Brazil and the Subprime Crisis[1]

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Let me start by thanking my hosts for their kind invitation. Back on June 4th, when they contacted me, they asked me to speak about the implications of external conditions for Brazilian interest rates. This was almost exactly two months to the day *before* the subprime crisis. Someone must have a crystal ball.

In line with their request, I will focus on the implications of the subprime crisis for Brazil and its interest rates. Other speakers are better qualified to address domestic developments. I would simply emphasize the following. It is hard to fault the Copom's monetary policy decisions. It has slowly but steadily reduced nominal rates to levels more commensurate with world levels – so that it no longer looks like Brazil and the rest of the world are on different planets – without undermining confidence in price stability. Its debt conversion operations, and in particular its decision to retire as much foreign-currency-denominated debt as possible, look deft in light of recent developments in financial markets. Reserves now fully cover not just the public sector's external obligations but also those of the private sector. (So the days when you could come to Brazil and say "Prepare for a debt crisis" simply on the grounds that there hadn't been one recently are now clearly over.) On the fiscal front, the improvement over the 1990s is remarkable, although there are growing reasons to worry about the expansion of government spending and the decline in the primary surplus.

Ultimately, the central bank's ability to reduce rates to single digit levels will hinge on the ability of Brazil to produce faster growth, so that debt/GDP ratios evolve more favorably and investors are reassured of continued political support for sound and stable policies. To be sure, there is an element of circularity here. High rates make it hard for the economy to grow faster, while the failure of the economy to grow faster makes it hard to cut rates. But of the two ways of breaking out of this vicious circle, one is clearly superior to the other. A monetary shock in the form of a larger than expected interest rate cut or a fiscal shock in the form of higher social spending could undermine confidence. Faster structural reform, in contrast, would enhance the prospects for growth without the same downside. Brazil can only have Asian interest rates if it has Asian growth prospects. And it can only grow like Asia if it has comparable market flexibility. I am not alone in calling for pension reform, labor market reform, and other forms of structural reform. But just because I lack originality doesn't make the point is any less important.

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But it is on the impact of external conditions, and the subprime crisis in particular, that I promised to focus. The most important fact, of course, is that the crisis in the U.S. has not produced a crisis in Brazil. This is remarkably different from previous periods marked by global shocks, 1998 for example. To be sure, Brazil has not been immune. The exchange rate depreciated against the dollar in early August when the subprime crisis erupted, although it has now recovered most of that lost ground. In my view, this mainly reflects the collapse of the dollar, not the strength of the *real*, which is still down from early August levels against the other major currencies. Admittedly, this is not entirely a bad thing, given that exporters can use the boost to competitiveness and depreciation no longer has adverse debt-servicing consequences owing to the disappearance of foreign-currency-denominated sovereign debt.

But the spike in volatility has led the Copom to scale back its interest rates cuts from 50 to 25 basis points and now to pause, even while the Fed and other advanced-country central banks have cut rates more aggressively. In effect, there has been a rise in Brazilian policy rates relative to policy rates in the advanced countries, which is the other side of the exchange rate coin. This also means that Brazil benefits less from real depreciation than it would otherwise.

The next stage will be a significant slowdown, not just in the United States but also here. I base this conclusion on two assumptions. First, the subprime crisis is not over. Second, Brazil remains quite sensitive to the state of the U.S. economy. Let me elaborate on these two premises in turn.

I am aware that my belief that the U.S. is headed for a significant slowdown and, quite likely, a recession is in contrast with the conventional wisdom, which has increasingly downplayed the subprime crisis as a determinant of the business cycle and therefore marked down the probability of a recession. (JP Morgan, which is a reasonable market bellweather, currently puts that probability at 30 percent.) My conviction that this figure is too low is based on the importance of the housing market to investment, the importance of housing re-financing for consumption, and the importance of the commercial paper market for investment. All three determinants of economic activity in the United States have shifted in strongly negative directions.

- Residential construction accounts (we should now say "accounted") for about 40 percent of fixed investment in the United States, and residential construction has collapsed. Housing starts have fallen by 45 percent from their peak at last report, and JP Morgan forecasts that they will fall by a further 25 percent before the bottom is reached. Just last week we learned that they had plunged by a further 10 percent in September to their lowest level since 1993. Existing home sales were down sharply again last month, as reported yesterday. New subprime and Alt-A mortgages, which financed 40 percent of the demand for homes last year, have essentially disappeared. We will have to wait and see if the sector recovers in 2008, as the real estate industry insists will be the case, or whether the slump is even more long lasting than that. It will take some time for the backlog of unsold single-family homes on the market to be worked off; measured in terms of months of supply, that backlog was higher in August than it had been anytime since May 1989. This is not good news for the fixed-investment component of demand. Moreover, residential fixed investment has declined in advance of every post-World War II recession in the United States except 1953 (which was caused by the post-Korean War defense build-down) and 2001 (which was caused by the collapse of the Nasdaq bubble). This is the most reliable leading indicator we have.

- Second, consumer confidence is weakening. The Conference Board's latest reading is way down – the worst since the aftermath of Hurricane Katrina. Chain store sales dropped sharply in the second half of September and are barely 1 percent above a year ago on a same-store basis. Why is not hard to see. U.S. households have been using their homes as piggy banks. Through creative refinancing, they have been extracting upwards of $750 billion a year from their homes to finance additional consumption. Now this gravy train is no longer running; indeed it has shifted into reverse. As household savings rates return to more normal levels from the negative territory reached in 2006, consumer demand will weaken. Not surprisingly, the component of the S&P that tracks companies whose profits depend on consumers' discretionary spending is way down as well.

- Third, the subprime crisis has heightened the cost and difficulty of carrying inventories. Producers rely on commercial paper to defray inventory carrying costs. And as the crisis in asset-backed commercial paper has spilled over into plain vanilla commercial paper markets, this form of financing has become more difficult to tap. Banks, seeing the operations of their conduits and structured investment vehicles coming back onto their balance sheets, are in no position to fill the gap.

So, Federal Reserve interest rate cuts or not, it is unlikely that the U.S. will avoid recession. With fixed investment, inventory investment and consumption all tanking, the only thing that can keep us out of recession is if we can sell more exports to you! If you're worried about the weakness of the dollar, this suggests you ain't seen nothin' yet.

My conviction that if the U.S. economy slows, and especially if it enters a full-blown recession, Brazilian growth will slow as well is predicated not on a single mechanism but on a trio:

First, I put little faith in decoupling. I see no evidence that the other advanced economies will be able to decouple from the United States. Consider the impact of the subprime crisis on the value of the euro if you harbor any illusion that Europe will be able to decouple. While proponents of the view that Asia can decouple from the United States point the growth of intra-Asian trade as evidence that China and its neighbors can avoid a growth slowdown, they neglect the fact that much of this trade is in parts and components that are assembled in China, after having been produced elsewhere in the region, and then exported to the United States and Europe. And Japan's difficulties appear to be deepening as well. Domestic demand may be strong in Brazil, but I would question whether this can sustain vigorous growth when the rest of the world is slowing significantly.

Second, this growth slowdown will reverse the strong upward pressure on commodity prices. Brazil may depend less on exports of commodities than some other Latin American economies – only 40 percent of its exports may be of agricultural and primary products, but 40 percent is still a lot. Weaker commodity prices still will not help its terms of trade or its balance of payments.

Third, I do not believe that spreads on Brazilian debt and the Brazilian stock market will remain immune. The reduction in risk tolerance on the part of advanced-country investors that we have seen in the last two months will be with us for some time – maybe for years. Investors have woken up and smelled the coffee. Banks are being forced to take risky structures back onto their balance sheets. Regulators are tightening up on supervision. For all these reasons, there will be less liquidity in search of yield.

It is interesting that, so far, the impact has hardly been felt in emerging debt markets. By the end of September, the EMBI Global spread over U.S. Treasuries had more than recouped the losses suffered in August. New allocations to emerging markets were an impressive $3.5 billion in August, despite the market turmoil. Brazil in particular has continued to enjoy strong inflows. So far credit to the private sector has continued to expand robustly, in contrast to the United States. But nothing guarantees that this disjuncture will last. Once the other mechanisms kick in – recession in the U.S., slower growth elsewhere, weaker commodity prices – investors will realize that emerging markets, and Brazil in particular, are riskier as well. With the rise in exchange rate volatility that is part and parcel with these other developments, the carry trade, of which Brazil has been an important beneficiary (if "beneficiary" is the right term) will unwind further. Further cuts on U.S. interest rates will not be enough to push more money into Brazilian markets, given this renewed appreciation of risk. Statistical studies suggest that about half of the decline in emerging market spreads in recent years has been due to improved fundamentals in the emerging markets themselves, while the other half has been due to favorable global financial conditions. (I am thinking of work by Michael Buchanan, for example.) Those favorable global financial conditions are about to disappear, to the extent that they have not already.

Admittedly, it is peculiar that the equity markets do not see credit crunches and real estate recessions as a dangerous combination. My own view is that this disconnect will ultimately be resolved in favor of the credit markets and real economy, with plenty of volatility along the way.

I should explain why I don't believe that the Fed's interest rate cuts, even if there are more of them, can prevent a significant slowdown. This is first and foremost a real-sector slowdown – a housing-led downturn in fixed investment – and not simply a financial problem that can be fixed by financial means. There is an overhang of unsold properties. We know from historical experience that sellers, especially of existing structures, are reluctant to cut prices. Hence the adjustment takes place through a protracted adjustment in quantities, as new construction remains depressed for some years, rather than a quick adjustment in prices. A change in the federal funds rate will have zero impact on these real-side dynamics.

Changes in the federal funds rate may seem more appropriate for resolving problems in distressed credit markets, but here I worry that the Fed is pushing on a string. It has taken steps, along with the Bank of England and the ECB, to make more liquidity available, but the danger now is that this additional liquidity will just sit idle in the banking system. The banks have little incentive to lend it, given the prevailing high level of risk and uncertainty (do they know whether Bear Stearns or their favorite investment bank counterparty, with large positions in opaque derivative securities, is really in a position to pay the money back?) and the fact that they are being forced to take risky structures back onto their balance sheets (in other words, the banks need liquidity themselves). I am not a hard-line believer in the liquidity trap – in the idea that Fed policy is totally ineffectual in this situation because liquidity injections under such circumstances all sit idle at the banks. But there will be some tendency in this direction.

So put together the real-side problem with this financial problem, and there is reason to doubt that discount-rate cuts can prevent slower growth.

What will slower growth imply for Brazilian interest rates? If you recall my earlier argument that what is needed for further cuts is faster growth, then the answer is obvious. Rates here will stop falling and may start heading back up. This prediction is troubling. In the United States, interest rates move countercyclically, as they should on stabilization grounds. That central banks not only here but in other emerging markets must raise rates, or at least stop cutting them in recessions, in order to reinforce confidence is disturbing. For me, the procyclicality of Brazilian interest rates is as troubling as the level.

Once upon a time I thought that this was mainly due to the problem of "original sin"–that such countries could not afford to let the exchange rate weaken in slowdowns because they relied on foreign-currency-denominated debt, whose cost went up when the exchange rate went down. Well, the Central Bank of Brazil and the Finance Ministry took that argument to heart and retired the foreign currency denominated debt, but the problem remains. It can be solved only when remaining doubts about the commitment of the authorities, and the support of the public, for stability are removed, once and for all. Faster growth is the only way to solidify that support. And faster growth requires a renewed commitment to structural reform.

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