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Brazil and Argentina: different economic challenges

Still relevant for the current debate on the world economy are the almost opposite ways in which Brazil and Argentina have come out of the foreign debt crisis at the beginning of the decade. Both economies have managed to build impressive primary surpluses. Yet Brazil managed to consolidate the framework of floating exchange rate and inflation targets by working with higher interest rates, while Argentina has abandoned its targets and has chosen to retain control of the nominal exchange rate within determined intervals and to slash real interest rates. After 2005, the Brazilian experience demonstrates clearly that its growth is constrained by production factor limitations rather than deficient aggregate demand. To accelerate long-term growth, Brazil needs to raise its domestic savings and introduce reforms to make the economy more efficient. In contrast, Argentina has worsened its medium-term growth prospects by resorting to populist measures. The return of dangerous levels of inflation jeopardizes the macroeconomic balance and calls urgently for policy adjustments. Today, doubts over the sustainability of Argentina's economic policy continue to grow.

Interview

Marcílio Marques Moreira, a diplomat and former finance minister, says that "today only one thing is certain about the crisis: its severity." "The previous crises were restricted to a given commodity or to a certain number of countries; this time the crisis is global." He believes the government is making a mistake by not preparing the country for the aftermath of the crisis, when the world will be much more competitive. He also criticizes those who claim to see the light at the end of the tunnel, because it is still not even clear that there is a tunnel to lead us out of the crisis. He thinks the government should convey confidence but warns against exaggeration: "Confidence, yes, but no illusion."

The G-20 and the crisis

Barry Eichengreen, professor of economics and political science at the University of California at Berkeley, maintains that one of the least expected but potentially most momentous consequences of the Great Global Credit Crisis of 2008 is that the G20 has seized power from the G7 as the steering committee for the world economy. In his opinion, "whether the task is developing ideas, reaching consensus on their desirability, or moving from ideas to implementation, the G20 — which has working groups active in all these areas — is where the action is. The G7 is dead. May it rest in peace."

The crisis and Brazilian executive compensation

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Marcílio Marques Moreira, former minister of finance, feels that the Brazilian government is making a mistake in adopting an economic policy that does not prepare the country for a much more competitive world after the crisis. According to Marques Moreira, who was finance minister between May 1991 and October 1992 in the Fernando Collor administration, “Brazil lacks a favorable business climate. Our regulatory framework is deficient.” In an exclusive interview with *The Brazilian Economy*, he emphasized that there is a serious credit tightening in the country because the banks are, at the most, renewing existing credit lines but they are not granting new credit. “Credit lines are being renegotiated at higher rates and shorter maturities,” he says. The scarce and more expensive money the minister refers to is the focal point of his interview in this edition.

Although the Central Bank announced a small increase in bank credit in January, Paulo Skaf, Chairman of the São Paulo State Industrial Federation (FIESP), argues that this apparent credit growth does not reflect the reality of the market. “To begin with, approximately 25% of the volume of credit, before the crisis, originated with the capital market and external borrowing. The companies have lost that source of financing and have therefore turned to traditional credit lines that are only available in the domestic market. Part of domestic credit growth, therefore, corresponds to replacement of external sources and the capital market.”

Another factor affecting credit growth, Skaf says, is that “many companies that had lost money in derivatives transactions have sold off their positions and, in an attempt to balance their position, have resorted to bank credit. But this does not mean increased credit for production. Furthermore, medium-size businesses are now orphans, as banks are now operating with much lower credit volumes. All these factors justify the complaints from the business sector, because the truth is that credit remains rather costly and scarce. This crisis has shown us that liquidity is not credit.”

Brazil and Argentina: different economic challenges

The Brazilian and the Argentine economies have for the past several decades followed paths that undoubtedly have shown many similarities. It is not difficult to establish a parallel between the common experiences of these two countries characterized by populist economic policies, hyperinflation, foreign debt default, fixed or semi-fixed exchange rate regimes, etc. The similarities often give rise to comparisons on both sides, and to an attempt to draw lessons from the achievements or failures of the neighboring country.

Despite the resemblance, however, recent decades have also shown fundamental differences in the economic histories of Brazil and Argentina. The currency board regime adopted by our southern neighbor, for instance, was a much more severe and inflexible fixed exchange rate option than the Brazilian experience, which was based on a semi-fixed exchange rate following the Real Plan. This difference in approaches to fighting hyperinflation since the end of the 1990s has brought about differences in economic performance.

Still more relevant for the current debate on the world economy are the almost totally opposite ways in which Brazil and Argentina came out of the foreign debt crisis at the beginning of this decade. Both economies have managed to build a path of impressive primary surpluses (cash surplus less interest); yet Brazil managed to consolidate its macroeconomic framework of floating exchange rate and inflation targets by working with high real interest rates. Argentina, on the other hand, has abandoned its targets and has chosen to retain the control of the nominal exchange rate within determined intervals and to slash real interest rates.

As is well-known, Argentina, with all its economic heterodoxy, has not fulfilled the gloomy growth predictions many economists have been making at least since 2002. After a 20% fall in GDP between 1999 and 2002, the country went through a period of high growth exceeding 8% a year. In contrast, inflation soared past 15%, perhaps even 20%, leading the government to ineffective price controls and the indecent practice of manipulating the price indices. In the area of regulating investment, particularly in infrastructure, the Argentineans created an institutional framework whose main feature is disregard for what has been contracted for.

This will certainly have serious effects in the future.

Domestic savings

The weaknesses of the "Argentine model" are obvious to most Brazilians. The violent global financial and economic crisis that exploded after the Lehman Brothers bankruptcy in September 2008 has only increased the risks to the future of the country. Even so, setting aside the most extravagant excesses of economic populism demonstrated by our neighbor, certain aspects of the Argentine performance are noteworthy. Take, for example, the recovery of domestic savings, whose high levels provoke envy in Brazil. At the peak of the crisis at the beginning of the decade, Argentine savings dropped to 14% of GDP but recovered to 27% by 2007 — an increase of more than 10 percentage points. On a more stable measure, savings went from an average of 15% of GDP from 1997 to 2001 to 24.3% between 2004 and 2007, an increase of 10 percentage points. In contrast, Brazilian domestic savings have been crawling along at between 16% and 18% of GDP since at least 2003.

This facts has led some economists to conclude that our neighbor made a better choice than us in adopting the regime of a controlled exchange rate and low interest rates as a way out of the crisis in 2001 and 2002. The Argentine example, once stripped of its populist excesses, may still contain some elements we can learn from.

To determine what can be learned from the Argentine experience, it is essential that we revisit our neighbor's economic history. Breaking away from the fixed exchange rate regime (currency board) at the end of 2001 with a significant devaluation of the exchange rate, followed by the default on foreign debt, represented a way out of the trap of the preceding years. After a fall in growth of more than 20%, which inevitably led to an underutilization of production factors, the economy recovered its breath in a more consistent way than foreseen by most critics (though it was true that the populist excesses that accompanied this process harbored the seed of new crises).

There are indications that the Keynesian investment phenomenon, determining its own savings, occurred in the Argentine recovery starting in 2002. However, this is only part of the story. It is important to note that the investment rate in the country jumped from an average of 15.4% of GDP between 2002 and 2004 to 22.1% between 2004 and 2007, followed by a 10 percentage point increase in savings as a proportion of GDP.

The post-2002 Argentine experience suggests that it is possible to come out of a depression period with underutilization of production factors the Keynesian way

Reforms

But there are other aspects of recent Argentine economic history that must be taken into account. The structural reforms (privatization, deregulation, Social Security reform) carried out by Domingo Cavallo, Minister of Finance, were profound. But the inconsistent macroeconomic regime (currency board and overvalued exchange rate) prematurely aborted the positive effects of the reforms. The departure from the Keynesian trap in 2002, in turn, brought about the possibility that those institutional reforms would bear fruit once more. In combination with the start of a period of high commodity prices in 2004, which benefited Argentina even more than Brazil, the good part of the Cavallo legacy lent extra oxygen to growth.

Furthermore, privatizations and reform of the individual accounts of the Social Security system, whose dismantling has just recently been decided, have also contributed to an increase of private savings, just as the default on foreign debt did. In this case, because the majority of the bond holders were Argentine citizens holding funds abroad, the default led to a natural restructuring of portfolios.

At the government level — similar to what occurred in Brazil at the end of the crises in 1999 and 2002 — an economic policy decision was made to increase public sector savings. Argentine domestic savings of 26.6% of GDP in 2007 was made up 25.1% of private savings and 1.6% of public savings. In 2004 and 2006 public savings peaked at 2.5% of GDP. In contrast, as the crisis culminated in 2001, the Argentine public sector showed negative savings of 6% of GDP. The recovery of the levels of public savings was also importantly related to the debt default, which reduced substantially interest payments on public debt. Although the default generated short-term benefits, it generated also long-term costs, such as the near shutdown of global capital markets to Argentina and the resulting increase in the spread of the country's bonds.

The "animal spirits" of the Brazilian business community were revived, and private investment increased. Nevertheless, private savings declined from 18.3% of GDP in 2003 to 14.2% in 2008, while the rates of domestic savings and investment remained unchanged

A last, positive element identified in the Argentine public sector in recent years is an increase in the export tax on agricultural commodities (*retenciones*), which has substantially increased tax revenues, helping explain improved public savings. Like the debt default, this formula carries long-term costs, such as discouraging investment in those sectors affected by the tax and raising the possibility of fiscal gaps if recurrent expenditures must be reduced when revenues vary in line with raw material prices. Needless to say, the recent fall in commodity prices has already had its effects on Argentina public accounts.

Argentina's Keynesian way out

In short, the post-2002 Argentine experience suggests that it is possible to come out of a period with underutilization of production factors the Keynesian way. For Argentina, currency devaluation and later a loose monetary policy were the levers that pulled the economy out of the mud. This led to a cycle of optimism that triggered a simultaneous rise in investments and savings, which in turn increased potential GDP growth. Part of the increase in private savings must be credited to abandonment of a bad Keynesian equilibrium; the rest is due to changes in the Social Security system, the debt default, and devaluation of the exchange rate. It must be said, too, that half the total increase in domestic savings must be credited simply to the increase in public savings, which in turn was powered by risky policies, such as the debt default and the *retenciones*.

To be sure, Argentina worsened its chances of success for the medium- and long-term by resorting to systematic populist diversions from the logic of its own model. The comeback of dangerous levels of inflation jeopardizes the macroeconomic balance and reveals the absence of adjustments: either public savings had to be increased to higher levels than what was actually achieved, to contain domestic demand; or the exchange rate and interest rate policy should have been different — less undervaluation in the first case, and higher real rates in the latter.

Today, doubts about the sustainability of the Kirchner economic policy continue to grow. Inflation has been reducing the real devaluation, and the Argentine exchange rate today is far less competitive, with the aggravating circumstance that the country has been virtually closed out of international financial markets as a consequence of the debt default. There is a risk, definitely not negligible, of a short-term shortage of foreign currency, which raises the specter of a new debt default. The roll back of the Social Security reform of the 1990s may reduce private savings. Lastly, the fall in commodity prices reduces *retenciones* revenue and will have a substantially negative impact on public savings.

Brazil

Even assuming that the Argentineans had flawlessly managed their post-2002 economic policy, the Keynesian impulse experienced in that country would not apply to Brazil. To justify this assertion, it is necessary to understand the conditions surrounding the Brazilian economic recovery after the difficult years from 2001 to 2003. High commodity prices and the maintenance of the macroeconomic model during the presidential transition of 2003 helped consolidate optimism about the economy and pushed up the return on investments, particularly after 2005. The "animal spirits" of the Brazilian business community were revived, and private investment increased.

Nevertheless, private savings declined from 18.3% of GDP in 2003 to 14.2% in 2008. The rates of domestic savings and investment leveled off, on a relatively mediocre level for an emerging economy, only because public savings increased. The public sector cannot be blamed for the fall in domestic savings because public savings went from a negative 2% of GDP to a positive 3% between 2005 and 2008.

In other words, and in contrast to what we saw in Argentina, Brazil had not fallen into the trap of underutilization of production factors before the recovery in 2005, although there was some idle capacity, particularly in 2001–02. The path to recovery was more classical than Keynesian. The increase in autonomous spending, notably the hike in private investment, put pressure on scarce resources, which led to exchange rate appreciation — which in turn matched excess demand with external supply. This was possible because of the growth in exports during that boom period.

Some claim that the appreciation in the exchange rate at that time was a consequence of high interest rates. However, in fact there was a fall in real interest rates: between mid-2005 and the beginning of 2008 the real interest rate fell by almost half, from about 13% to just over 7% a year. The Central Bank increased Brazil's international reserves and maintained the nominal valuation of the real. Finally, the international crisis, and the resulting collapse of credit and investor and consumer confidence, dried up demand, helping the Central Bank to contain inflation. But a price was paid in terms of lower economic activity, employment, and welfare.

The post-2005 Brazilian experience makes it clear that growth is constrained by a limited supply of production factors rather than by structurally deficient aggregate demand. The Argentine example thus provides nothing with which to address the Brazilian challenge. To accelerate potential long-term growth, our task will continue to be to build up savings and introduce reforms to render our economy more efficient.

March 2009

"Confidence, yes, but no illusion"

Marcílio Marques Moreira

Former Finance Minister

Ernesto Borges, from Rio de Janeiro

The current economic crisis cannot be compared to those in the 1980s or 1990s or to other international economic crises at the outset of the 21st century. According to Marcílio Marques Moreira, a diplomat, former finance minister between May 1991 and October 1992, and member of the Board of the Getulio Vargas Foundation, today only one thing is certain about the crisis: its severity. "The previous crises were restricted to a given commodity or to a certain number of countries; this time the crisis is global." He believes the government is making a mistake by not preparing the country for the aftermath of the crisis, when the world will be much more competitive. "Brazil lacks a favorable business climate. Our regulatory framework is deficient," he states. He also criticizes those who claim to see the light at the end of the tunnel, because it is still not even clear that there is a tunnel to lead us out of the crisis. "The United States will recover more rapidly than other countries. Its economy is enormously flexible and responsive," he says. The former minister thinks that the government should convey confidence, but he warns against exaggeration: "Confidence, yes, but no illusion."

***The Brazilian Economy* — What makes the current international crisis different from previous crises that have affected Brazil — such as two oil shocks, the Asian crisis, and more recently the latest liquidity crisis in international markets?**

Marcílio Marques Moreira — What makes this crisis different is that the previous crises were restricted to one commodity, oil, or to certain countries, as in the case of the debt crisis; this time we are facing the first really global crisis. It is restricted neither to any single country nor to any single sector, although it obviously unfolds in different ways in different sectors and countries. As a phenomenon, however, it is truly global. I would go as far as to call it a holistic crisis. The only certainty we have as it unfolds is its severity. Uncertainty prevails, as Frank Knight[1] defined it in the 1930s. He set out a distinction between risk and uncertainty: risk is a calculable probability, which can be dealt with by insurance, hedging, or other measures. Uncertainty, on the other hand, is something totally open — something that constantly surprises us.

At the outset of the crisis, and even today, when its effects are becoming more clear, it was said that Brazil would not be hit hard because of its solid economic fundamentals; however, as time goes by, the pain increases. To what extent will the Brazilian economy suffer?

Here again the uncertainty equation is valid. Indeed, Brazil has certain positive characteristics, particularly a macroeconomic policy

Foto: Americo Vermelho

implemented consistently for almost two decades, that provides the basis for dealing with this crisis differently from the way we handled previous crises. It is quite difficult to predict whether we are going to suffer less and, above all, how hard we are going to be hit, as those processes are very hard to assess. Generally speaking, the same was said about countries such as China. Two years ago, when it all started, the uncoupling theory contended that the US would be hit hardest, but the fall in American production would be offset by Europe and Japan. Today we see that the Europeans and the Japanese have experienced a larger fall in production than the US. Today one hypothesis is that the US may be the country to recover first and more vigorously. I am certain it will recover before the European countries.

Despite serious problems with the automotive industry and the lack of credit, the world continues to buy US bonds. Is that what will help them to recover more quickly?
It may be one of the reasons, but it is not the only one. The main reason is the flexibility and the agility the American economy has shown repeatedly in the past. It is highly flexible and agile; thus, I think that the country will be able to respond more consistently — once confidence is restored, obviously. Confidence is a critical factor in the present crisis, and lack of it severely reduces credit. Credit is almost synonymous with credibility; and credibility has been shaken. All one can expect from the stimulus package approved by the American Congress is that it will be a sort of Cape of Good Hope that, once passed, will signal the start of recovery.

What is your view of the package proposed by the Obama administration?
The package was unavoidable. Granted, in times of crisis it is extremely difficult to put together the ideal package, and above all to persuade such a complex Congress, people with very different interests, to approve the package. Notwithstanding, I would say that the package is on the right track because it seeks to counter the crisis with instruments that will prepare the economy for the post-crisis period. This is one of the reasons why the US has the potential to come out of this crisis relatively well. It invests in education, in information technology, in upgrading infrastructure — all with the intent of preparing the country for the aftermath of the crisis. This is precisely what astonishes and distresses me in the case of Brazil, for I cannot see a vision of a country capable of facing a world after the crisis, where conditions will be more somber and much more competitive.

How do you assess the measures being taken by the Brazilian government to mitigate the effects of the crisis, and what measures would you suggest to prepare the country for the world after the crisis?
Many of the measures are on the right track, but as far as I can see a strategy is lacking. The same is true, by the way, of the PAC (Growth Acceleration Program), which can be said to be a topical and inarticulate initiative. It is the sum of parts rather than a holistic program. Thus, if there is a problem with the automotive industry, you come to its rescue, disregarding the fact that the industry is actually a chain that needs to be

Confidence is a critical factor in the present crisis, and lack of it severely reduces credit. Credit is almost synonymous with credibility; and credibility has been shaken addressed as a whole. Had you looked more carefully at this chain, you would have noticed that the first link to fail was the second-hand-car segment. This market segment came to a halt before the new car market. The climax of this topic approach is the idea that the worker who loses his job in a hard-hit industry will be treated differently from a worker who also lost his job, but in an industry not as severely hit. It does not make sense. It is incoherent. It shows a lack of a vision of the future, which requires an open, wide-angle lens.

At present, international reserves are a buffer, ensuring some comfort over the next couple of years; however, that is not a solid base over the medium and long run

Brazil went through a critical period late last year that included tighter credit and mass dismissals. Do you believe that confidence was as shaken here as in the US?
The confidence factor has been much less decisive in Brazil, although it is a concern. This reflects the administration's great effort to minimize the extent and severity of the crisis. Obviously, I think the government should not spread panic but rather instill confidence. But if this is carried to an extreme — when we all are aware of a global crisis of this magnitude, and know that a country like Brazil has benefited from globalization and cannot evade the crisis — I think it may create frustration in the future and a serious lack of confidence that can aggravate the effects of the crisis. I am quite concerned with the fact that ministers are saying that we will begin to see the light at the end of the tunnel from March on. That is absolutely unrealistic. To be able to see the light at the end of the tunnel, first there must be a tunnel.

Lately, there has been a lot of speculation about a liquidity tightening. If the situation deteriorates, how could that affect the country? Is international liquidity getting back to normal?
Absolutely not. What happened was an attempt to conceal the situation to some extent. All you have to do is to talk to any businessman in Brazil, small, medium, or large. Banks are only renewing existing credit lines, they are not granting new credit. Credit lines are being renegotiated at higher rates and shorter maturities.

What is the major limitation? The major limiting factor in Brazil is low savings. When there is no external savings inflow, private savings are very small, and the government is not saving enough, no rabbit can come out of the hat, because there is neither a rabbit nor a hat! Therefore it is impossible internally to restore earlier credit levels. That is because it was not only credit that disappeared: investment in the Stock Exchange, in government bonds, in fixed-rate bonds also disappeared. At the same time, the corporations anticipated the payments of dividends. They took advantage of a very strong real, which gave them a very comfortable position; therefore, a lot of money flowed out as inflows ceased. Today there is talk of a downturn in the flow of foreign direct investment (FDI). This is something that takes a little longer to notice, but there is every indication that FDI will be much lower.

What, then, could be done to prepare Brazil? One of the objectives could be to introduce a fiscal system that encourages savings. We have had many different taxes — thank God, we no longer have the tax on financial transactions, which punished both savings and investment. Even fixed-rate investments, after deduction of tax on financial operations and income tax, ended up not yielding much.

Foto: crédito das fotos

This is a very relevant limiting factor.

Another important factor is the disinvestment in infrastructure, because it is not enough to say that there was a lack of investment: there was actually disinvestment. Roads, for example, have deteriorated geometrically, and potholes reproduce like a family of rabbits. This is yet another factor limiting the country's future growth.

Last year, before the crisis hit Brazil hard, there was an enormous concern over the external accounts. Is this issue aggravated by the crisis? Do our international reserves inspire confidence?

At present, international reserves are a buffer, ensuring some comfort over the next couple of years; however, that is not a solid base over the medium and long run. We are being affected precisely in those areas where we were most vulnerable. Namely, the current account balance deficit is highly negative, and the trade surplus is falling sharply. Despite having sound reserves as a buffer, I am not comfortable that external flows are negative, reflecting the absence of savings. The only way to import anything today is through financing.

In any event, we need to work on improving our competitiveness. It is a more competitive world. For example, the price of steel has dropped, but domestic producers are complaining and expect Vale or Petrobras corporations to purchase steel at prices 60% higher than those on the international market. Moreover, we have totally stopped the process of structural reforms and strengthening the microeconomic framework. In this respect we are way behind, we are certainly not better than the rest, we are in fact even worse off than China.

Brazil lacks a favorable business climate. There are enormous bottlenecks because the microeconomic framework is volatile and unpredictable. The regulatory agencies — which should bear the responsibility for a state, rather than a government, policy, and for ensuring the tranquility and confidence of investors — have not been sufficiently strengthened to play that role.

What is your view on this new wave of protectionism brought about by the economic crisis? Several countries, including the US, China, France, and Argentina, have already announced this type of measure. Can that affect Brazil?

It is an unavoidable temptation. Today, there is understanding that this is precisely what should be avoided. Protectionism was responsible for deepening the depression in the 1930s. In China, for example, exports have dropped significantly, but imports dropped yet more drastically, over 40%.

If this trend is confirmed, do you think that Brazil will have to become more protectionists?

In my opinion, that should be avoided; however, the issue is complex. Some segments linked to the manufacturing industry have already asked for something that was revoked, namely licenses for Chinese products. What will the Chinese do? They will reduce their prices even more; it is a question of survival. For us this combination of protectionism and improved competitiveness is difficult to solve, precisely because the private sector in Brazil has made an effort to modernize. However, efficiency stops at

The financial crisis begins to show some signs of stabilizing, but the economic crisis deepens. It is highly unlikely that we will see any recovery in 2009 the factory gates. When the product hits the road, potholes and general poor road conditions are the rule. The ports remain extremely expensive. What we call the "Brazil cost" is very high. The little breathing room to be found is in São Paulo State, where roads are decent, at least the state-level network. Public policies are inconsistent. Our main vulnerability is therefore the Brazil cost. This is where I do not see any great effort to solve the problem.

Another characteristic of the reaction to this crisis is the increased intervention of the state in the economy. That is happening even in the US. Is this a temporary trend?

This is an additional medium-term risk of the measures taken to deal with short-term risks, but it is essential that the prominent presence of the state in the economy not be perpetuated. I do not believe it will be in most countries, but I think that we will still witness this type of measure in the next few months.

At the outset of the crisis it was said that the developing countries, particularly the BRIC countries (Brazil, Russia, India and China) would not be hit as severely. Now, many people have changed their view.

China will be one of the countries that will suffer most. No, it will not have a recession, but its GDP growth is dropping from 13% to 7% a year. That is a fall of 6 percentage points, larger than that of the United States, which grew at a rate of 3%, and now is growing at 1%. Brazil will also suffer a lot. The country grew 5% in 2008, and this year growth will hardly reach 2%. When you are driving at 80 miles per hour and then come down to 20 miles per hour, the shock is tremendous — like hitting a wall.

Do you think the crisis will be over in 2009, or do you think it will extend on to 2010?

Nearly all the most attentive and balanced observers tend to agree that the closest date is 2010; before that a recovery will be very difficult. In some respects the financial crisis begins to show some signs of stabilizing but the economic crisis deepens. There is a time gap, so it is highly unlikely that we will see any recovery in 2009. By arriving late for the party, this great boom of the globalized economy, Brazil has certain advantages. We have not had the time to acquire certain vices, mostly because we are a more closed economy and less developed particularly with regard to credit. Real estate credit in Brazil is only two years old.

In this respect, even if that was not the intent, the PROER (Stimulus Program for Restructuring and Strengthening on the National Financial System) has prepared us for the crisis. By accumulating reserves, we prepared for the last crisis, but this gives some degree of comfort now. This volume of reserves, approximately US$200 billion, is a buffer, but not armor. It is nonsense to claim that Brazil will be spared because of its reserves. China also has reserves, and it is suffering; the same is true for Russia. I believe it is important that the government convey confidence, but not illusion. That would be dangerous.

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[1] Economist, co-founder of the Chicago School.

The G-20 and the crisis

Barry Eichengreen

One of the least expected but potentially most momentous consequences of the Great Global Credit Crisis of 2008 is the coup staged by the Group of Twenty. The G20 has seized power from the G7/8 as the steering committee for the world economy.[1] If you did not realize this before, just compare the attention that was directed at the G20 summit last November with the muted response to the G7 finance ministers meeting in February in Rome. No one who contemplates reform of global financial markets thinks that such a task can be organized, much less executed, within the cozy confines of the G7. No one who seeks to reform the IMF and the World Bank thinks that the solution can be hashed out by the G7. No one who is serious about coordinating a global monetary and fiscal response to the deepest recession since World War II thinks that this is something the G7 can engineer. Whether the task is developing ideas, reaching consensus on their desirability, or moving from ideas to implementation, the G20 — which has working groups active in all these areas — is where the action is. The G7 is dead. May it rest in peace.

Unwieldy group

This is not to suggest that the G20 is without problems. First, it is a more unwieldy group than the G7. Twenty is an awkwardly large number for a conference call. This makes the G20 ill-suited for putting out fires. It is not a reliable mechanism for marshaling an urgent response over a weekend before markets reopen in Asia on Monday morning. For this there is still a need for smaller groupings, though presumably with a different composition than the historical G7/8.

Second, there is the issue of legitimacy. Who, in other words, appointed the G20 to represent the 190 countries of the world? Where is the international agreement or treaty describing selection and rotation mechanisms? What about countries that are left out — ASEAN members that do not consider it obvious that they should be represented by Indonesia, for example? (Thailand, for instance, has a larger GDP, whether measured by market exchange rates or purchasing power parity.) Where is Iran, which is a larger economy than Argentina?

Third, there is the tension, most notably in connection with International Monetary Fund (IMF) reform, and the International Monetary and Financial Committee (IMFC). The IMFC has 24 members, not 20. Most but not all of those 24 members represent groups of countries, known as constituencies. The IMFC is constitutionally empowered by the IMF's Articles of Agreement to make decisions about the strategies and policy priorities of the Fund. This, of course, is something to which the G20 aspires. Presented with competing recommendations from these two bodies, to which should the global community listen?

Fourth, the G20 has organized its work program into four silos:

The key problem facing the G20 and the world economy is how to rebalance demand, provide support for global growth, and prevent the recurrence of crises, all at the same time

strengthening financial supervision and regulation, fostering international cooperation in regulating financial markets, reforming the IMF, and strengthening the World Bank and other multilateral development banks. This organization is not optimal. The four areas are connected: optimal policy reforms in one area depend on what kinds of policy reforms are adopted in others. There is also likely to be more scope for productive bargaining if everything is on the table at the same time. There could be cross-issue trades where countries accept compromises on some issues that they might otherwise regard as undesirable in return for getting their preferred position on another issue. Indeed, it is hard to imagine how we can make progress toward global agreement on any of these issues without such horse trading.

Changes

What to do? To start, membership in the G20 and IMFC should be rendered consistent with one another. This may require changes in the membership of the G20, conceivably expanding it from 20 to 24. It is possible to imagine rotation in the countries representing different IMF constituencies, which would not be an entirely bad thing. This would not make everyone better off; certain countries with a seat at the G20 table might find themselves having to share that seat, depending on the rotation convention, with other members of their constituency. But these transaction costs and compromises would be more than justified by the increase in legitimacy of the resulting body and by the elimination of the conflict between the G20 and the IMFC. The IMFC could then be transformed into a Council to oversee the IMF, as provided for in the IMF's Articles of Agreement.

There might also be changes in the composition of the IMFC, which currently includes 7 European Union countries among its 24 members. A single EU seat at the IMF being controversial, a single EU representative on the IMFC would not be easy to achieve. But note that the EU is a member of the G20. If the Europeans are serious about making the G20 the steering committee for the world economy, then they are going to have to rethink this conflict with their representation on the IMFC. This would be a prerequisite for a more serious role for the IMFC as the IMF governing council.

There is nothing to prevent this continuing evolution. The G20 itself evolved out of an earlier body, the Group of 33, which in turn evolved out of the Group of 22 that was established in the wake of the 1997–98 Asian financial crisis. This precedent suggests that there is nothing other than the entrenched interests of the incumbents to prevent the G20 from evolving into an IMFC-compatible grouping.

Finally, collapsing the four silos of the G20 process into a larger consolidated negotiation could create scope for a Grand Bargain from which everyone, advanced countries and emerging markets alike, could benefit. The key problem facing the G20 and the world economy is how to rebalance demand, support global growth, and prevent the recurrence of crises, all at the same time. The advanced countries emphasize the need for emerging markets to stimulate demand in order to support global growth while preventing the reemergence of global imbalances. But emerging markets have concluded from the 2008–09 crisis, not unreasonably, that they need more insurance against volatility, not less. In other words, they need more foreign reserves as a buffer against shocks, which they can obtain only by running even larger current account surpluses and holding down their currencies against the dollar rather than letting them rise.

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The way out

There is a solution. It is to give emerging markets with sound policies access to large, long-duration, unconditional credit lines at the IMF. Knowing that insurance will be available via the IMF, which will then act as a reserve-pooling arrangement for its members, the demand for reserves to insure against volatility will be less. Emerging markets with the capacity to do so will be more willing to stimulate demand even if this means smaller current account surpluses, stronger exchange rates, and less reserve accumulation.

But this solution presupposes further changes. Specifically, the IMF's new Short-Term Liquidity Facility needs to be reformed so that countries can treat it as precautionary and qualify for a line of credit without having to draw on it. It needs to be reformed so that it can be drawn for more than three months at a time — recent experience suggests that volatility and the corresponding need for emergency finance can last for more than three months. And it needs to be reformed so that they can draw larger amounts — recent experience reminds us of the magnitude of capital-flow reversals. More fundamentally, this solution presupposes far-reaching changes in the governance of the IMF to give the institution the legitimacy it lacks in the emerging world. In turn this implies changes in the quotas, votes, and voice of emerging countries that extend beyond the token reforms of 2006–08. Half measures will no longer suffice.

In April the G20 will issue reports recommending, among other things, measures to promote global rebalancing and reform the IMF. But if the IMF reform measures fail to adequately address the concerns of emerging market countries, the measures to rebalance the world economy and stabilize global demand will not be adopted, even though they may be attractive from the vantage point of the advanced economies. The G20 needs an overall game plan. It needs to know on what issues (such as IMF reform) to push the envelope if progress on other issues (like global rebalancing) is to be even remotely feasible. More generally, the G20 needs an overarching vision. And it is not clear that it possesses one. These problems can be solved, but they need first recognition and then action.

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[1] The countries that constitute the G-20 are South Africa, Germany, Saudi Arabia, Argentina, Australia, Brazil, Canada, China, South Korea, United States, France, India, Indonesia, Italy, Japan, Mexico, the UK, Russia, and Turkey. The G-7/8 consists of Germany, Canada, United States, France, Italy, Japan, the UK, and Russia.

The crisis and Brazilian executive compensation

Érica Gorga

In his inaugural address Barack Obama said that the question is not whether the market is a force for good or evil—its power to generate wealth is unmatched. But the current crisis has shown that, without adequate supervision, it may get out of control.

Between 2005 and 2007, the Brazilian capital market experienced a boom of issuance of new shares; now, however, the shares of many of the companies that issued those shares are being traded at levels that are lower than their issue prices. It is a known fact that times of economic difficulties increase the potential for top executives to draw private benefits at the expense of minority shareholders. Those benefits are granted to executive officers merely because they exert control. This phenomenon was examined earlier in connection with the Asian crisis and similar periods. The task of the regulator is to determine what measures are needed to increase transparency and to reassure investors.

The Brazilian Securities and Exchange Commission (CVM) has recently submitted for public hearing new rules relating to the registration of securities issues, which replace regulation no. 202 and which propose, among other things, more comprehensive disclosure of information related to executive remuneration.

Information on compensation will be disclosed individually, in accordance with international practice. In its presentation to the public hearing, the CVM offers three arguments it considers relevant to deciding whether this disclosure procedure must be adopted and invites opinions on its need and utility. This CVM initiative to allow the market to express its opinions on such a controversial issue is very important.

The first argument advanced by CVM is "cultural." In other cultures, sharing information on the assets and income of highly paid individuals is accepted as a matter of course. Allegedly, in Brazil, where this culture is absent, competent individuals would lose interest in positions were they to be subject to disclosure of their compensation. A simple analogy makes it clear that this argument does not hold: the highest-paid public offices are undeniably the most sought after. No one would refuse to consider a career in the

Federal Justice Department, for instance, because he would be one of the country's highest-paid civil servants. Why, then, apply a different reasoning to the private sector?

The second argument relates to competition with private joint stock companies, where levels of transparency are far lower and whose executives might fear disclosure of their compensation. This argument ignores the basic issue: a private joint stock company does not seek to attract resources from the savings of the general public. If an open corporation seeks those resources, it must comply with rules that allow the investor to assess executive incentives for better management.

The third argument is that of the safety of executives, which again does not hold up against an analysis of the facts. What would be more likely to attract the attention of a kidnapper: disclosure by CVM of an executive's compensation, or an imported car parading down the street? Perhaps we should require that for their own safety executives stop using imported cars.

In times when everyone worries about possible job cuts, it is surprising that some would support the idea that making executive compensation transparent would trigger their departure from corporations. It is equally surprising that CVM should advance such simplistic arguments. The international system has yet to find a better method for identifying the executive compensation structure than disclosure of individual pay and other benefits. The latter is, by the way, an essential aspect that CVM has failed to address: What about the other benefits granted executives in addition to salary, such as bonuses or variable pay? Other laws require the disclosure of all benefits (for example, a company car) when they surpass a certain value.

Moreover, CVM asks whether disclosure of the earnings of the three highest-paid executives in a corporation would suffice, and whether personal identification would be necessary. The purpose of pay disclosure is to identify uncontrolled granting of benefits to executives at the expense of minority shareholders. In a study published by the *Journal of Finance*, Brazil has been singled out as paying the highest private benefits in the world—something that speaks for itself. Shareholders need to know how much is being paid to executives in the company so that they can understand what incentive structure they have for their actions and evaluate their performance accordingly.

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CVM also asks whether seeking inspiration in the USA, where the market has a different profile, could lead to problems. A recent study I did reveals that on average the largest shareholder owns about 36% of the common shares in listed companies, which indicates—for the first time in the history of Brazil's capital market—a substantial change in the ownership structure of traditional listed corporations. As a result, the role of management in those corporations will become increasingly decisive—and that is yet another argument in favor of more information.

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