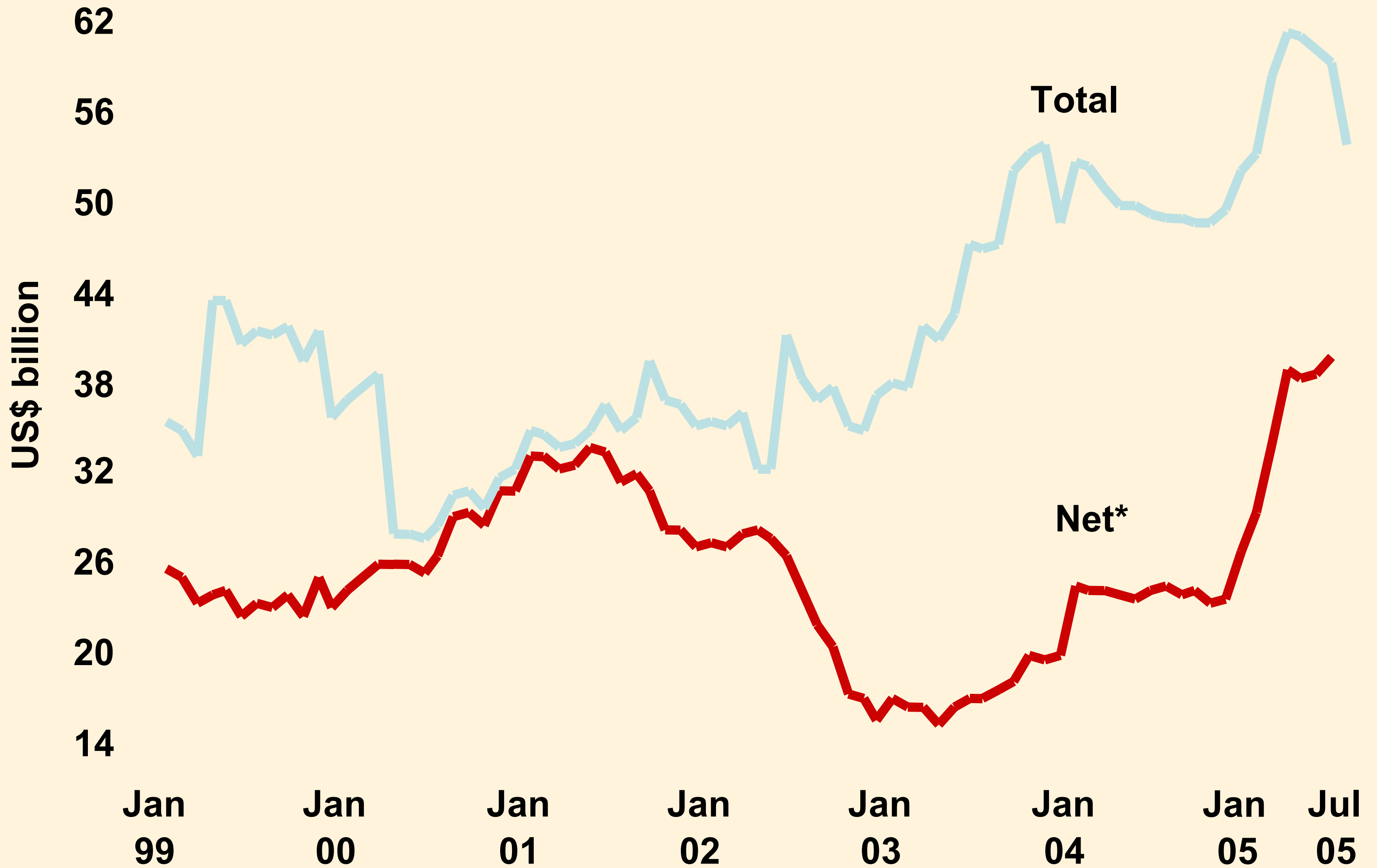
## Accumulated in 12 months



# External Debt (Excluding IMF Loans)

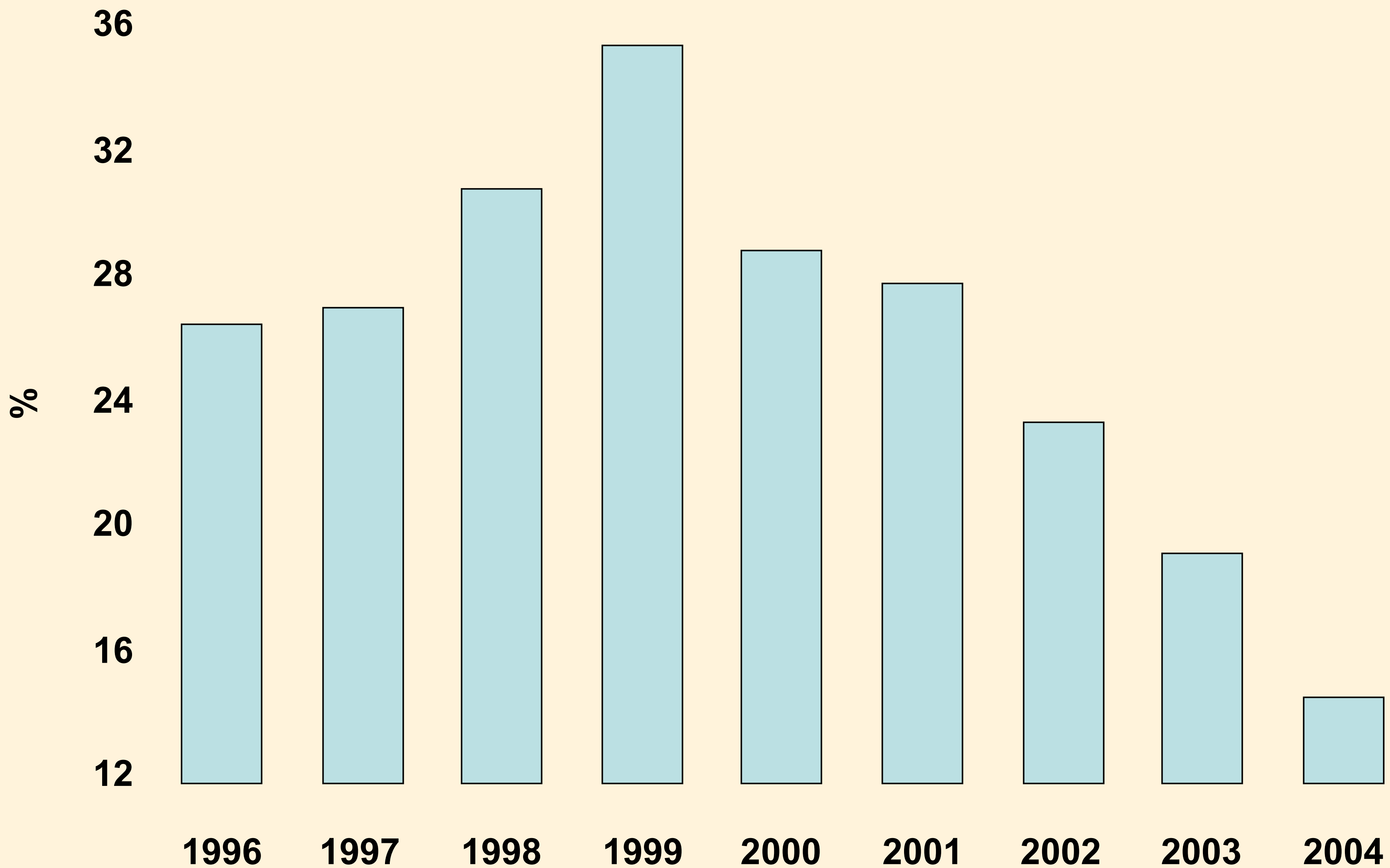


# International Reserves

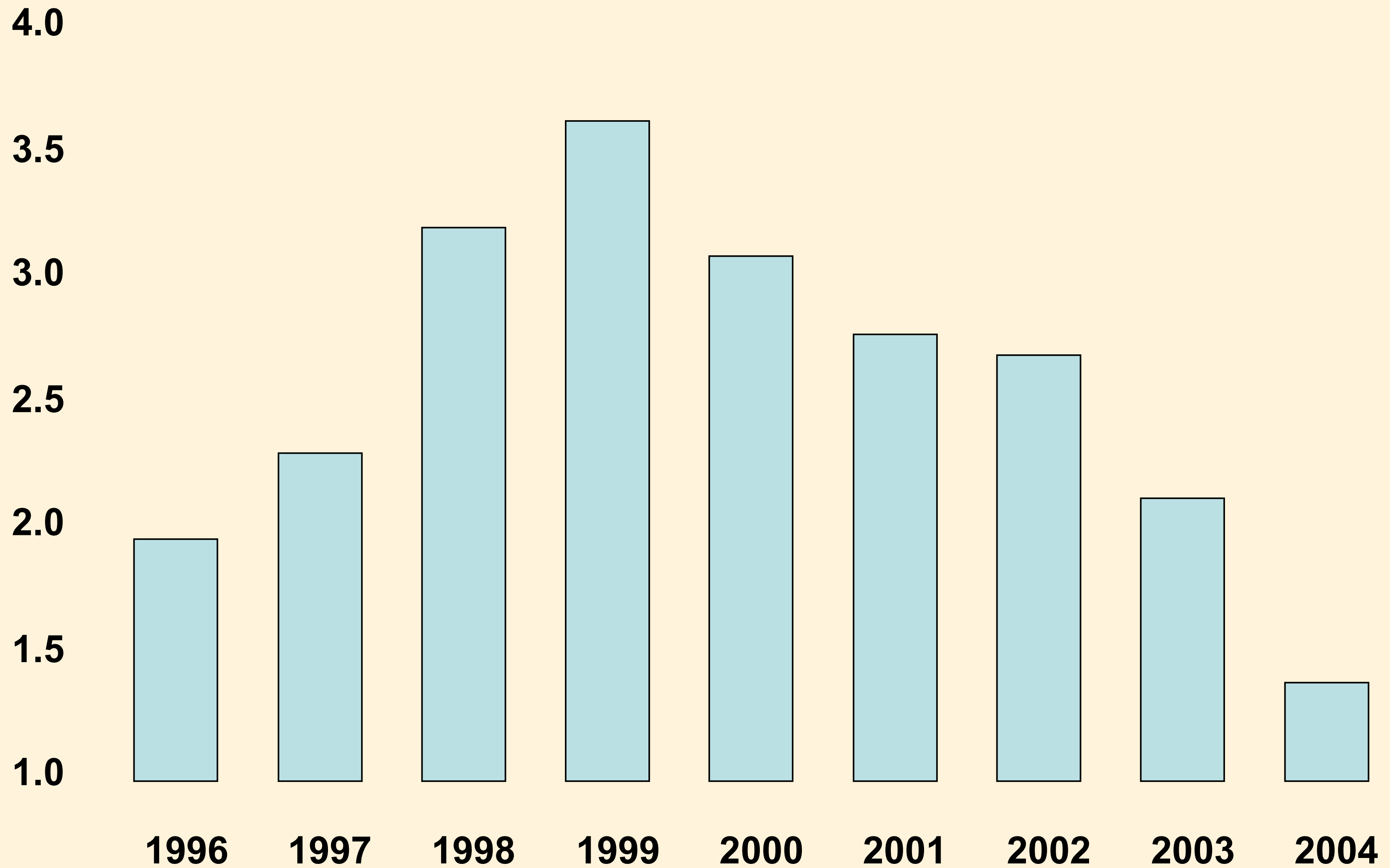



* Net of IMF Loans

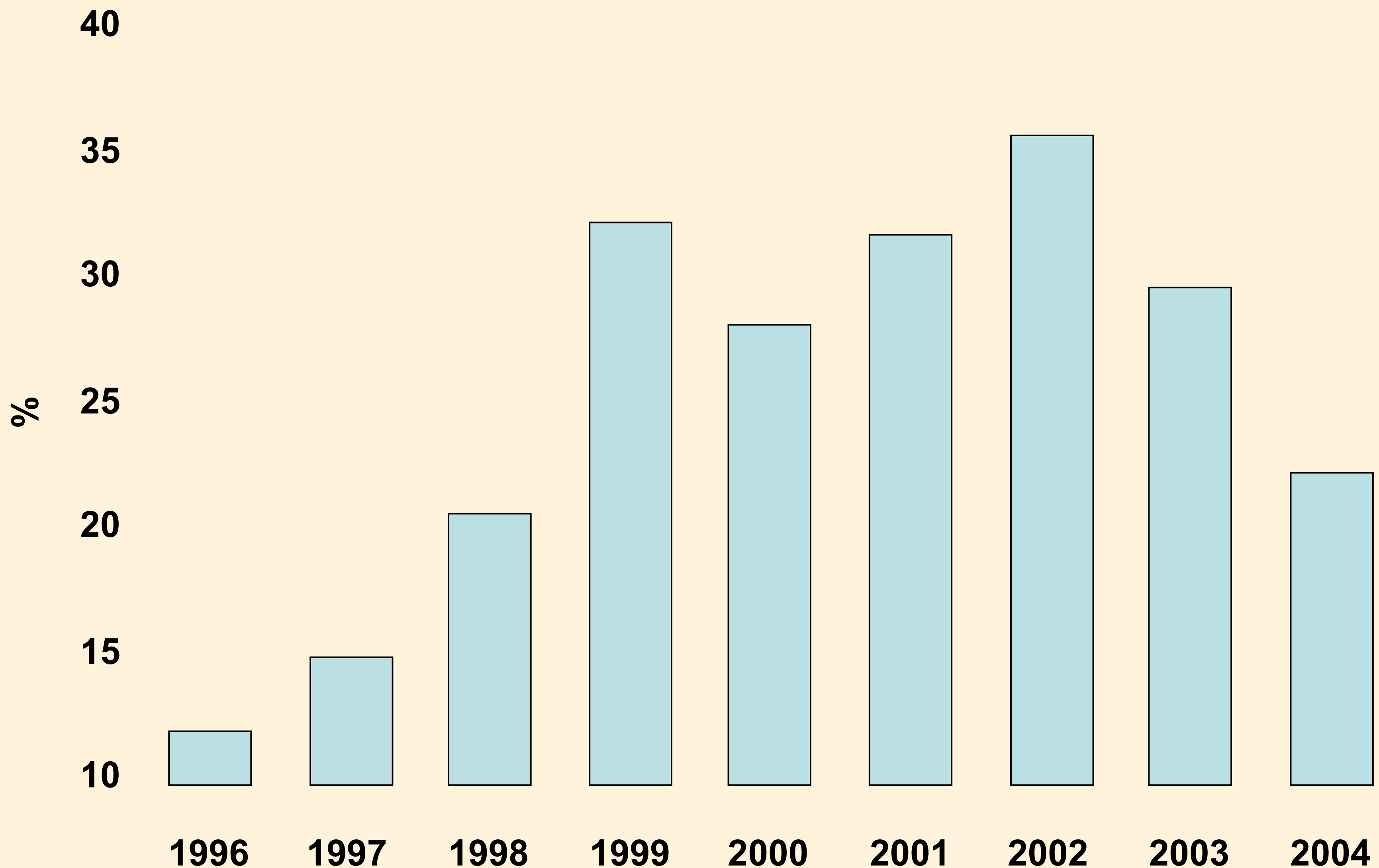
# Interest Payments/Exports



# Net External Debt/Exports



# Net External Debt/GDP



# So what is to be done?

# PICK THE LOW HANGING FRUIT

- **Central Bank independence is a no brainer for Brazil.**
  – little downside
  – clear potential credibility gain.
  – works everywhere it has been tried
  – essential to mute fiscal dominance

- Liberalize trade. Sharply reduce import tariffs and non-tarrif barriers. Among major emerging markets, Brazil is second only to India in its restrictions on imports.
- Despite significant liberalization, Brazil has not kept up with the rest of the world.

- Brazil suffers because today's complex global supply chains involve complex transhipping and multi-country production schemes.
- Consider that the typical Chinese export is composed of 70% intermediate imported goods, only 30% Chinese!! China would collapse with Brazil style tariffs.

# Other reforms to promote growth important to improve long-run debt dynamics

- Labor market reforms,
- Competition Policy
- Bankruptcy laws

REFORMS THAT RAISE LONG TERM GROWTH RATE WILL LOWER INTEREST RATES EVEN IF SHORT TERM GROWTH EFFECTS ARE MODEST

# Improve Public Debt Dynamics

- Brazil has first world tax rates with Third World government service

- Government size must adjust

# Conclusions

- Brazil's real interest rates have come down at a disappointingly slow pace, despite commited monetary policy
- Markets fear high debt levels, concern over long-term fiscal dominance.
- Reforms to improve growth, shrink government, would help lower real rates even if growth payoff is very long-term. Trade liberalization especially important.
- Failure to enthusiastically embrace central bank independence is a major tactical error.