**ECONOMIC AND SOCIAL POLICIES INCONSISTENCY, CONVENTIONS AND CRISIS IN THE BRAZILIAN ECONOMY, 2011-2016**

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**Resumo**

Nos períodos 2004-2008 e 2009-2014 a economia brasileira cresceu a uma taxa média anual de 4,8% e 2,7%, respectivamente. Após 2014, porém, ela entrou em profunda depressão, com taxas de crescimento de -3,8% em 2015 e -3,6% em 2016. O objetivo deste artigo é analisar as causas da crise brasileira, tendo como base a abordagem Pós-Keynesiana e o foco em dois pontos, a saber, (i) a inconsistência entre as políticas sociais e macroeconômicas, em particular a política cambial, adotadas entre 2003 e 2014; e, ii) alguns equívocos de política macroeconômica e sua administração inadequada pelo governo. Aparentemente, estas políticas foram implementadas para estimular a confiança dos agentes por meio da criação de uma convenção otimista sobre o futuro da economia brasileira que, por sua vez, deveria detonar o *animal spirits* dos empresários e os investimentos. Contudo, estas políticas eram inadequadas e alcançaram o efeito oposto, conforme descrevemos neste artigo.

**Palavras-Chave:** economia brasileira, política econômica, convenções

**Abstract**

Over 2004-2008 and 2009-2014 the Brazilian economy performed an average growth rate of 4.8% and 2.7% per year, respectively. After 2014, however, the economy emerged into a deep depression showing growth rates of -3.8% in 2015 and -3.6% in 2016. In view of that, this paper aims to analyze the causes of the Brazilian crisis, based on a Post-Keynesian point of view to focus on two issues: (i) the inconsistency between the social and macroeconomic policies, in particular the exchange rate policy, adopted over 2003-2014; (ii) some macroeconomic policy mistakes and their inappropriate management by the government. At the first sight, those policies were intended to boost the agents’ confidence by creating an optimistic convention about the future of the Brazilian economy what would trigger the entrepreneurs’ animal spirits and investments. However, these policies had gone wrong and reached the opposite effect as we describe.

**Key words:** Brazilian economy, economic policy, conventions

**Código JEL:** E12, E60, H00

**Área 1:** Macroeconomia, política econômica e financiamento do desenvolvimento

**1. Introduction[[1]](#footnote-1)**

Keynes (1973, 1980, and 1982) and the Post Keynesians, summarized in Arestis et al. (2016), prescribed economic policies aiming at solving the two main issues of the monetary economies of production, namely unemployment and its unequal income share. To Keynes (op. cit.), the main macroeconomic policies are the monetary, exchange rate and fiscal policies. Each has its own tools and specific goals and if their operation is coordinated and coherent, the two ultimate objectives of economic policy mix are expected to be reached. Besides the State cooperation with the private activity through economic policies, Keynes (1973) claimed for a good institutional environment, that is, a set of speeches, laws, functional bureaucracy, executions of contracts, etc., that allows the best business making process.

The complementarity between the public and private initiatives comes from the economy’s nature: its dynamics depend on private investment which is, however, undertaken under uncertainty, as it is impossible to know at present, when investment occurs, whether it would be profitable or not. If there is uncertainty, entrepreneurs do not know the results of their decisions so they can only expect some outcome. In what do the entrepreneurs’ expectations rely on? In several instances, some more or less known, and some only supposed with more or less confidence. Amongst this information, there is one special to ground expectations: conventions, i.e., a public shared belief.

Considering this, Keynes (1973, 1980, and 1982) and the Post Keynesians (Arestis et al., 2016) offer theoretical models capable of analysing what has gone wrong with Brazil’s economy, which went through two different periods since 2003. From 2003 to 2010, it experienced growth, though it decreased by 0.2% in 2009, due to the Global Financial Crisis. Over 2011-2016 Brazil first showed signs of stagnation up to 2014, and then went into its worst recession ever, 2015-2016. Thus, this chapter aims at analysing, based on the Keynesian notion of conventions, what has gone wrong with the Brazilian economy after 2011. Specifically, we investigate what were the problems of both the economic policies and the overall institutional environment the governments of the period framed, to understand how the Brazilian government brought about conventions grounding expectations that leaded entrepreneurs to hoard instead of investing. This contribution adds to the relevant literature by offering an analysis that focus on the consequences of the State economic action, but spotlighting the role of conventions on it.

The chapter has four other sections beyond this introduction. Section 2 describes, at its first subsection, the Post Keynesian notion of convention whereas the second subsection discusses the role government plays in framing conventions. Section 3 presents, markedly based on Keynes’s writings, the Post Keynesian macroeconomic policy mix, namely exchange rate, monetary and fiscal policies. Then, Section 4 analyses what has happened to the Brazilian economy over 2011-2016. Section 5 presents the final remarks.

**2. Conventions and the role of government in framing them**

***2.1 The notion of conventions and Post Keynesian developments on the topic***

In Keynes’s (1973) monetary economy, uncertainty is crucial, since agents’ decisions in the present builds the future of the economic system; yet, the information required for the decision-making process is only partly available. So, future cannot be foretold and, consequently, agents can seek protection against losses that may result from their investments; such as liquidity preference outcomes, revealing the agents’ conventional behaviour to gain protection against uncertainty (Carvalho, 2015; Ferrari-Filho and Conceição, 2005).

One pillar the agents base their uncertain decision is conventions, whose essence “lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change” (Keynes, 1973, p. 152). To Dequech (1999), convention can be understood as a collective rule of behavior. Plihon (1995) interpreted convention as a mimetic behavior. To Dow (2010, p. 8), convention relates to expectations, though both are formed interdependently. Davis (1997) saw conventions “as interactive, as is confidence, individual and collective […] individuals concentrate on change, and so makes the convention itself more likely to be precarious” (p. xiii). Modenesi (2012) and Carvalho (2014) considered convention a belief shared by many individuals.

Thereby, we summarize convention as a public opinion prevailing in some instance. It forms a conventional reasoning, which agents use as an important aspect to form their expectations. As future economic events cannot be calculated, decision-makers guide themselves, based on their *confidence* on their own expectations. Decisions are not just a matter of expectations but also of how one trusts on what is expected. Hence, if conventions partly help forming expectations under uncertainty, the state of confidence of agents also depends on them.

Two further elements in the decision-making process are intuition and animal spirits. Intuition is a mechanism agents use to subjectively mix material and abstract data (like conventions) to reach conclusions. If entrepreneurs’ intuition finds a stimulating conclusion, a positive expectation about profiting, they invest. So, they put into action their animal spirits, a spontaneous optimism that leads them to face the risks of investment (Carvalho, 2014).

Nevertheless, as a great number of independent decision units coexists, if each decision-maker does not account for the other’s expectations, plans may not succeed and expectations would despair. Consequently, there is convergence of expectations, giving room for convention as a belief shared by many individuals and which they consider for their state of confidence upon which they reason prospects (Carvalho, 2014).

***2.2 The role of government in framing conventions***

Convention and conventional behavior are relevant elements within the core assumptions of Keynes’s General Theory (GT) (Modenesi et al., 2012).[[2]](#footnote-2) Convention matters for the agents’ state of confidence, but their belief may change over time, showing the fragile basis upon which individuals form expectations under uncertainty.[[3]](#footnote-3) Then, which are the forces that guide or influence conventions? Does government play a role in the raise and maintenance of a given convention? Although Keynes has not explicitly formulated the connection between the government and conventions in his works, his GT has passages regarding this link. To make it clearer, some quotes are useful, as per below:

“The considerations upon which expectations of prospective yields are based are partly existing facts which we can assume to be known more or less for certain, and partly future events which can only be forecasted with more or less confidence […] It is reasonable, therefore, to be guided to a considerable degree by the facts about which we feel somewhat confident, even though they may be less decisively relevant to the issue than other facts about which our knowledge is vague and scanty. For this reason the facts of the existing situation enter, in a sense disproportionately, into the formation of our long-term expectations” (Keynes, 1973, pp. 147-148).

The knowledge of future is ‘vague and scanty’. So, government’s speeches, plans, policies and even circumstantial measures may be included in the set of ‘existing facts which we can assume to be known more or less for certain’, furnishing to the decision-makers more instances, and consequently confidence, in their expectations. Therefore, the government can frame economic conventions as it plays the following roles: (i) it issues exogenous money and affects the creation of endogenous money; (ii) it stipulates taxes and gathers revenues; (iii) it undertakes a wide scope of public policies; (iv) it establishes laws which builds the society’s institutional structure; and (v) it has the legal jurisdiction to reinforce the power of law. Carvalho (1992) enlightens the idea:

“The state has powers to influence or even to determine future paths […] all these factors allow the state to lead the process of development of a monetary economy […] it is not a question of replacing private property or the market […] but of allowing the state to issue the signals that markets are not able to and of pointing out” (p. 205).

Government can provide both the rules of markets’ operation and the signals that market fails to offer. If uncertainty is pervasive, in a considerable degree agents ground expectations in the signals issued by governmental speeches, plans, policies and so forth. Keynes (1973) gave further hints to advance the link between governmental actions and the prevailing conventions, emphasizing the role of fiscal and monetary policies, “the long-term market-rate of interest will depend, not only on the current policy of the monetary authority, but also on market expectations concerning its future policy” (p. 202), and

"The State will have to exercise a guiding influence on the propensity to consume partly through its scheme of taxation, partly by fixing the rate of interest […] I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment.” (p. 378)

Ferrari-Filho and Conceição (2005) and Arestis et al. (2016) interpreted Keynes’ ‘socialization of investment’, concerning the government role in providing institutional mechanisms to mitigate uncertainty and stimulate investment. Accordingly, Marcuzzo (2010) argues that Keynes’ (1980a) suggestions on fiscal policy (FP) account for stabilizing confidence – that is, conventions. This same interpretation is compatible with Minsky's (1986) ‘Big Government’ and ‘Big Bank’, institutions which ensure economic stability and regulate the unstable financial system. As Arestis et al. (2016) argue:

“In this uncertain world […] economic policy is the main source of solidity that private enterprises have to support their expectations and investment. In this sense, economic policy […] in a context of coordination and discretion, is capable of facing insufficient effective demand as well as building a good institutional environment, which is essential to keep the entrepreneurs’ expectations confident and stimulate their animal spirits” (p. 151).

Successful policies depend on the government persuading the agents not only that its actions are in the right way, but also that people believe it: “a convention is a tool deployed to coordinate expectations that inform each agent what the other ones expect from a given stimulus” (Carvalho, 2014, p. 257). Also, the effectiveness of economic policies rest on the strength of the dominant convention, i.e. it depends on how many individuals are confident that the others share the same belief and that the government is reliable enough to allow a common opinion that its intentions are trustworthy. Given that, Carvalho (2014) argued that the agents are more sensible to the government policies when they have a shared belief, which led a great number of agents to give a similar response to a governmental stimulus.

Thus, in the Post Keynesian approach, government can guide conventions. Further, the success of its policies depends on how proper and pervasive is a convention it stimulated. To sum up, all means of governmental influences on the institutional structure of society should be coherently coordinated to guide conventions. So, what are the goals and operational guidelines of the Post Keynesian macroeconomic policies?

**3. Post Keynesian macroeconomic policy mix**

Arestis et al. (2016) explain the three reasons that make macroeconomic policy crucial for overcoming unemployment and income inequality:

“Firstly, they serve as an anchor to the business sector’s expectations, signaling the general tendency the government pursues […]. Secondly, one of the macroeconomic policies, namely the fiscal one, is able to directly impact effective demand […] preventing insufficient effective demand. Thirdly, macroeconomic policies, together with the political and juridical stances, build the society’s institutional structure. The more prone-to-business, stable, credible and transparent such environment is, the more it would favor good and trustful expectations, stimulating investments” (p. 153).

The State must issue the signals that markets cannot furnish, by creating a stable and safe economic environment that shows the directions it pursues to generate full employment and equitable income share. Thus, a State gains coordination through: (i) institutional reforms to improve the channels that connect agents, leading to better information provision and offsetting income inequalities; (ii) economic planning to coordinate conventions and expectations of the economy’s future path; (iii) a day-to-day concern with the circumstances, to face the failures of the monetary economy (Carvalho, 1992; Arestis et al., 2016). The government coordination of agents’ expectations is required to manage its daily operation and to lead the agents towards the society’s intentions.

In terms of FP, Keynes (1980a) argued that the public spending should be split into two budgets: the ordinary (current) and the capital budget. The latter covers discretionary investment expenditures, mainly those made by no one if the State does not move them, in a long-term investment plan that is a device to smooth economic cycles (Arestis et al., 2016). The State must complement, and not compete with, the private sector, creating a crowding-in effect. The State’s long-term plan coordinates the agents’ conventions, as it is a long-run commitment to accomplish and sustain an adequate level of aggregate demand, showing the “state’s readiness to compensate for reductions in private investments with its own expenditures” (Keynes, 1980a, p. 322).

Accordingly, investment in infrastructure is the most adequate for the capital budget. Many studies highlight features of this kind of investment, such as its long-term payback, its huge cost, its relevance for generating gains on productivity, lower production costs and better profits (Aschauer, 1989; Calderón and Sérven, 2004;), as well as its improvements to the income share and poverty reduction (Rozas and Sánches, 2004; Calderón and Sérven, 2002). Thus, infrastructure investment has a dual character as it has a long-term payback and high costs to private firms that make them, however it provides several essential elements for improving firms’ profits.

There are two further aspects of the Post Keynesian FP. The current budget embraces the public services the State furnishes and it should be in surplus or in equilibrium all the time so that the public budget reaches intertemporal equilibrium. Moreover, FP is a tool to implement institutional reforms, particularly income ones through taxation and incomes policy, improving the consumption propensity and social stability.

In terms of monetary policy (MP), Keynes (1973) saw it bearing a hard task – to set a financial system yield curve, which is not an opportunity cost to productive investment. That strongly depends on agents’ response to the Central Bank (CB) as its interest rate works on the agents’ speculative money demand. In financial markets, agents bargain assets to profit through the difference between the actual and future interest rates. They first consider the CB rate, which is the basic rate of return of the economy; depending on what they consider will happen to it, they negotiate debt.

The CB controls its interest rate to impact other variables such as price, exchange rate, expectations. Yet, this tool is considered by the agents as a fundamental rate of return. Then, CB has, in its operations, an eye at the aspects it oversees and another eye at the agents’ expectations. In this sense, conventions are key for a successful MP. Given uncertainty, if conventions are misguided, agents have even less information of what expect of the movements between the current and future interest rates. When the CB changes its interest rate without considering the agents’ expectations it may stop agents from negotiating debt; thereby, in an extreme case, there is the ineffectiveness of the MP, as Keynes (1973) illustrated:

“a monetary policy which strikes public opinion as being experimental in character or easily liable to change may fail in its objective of greatly reducing the long-term rate of interest […] The same policy, […] on the other hand, may prove easily successful if it appeals to public opinion as being reasonable and practicable and in the public interest, rooted in strong conviction […], and promoted by an authority unlikely to be superseded […] the rate of interest is a highly conventional, rather than a highly psychological, phenomenon” (p. 203).

Hence, the financial system yield curve is a conventional phenomenon, set by reciprocal deals between the CB and agents in the financial system. These negotiations first consider the basic rate of interest and if the CB is reliable, there is room for them to occur. Different opinions about the future interest rate make agents speculate. Still, diverse opinions found themselves in the convention that the CB would not stablish its future interest rate based on non-reasonable ideas. If the convention is that the CB has no basis and coherence in setting its interest rate, the shared belief would probably understand that the MP is misleading.

The other MP tool is regulation. It is laws/rules that stipulate what can be done in the financial markets. Like the interest rate, regulation should be stable, because it direct impacts agents’ behavior in financial markets. If the CB continuously switches the regulatory framework, it sets an uncertain environment where agents become confused about which business is allowed.

So, MP should be conducted with parsimony, pragmatism, transparency and a kind of ruled discretion. CB interest rate does not help reaching full employment at any cost, but in accordance with the economic circumstances. Also, if the regulatory framework changes a lot, it constitutes bad conventions. Conventions about the current and future behaviors of MP are fundamental to its own success and, reciprocally, a well conducted MP is essential to building fine conventions.

In terms of the exchange rate policy (ERP), Ferrari-Filho (2006) argues that Keynes suggested a managed exchange rate that could change regarding the circumstances. A stable currency brings at least three benefits: (i) permits better estimations of the production costs of imported inputs; (ii) allows business-people, seeking to sell tradable goods to external or internal markets, to improve their revenue calculus; (iii) stabilizes the real wage in foreign money, enabling finer assessment of the domestic demand. Thus, a managed exchange rate pursues stability and furnishes predictability to entrepreneurs (Arestis et al., 2016).

However, exchange rates are not easily managed. On that, Keynes (1980b) had two concerns: first, the ERP should not kidnap the CB interest rate, what would happen if the exchange rate management uses the interest rate to attract foreign financial capital. If so, the interest rate volatility tends to rise, leading to a higher opportunity cost to productive investment. The second concern deals with the autonomy of the CB interest rate given by capital controls over capital flows. Without capital controls, the management the exchange rate solely relies on the interest rate, elevating its level and making it more volatile.

The exchange rate stability is also a MP’s goal, since all external flux changes the liquidity conditions at the money market. Again, this feature stresses the need of coordinated economic policies, which is the key to construct good conventions about the economy’s future trail. If the government does not swap its economic policy in a peremptory manner, within this economic policy framework, good conventions are expected.

Having argued about the links between government’s actions and conventions, we analyze next the Brazilian economy slump after 2011. Over 2003-2010, Brazilian economy passed through a boom. From 2011, but mainly since 2014 onwards, Brazil has been suffering its worst recession ever. How the economic policies and their influence on conventions help explaining what happened to Brazil is the topic of next section.

**4. The Role of Conventions in the Brazilian Economic Slump: 2011-2016**

To understand Brazil’s economic downturn over 2011-2016, a brief analysis about the previous period, 2003-2010, is needed. Brazil went through a full economic cycle, being the period 2004-2008 the boom phase, with 4.8% annual average growth. That period came along with a benign external scenario, which improved Brazilian exports by 105%, and the trade terms by 12.5%, chiefly because of the expansion of mining and agriculture commodities’ international prices. In the financial sphere, international liquidity grew until 2008, when the great financial crisis (GFC) emerged (BCB, 2017).

Two main factors influenced the Brazilian growth from 2004 onward: the external scenario and the strengthening of the domestic market. The latter was due to: (i) the pass-through effect of the positive external context to the internal market; (ii) the minimum wage real appreciation; (iii) the social policy of income transfer; and (iv) the increase in the credit/GDP ratio. These elements fortified households’ consumption, which met the installed productive capacity utilized in the manufacturing industry by 79.7% in 2003 whereas in 2008, when the GFC started affecting Brazil, its occupation was around 83% (Ipedata, 2017), a level incapable of exerting inflationary pressures on the labor market. Reasons (ii) and (iii) arose as Lula da Silva’s government (2003-2010) widened old social and wage policies to enhance the internal market and reduce poverty and income inequality; (iv) occurred as the government implemented credit policies, lifting the credit/GDP ratio from 25% to 40% over 2003-2008 (Ipeadata, 2017).

However, Brazil’s boom was not investment driven, but export- and consumption-led. Over 2004-2008, the investment rate widened by 11.9%; still, it departed from a low level, 17.3% of the GDP in 2004, reaching 19.4% in 2008; during 2003-2007, the investment/GDP ratio was always below 18.1% (Ipeadata, 2017), insufficient to guaranteeing a sustainable growth. So, Brazil grew while there was idle productive capacity to attend exports and consumption.

In 2008, the GFC erupted and affected Brazil, with growth decreasing by 0.2% in 2009, but it increased by 7.5% in 2010 and 3.9% in 2011 (Ipeadata, 2017). Brazil’s recovery, according to Arestis and Terra (2015), was due to: (i) the heated domestic market in view of increasing wages and income transfers; (ii) exports to developing countries, chiefly to China; and (iii) the economic policy measures in a counter cyclical stance after the end of 2008.[[4]](#footnote-4) These measures boosted the aggregate demand and the investment rate, which reached 20.5% of the GDP in 2010 (Ipeadata, 2017). Furthermore, this demand-led recovery was again based on idle industrial installed capacity – in 2009 and 2010 their rates were 80.6% and 83.3%, respectively (Ipeadata, 2017). Again, consumption and the external sector drove Brazil’s economy without having the investment levels at the rate required for achieving sustainable growth. Having this in mind, we now analyze the causes of the meltdown of the Brazilian economy from 2014 and subsequently.[[5]](#footnote-5)

**4.1 – Exchange Rate Policy and Conventions**

Starting with the ERP, the Brazilian currency was kept overvalued in real terms almost over the full period 2011-2016. Regulations on capital flows and foreign exchange derivatives were adopted by the government (De Paula and Prates, 2015), but it was not sufficient to eliminate the great currency appreciation observed during the last years. Figure 1 reports that at the beginning of 2011, the real exchange rate (RER) attained its highest level, with a soft devaluation starting in 2012. This overvalued RER brought the following consequences to Brazil: smashed profits in the tradeable goods sector, especially so given that there was a ceiling for investments in the manufacturing industry and for productivity gains in the whole economy.[[6]](#footnote-6) This process had a large brunt, going from low investment/GDP ratio to the re-escalation of the primary sector both in the Brazilian GDP and exports (Bresser-Pereira et al, 2015; Rossi and Mello, 2016).[[7]](#footnote-7) Investment reached 20.9% of the GDP in 2013 (Ipeadata, 2017), the highest during 2003-2016, and dropped to 16.4% in 2016 (IBGE, 2017).

Figure 1 – Brazilian/US$ Real Effective Exchange Rate, 2002-2016 (2010 = 100)

Source: Ipeadata (2017).

On the one hand, Gala (2008) argues that the manufacturing firms are the most dynamics because of their increasing returns of scale and technology-intensive products, features that enhance their learning-by-doing process and technological progress. On the other hand, an overvalued currency climbs the real wage in foreign money, changing the tradeable/non-tradeable trade terms in disfavor of the first, which greatly concerns the manufacturing industry. So, the overvalued currency implies profit rate reductions, in particular at the industrial sector, since non-tradable goods, workers included, are cost of production of tradable goods.

Since Rousseff’s government kept the credit, social and wage policies introduced by Lula da Silva, her government had an incoherence, that Lula da Silva had already had, between the ERP and the socioeconomic-institutional reforms encompassing the policies of minimum wage real valorization, credit expansion and income transfers, which changed the consumption patterns in the country. These policies contradictorily enticed the elevation of the domestic consumption concomitantly with the reduction of the profit rate due to the lower RER and the real wage appreciation higher than the productivity gains.

The currency appreciation increases real wages in the short run, in accordance with the intentions of social policy. However, it smashes the profit rates in many industrial sectors, discouraging investments which are crucial to expand the supply capacity. So, in the medium- and long-term, smaller supply levels relate themselves to smaller employment levels. Moreover, since the productivity gains in the industry are bigger than in the other sectors due to both static and dynamic scales economies and industry-related technological progress (Bresser-Pereira et al, 2015), smashed industrial profits lead to lower investments and productivity gains in the whole economy as well as to smaller increases in real wages.

Besides, it is worth noticing that there was an increase in Brazil’s average salary accompanying the minimum wage real valorization. Thereby, along with a better income share, a greater demand for labor-intensive services emerged. As Brazil went through a demographic transition in which the economic active population stagnated, the larger demand for services started pressurizing the labor market, culminating to a constant salary expansion (Resende et al., 2013).

This contradictory signaling of economic policies generated optimistic conventions, investment and productivity only in the sectors attached to primary commodities. The flat profit and investment rates in the manufacturing industry did not trigger a production expansion to satisfy the larger domestic consumption, which was met by imports and fulfilling empty productive capacity. Thus, the economy grew while there was idle capacity, a living on borrowed time economic growth. Even with the progress of the primary exports, Brazil’s current account deteriorated from a 2011 deficit equal to 2.95% of the GDP to 4.24% in 2014 (BCB, 2017).[[8]](#footnote-8) This scenario pinpointed future elevation of the external fragility, depriving investment because agents’ confidence declined as conventions identified a deteriorated future external position of Brazil.

Nonetheless, from October 2010 on, the government broadened its control of capital and foreign exchange derivative measures it introduced in October 2009, to restrain the influx of external capital into the Brazilian economy. After starting her term in January 2011, Rousseff started an ERP that managed the trend of the exchange rate devaluation, hoping to make the Brazilian manufacturing industry re-enter the international markets through exchange rate competitiveness.[[9]](#footnote-9) Beyond Rousseff’s ERP, the lower Real was due to some other factors, like the reversion of positions of investors fostered by the foreign exchange derivatives regulation, the reduction of the policy rate and the deterioration of the external context because of the euro crisis by mid-2011. Thus, in December 2011, the nominal exchange rate was devalued by 12.6% in relation to its December 2010 value; in 2012, it had an additional 8.9% devaluation. In terms of the effective RER, those percentages were 5.4% and 9.8% respectively (Ipeadata, 2017). Still, the 23.3% nominal exchange rate devaluation between 2011 and 2013 was insufficient to offset the 2003-2010 56.8% RER valuation (Ipeadata, 2017).

The BCB took measures to attain the mild currency devaluation, namely controls on capital flows and on foreign exchange derivatives, foreign reserves accumulation and hedge contracts through exchange rate swap operations. Capital controls began in 2011, when the government rose taxes on short-term capital influx. However, the government started changing the rule as per the international liquidity. It implemented capital controls, then elevated the levy and briefly afterwards retired the rule; all in a very short period between 2011 and 2012. This attitude made clear that its actions were temporary and did not follow any long-term strategy. Following what was happening in the international front, regulation in Brazil changed too much in a short period of time, disturbing what agents expect of the future. In such a case, what should be done to frame good conventions in an unstable context is not changing the measures as fast as the world swings, but making them stable. Otherwise, expectations would switch a lot too, making it harder the occurrence of investments.

Notwithstanding the swinging capital controls, the buffer offered by foreign reserves was inflated over 2011-2014: it augmented from US$ 288.575 million in 2010 to US$ 362.551 million in 2014 (BCB, 2017). Because of the difference between the Brazilian base rate, named Selic, and the world average interest rate, Brazil pays a higher return to buy foreign money than it receives by investing its American Dollars in bonds worldwide. As over 2011-2014 the fiscal situation in Brazil got worse. The burden of hoarding foreign money ended up being too heavy for a deteriorating FP. Agents knew that and their conventions built dishearten expectations of what to expect from the match between the exchange rate and fiscal policies in Brazil.

Furthermore, the BCB supply of hedge contracts, which had been used in Brazil since 1995, was subsequently used in a larger scale after 2011. These contracts were the main method the ERP controlled the trend of the national currency in Brazil, aiming at mildly devaluating it.[[10]](#footnote-10) The BCB sold short-term contracts hedging the agents against exchange rate losses. Furthermore, with this operation, the BCB eased agents’ expectations of variations on the value of the national currency so that it could manage a smoother exchange rate.

Yet, as the intention of the BCB is to protect the agents against currency devaluations, whenever it happens, BCB affords it. As the nominal exchange rate fell 34% over 2011-2014, the BCB had costs with that policy. Still, the fast elevation of the amount of exchange rate swaps contracts was another issue. Arestis and Terra (2015) report that Brazilian government had almost US$ 100 billion in this sort of liabilities in 2014, nearly one third of the country’s foreign reserves.[[11]](#footnote-11) The bulk of liabilities was raised up to a significant portion of the Brazilian assets, and once again what would be a good figure to agents’ confidence, started being a misleading and costly to the economic policy.

In short, the credit, social and wage policies together with exports boosted the Brazilian growth, but the ERP maintained an overvalued currency, whose consequences were smashed profits and the worsening of the current account. Capital controls, foreign reserves accumulation and hedge contract policies offered contradictory signals insofar as they were unstable or negatively influenced the fiscal situation. Likewise, the overvalued currency led to the re-escalation of the primary sector both in the GDP and in the exports, diminishing the productivity gains of the economy. Consequently, agents’ confidence declined given the incoherence between these policies: consumption was fostered by social policies, but investment was inhibited by an overvalued RER (Arestis and Terra, 2015). These features consolidated a maximum limit to the investment rate and, consequently, to the dynamics of economic growth.

Lastly, 2015 had intense exchange rate depreciation, around 47% (Ipedata, 2017). Brazil suffered an overshooting, though the world was not going through any similar problems. It was a Brazilian issue, an outcome of conventions that understood that Rousseff had a misleading macroeconomic policy framework – as it was stressed in the previous sections, coordination and coherence amongst economic policies are needed to generate good conventions, which are crucial to boost investment in an uncertainty context. Although the economic recession was already there in 2015, conventions disheartened by the political crisis and the judicial operation against corruption and money laundering crimes that took place in Brazil by the end of 2014 onwards also contributed to the 47% currency devaluation that happened that year – an overshooting bigger than the one Brazil had during the 2008 international economic crisis.

**4.2. Conventions and Fiscal Policy Problems**

After 2011, Brazilian economy started feeling the path of the world economic policies (Euro Crisis, Quantitative Easing provoking depreciation of the developed countries’ currencies, China ‘New Normal’, the higher competition on international markets, etc.) and of its own problems. Even accounting for a currency devaluation, its magnitude was not sufficient to offset the fall in the exports, that was so important to the dynamics of the Brazilian economic growth years before. Without the external drive, FP was due to foster growth.

When Rousseff’s cabinet started in 2011, as a counter cyclical measure, it pursued decreasing primary surpluses, which went from 2.89% to 1.74% of GDP between 2011 and 2013 (Ipeadata, 2017). Then, some manufacturing sectors (automobile, household appliances, building material, basic basket goods, etc.) gained tax allowances; similar allowances emerged to the taxes on the wage bill of the economy. The tax allowance started for a few sectors of the manufacturing industry, but it was spread to other sectors in a confused manner, following lobby pressures. The lack of strategy, lobby-guided, and in a confused manner by which the tax allowance policy was implemented, jeopardized optimistic conventions.

Moreover, in 2011 Rousseff launched the second phase of the *Program for Growth Acceleration* (PAC), a four-year plan of public investments mainly in infrastructure (such as public sanitation, housing, transports, energy and hydric resources). The Program had features of a Keynesian investment policy as it was a plan of public investments, previously announced to the public opinion, lasting for the medium term and could be used in a counter cyclical manner. The PAC was expected to flag the government guaranteeing a minimum level of future aggregate demand and improvement of infrastructure. Altogether, it would beckon conventions supporting optimistic expectations that encourage investments, however, economic and political problems avoided it. Resende et al. (2013) explain:

“the rules of spending public resources, the managerial State capacity, institutional norms and legal framework that set a relatively bureaucratic structure to the Brazilian National State and make it hard the expansion of the public outgoings (in particular, investments), the bidding process and the public-private partnerships. Beyond of not making several of its endeavors, PAC did not imply a substantial increasing in the public investment, which standstill around 2.5% of the GDP. Moreover, given the public sector primary surplus target, there is no available resources for a reasonable enhancement of the State capability of investing. Neither the government presents an organized capital budget, capable of fulfilling the gaps of the private investment and assuring the heightening of the infrastructure, competitiveness of the domestic products, positive expectations of future income and aggregate demand […] public investment is not made in a planned and transparent mood to coordinate the expectations and strategies of private investments” (pp. 106-107).

Hence, the FP issued contradictory signals. It both pursued primary surpluses instead of effective counter cyclical outgoings and had an ambitious program of investment that, if fully accomplished, would jeopardize the primary surplus, athough there was a reduction in primary fiscal surpluses during Rousseff’s government; but it was not sufficient to settle an effective counter cyclical FP. Moreover, mainstream policy prescriptions turned Brazil unable to produce a capital budget as big as required by the PAC. Over 2011-2013, Brazilian government made primary surpluses of 2.89% in 2011, and 1.74% of GDP in 2013, whereas its interest payments summed out nearly 4.5%-5.5% of the GDP as the restrictive MP practiced in Brazil, a common feature of the Inflation Targeting Regime, which required huge amounts of resources to be affordable.

Such a policy was incoherent with an expansionary FP aimed at financing public investments, with an income sharing policy and with measures seeking to augment the aggregate consumption. Furthermore, the tax allowance damaged both the primary surplus and the level of disposable resources to finance PAC investments. Instead of just giving up on the resources related to the tax allowance, the government should have gathered them to finance PAC expenditures since it directly impacted effective demand as well as it had a greater fiscal multiplier than the one emerging from tax allowances. Since public investment did not increase and private investment did not respond to the tax allowance policy,[[12]](#footnote-12) two demand drivers, exports and investment, slowed down, reducing taxes, and even more so as the economic activity was getting cooler.

The continuity of tax allowances to the manufacturing industry as part of the counter cyclical fiscal measures was also withdrawing resources from the Brazilian Treasury. Brazil’s public finance commenced suffering, first a stagnation of levy collection and, from 2014 onward, a strong reduction of public revenues. Nevertheless, public expenditures did not follow the same trend of the tax gathering. Over 2011-2014, they increased and so the fiscal condition of the Brazilian economy deteriorated quickly. BCB (2017) confirms that the Federal government (including the BCB) went from a primary surplus of 1.74% of the GDP in 2013, to a deficit of 0.49% in 2014, 1.77% in 2015 and 2.45% in 2016. As it could not be otherwise, the general government[[13]](#footnote-13) gross public debt swelled from 53.7% of the GDP in December 2012, to 65.5% in December 2015.

In view of that, conventions about the trend of FP in Brazil were pessimistic, even being the actions it afforded that meant to sustain the economic activity. Moreover, contradictory beckons issued by the FP (primary surpluses and tax allowances along with the PAC) also jeopardized conventions. Public opinion wondered whether the FP’s intentions were set in the right direction, yet they were too costly and crumbled the fiscal situation, resulting in the upturn of the public debt. Anyhow, not only economic reasons accounted for the bummer conventions hovering over Brazil. A political crisis that emerged in 2013 and lasted until the impeachment of Rousseff, in April 2016, also bolstered the idea that public finance under her government was disordered.

By the end 2014, Rousseff won her second presidential election and started a new term in January 2015. Now that the fiscal situation in Brazil was so downgraded, Rousseff changed the strategy and decided to promote a fiscal consolidation via austerity at the time of an economic deceleration. As Arestis and Terra (2015) argue, these measures had a market-based nature given that the policy actions of Rousseff’s first government were interpreted like too interventionist. Still, there were two attempts of reaching fiscal consolidation; the first was a fiscal shock proposed by Minister Joaquim Levy, and the second, a gradual consolidation undertaken by Minister Nelson Barbosa. They were not successful. Both plans buoyed the conventions that Brazil was melting down and that the market-based fiscal consolidation would withdraw public investment. Conventions were already not good; still they have not got anything to back any chance of healing with the fiscal measures the government was executing after 2015.

That was the fiscal input to the Brazilian crisis. The country’s economic shrinkage amounted to 0.1% in 2014, -3.8% in 2015, and -3.6% in 2016 of the growth rate. Conventions did not change when the fiscal consolidation policy entered into the scene in 2015 as well as they did not get better after Rousseff’s impeachment, as Brazil’s economy continued its downward path in 2016. Rather than fiscal consolidation, conventions are looking for demand drivers to promote sustainable growth, a role that public investment is expected to accomplish; otherwise, an absence of prone-to-invest convention outcomes would occur, given that expectations of future have no upholds. In an uncertain world, backless conventions mean no investment, unemployment and economic downturn.

**4.3. An Erratic Monetary Policy**

Under Rousseff, the MP was managed in a diverse way in relation to past governments since the Inflation Targeting was initiated in 1999. Although the Regime was still in force, a sort of its mollification was tried by the BCB, which raised its interest rate up to 12.50% per year in 2011, but by the end of 2011 until October 2012, it cut its interest rate to 7.25%, the lowest rate in decades.

Figure 2 shows that the market rate followed BCB’s intentions and its future rate (one year ahead) was, then, at Selic’s current level. This shows that the MP was successful in building positive conventions about the future of its own policy. However, at the beginning of 2013 the market rate started decoupling from Selic, signaling that conventions were changing because of expected higher inflation, which obliged the BCB to raise the interest rate; so, in the dawn of 2014, conventions of higher future inflation were calmed. Still, by mid-2014, conventions saw higher inflation again and so, and because actual inflation was expanding, the market rate increased. However, perhaps due to the electoral period, the BCB later raised its rate, what culminated on more deteriorated conventions on future inflation. When the BCB finally moved its interest rate up, conventions were so sensible that compelled it to an intense climb. If productive investment was already tender, the higher opportunity cost of the financial system yield curve made it even harder to occur.

Source: Authors’ own elaboration based on BCB (2017).

Note: Expected Inflation Gap is the monthly expected Inflation minus the series’ average.

What has gone wrong with the BCB MP? Brazil historically has two characteristics in terms of the conduct of MP. First, because of the 1980s hyperinflation period, Brazilian population is too sensitive to variations of inflations rates, what makes price-makers start protecting their yield by moving their prices upwards. This fear of inflation can be seen through the automatic contracted price readjustments overspread throughout the economy, which adjusts actual prices by past inflation (like rents, energy, schools, the minimum wage, etc.). Thus, the ongoing convention in Brazil commonly bears fear of inflation. Second, the financial system in Brazil, chiefly the concentrated banking system, has a strong communication power and easily helps forming conventions. This implies a very-sensible-to-inflation market rate, what makes Selic very responsive to inflation too. This is promoted by the Inflation Targeting Regime, in which the interest rate is the exclusive tool to inflation targeting. So, Selic is very much sensible to inflation, expected inflation and conventions that remarkably fear inflation, making it hard for the BCB to drive a prone-to-investment Selic.

Thus, if the BCB’s intention is to reduce the Selic and if it makes it happen on conventions that the lower interest rate would continue in the future, it should take full care of inflation expectations. In Keynesian terms, this would be the construction of the guidance necessary to ground conventions, building an institutional environment keen to productive investments. Though, to accommodate inflation, Rousseff’s government started freezing administered prices, mainly oil and its products, as well as changing contracts of energy producers in a unilateral negotiation. It also excluded some products of the inflation index to smooth its trend and transformed the superior range of the inflation target in the pursued target. BCB undertook those actions without accounting for the public’s expectations on the economic policy goals. Contrarily, the government insisted that it was seeking the inflation target blank, that the exchange rate was entirely market determined and that the fiscal situation was fine. Given that, the MP was erratic.

After seeing for a while that the scenario was not as fine as communicated, conventions about Brazil pointed to a hazy future. This explains why Brazil has taken so long to rebuild positive conventions on MP and on the expected future inflation. As Figure 2 shows, this happened by mid-2016 and just after that convention that enabled the BCB to reduce the Selic, which is still high, paying the price of leading conventions. The fiscal consolidation programs plastered public demand drivers, making Brazilian dive faster into the recession. At the monetary management sphere, Selic’s level worked as if the diving air tube was filled with rocks. Investment, in turn, was reduced.

**4.4. Further Issues: ‘Lava Jato’ Lawsuit and the political crisis**

In addition to the contradictions within the macroeconomic policies, and between them and the institutional reforms, there were two further non-economic problems reinforcing the Brazilian economic problems. The -3.8% growth rate in 2015 gave room for a political crisis and the impeachment of Rousseff, based on a doubtful crime against fiscal rules. Even after her fall, with President Temer in charge, the political crisis is still enduring.

Moreover, the so-called ‘Lava Jato’ lawsuit has been the biggest judicial operation against corruption and money laundering crimes in Brazil since when it began in 2014. It investigates criminal relations between political parties, politicians and big corporations, and has fueled the mentioned political crisis. Furthermore, the lawsuit investigates giant companies, such as Petrobras and Oderbretch, which account for a significant part of investment in the country.

These non-economic facts are fomenting conventions of volatility in Brazilian politics as it is uncertain if the current set of politicians reaches the end of their terms. Consequently, it only generates short-term policies, what means that fiscal consolidation produces reduction of public investment, whereas private investment is reduced by the companies directly influenced by the ‘Lava-Jato’. The fragility of the current government, in view of these two non-economic issues, curbs the economic leadership. Again, conventions fulfill prospects of a bad future, making liquidity preferred to investment, pushing the economic growth down and the employment rate down.

**5. Final Remarks**

Brazil has been going through its bitter moment in history. Economic contradictions and more recently a period of economic and political problems have provoked conventions that dishearten the expectations of the country’s economic future. The issues rest in contradictions within the macroeconomic policy mix and between them and the institutional reforms, as also debated in Chapter 1 of this book. Over 2011-2016, noticeably between 2014 and 2016, the political crisis and the impact of ‘Lava Jato’ also heated the controversial atmosphere in the country and casted despaired conventions and expectations.

In contrast to what the government has been doing, conventions of a better future would only emerge if agents saw the economic policy as trustful and aimed at building demand drivers, notably public investment, monetary and exchange rate stability, and good institutional environment. These Keynesian and Post Keynesian policies were not implemented in Brazil, although some critics argue that the failed experience of Rousseff’s macroeconomic policy was Keynesian. As Resende et al. (2013) stated, this was not the case. Thus, the Keynesian economic policies this paper presents are the right choice to foment conventions that would forge expectations of a better future. If policies, such as the orthodox fiscal austerity and the restrictive inflation targeting, are still in place, and diverse from Keynesian economics, we would agree with the conventional view that no great economic possibilities for our grandchild are in place.

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1. Marco F.C. Resende thanks FAPEMIG/CNPq for their financial support. [↑](#footnote-ref-1)
2. As Davis (1997) pointed out, “the genuinely revolutionary positions found in The General Theory appear to depend on important respects upon the new views Keynes developed there regarding to history and conventions” (p. 149). [↑](#footnote-ref-2)
3. As Keynes (1973) states “a conventional valuation […] is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield; since there will be no strong roots of conviction to hold it steady” (p. 154). [↑](#footnote-ref-3)
4. Arestis and Terra (2015, p. 534) itemized the counter cyclical measures the Brazilian government launched. On the counter cyclical role of public banks, see chapter 12 of this book. [↑](#footnote-ref-4)
5. The period 2011-2016 comprehends two Presidents, Dilma Rousseff and Michel Temer. Rousseff was in charge from January 2011 to April 2016, when an impeachment took her off the cabinet. Then, in April 2016, Temer became President. Over this period, Rousseff took most of the economic policy measures; thereby, we focus on the actions she ventured. [↑](#footnote-ref-5)
6. There were different sectorial impacts of the overvalued RER. The greater international prices of mining and agriculture commodities reduced the RER in these sectors. However, the manufacturing industry (like the textile, electronics, capital goods industries, etc.) was badly affected. [↑](#footnote-ref-6)
7. Rossi and Mello (2016) saw a contradiction at the modernization of the consumption standard for a significant part of the Brazilian population. As a necessary condition to overcome the underdevelopment and the regressive production of the country, the supply that met this new consumption pattern came from imports enabled by the overvalued RER and so the Brazilian industry did not respond to it. [↑](#footnote-ref-7)
8. The enhanced current account in 2016 (-1.31% of GDP) due to the recession emerged from 2014 and onwards (BCB, 2017). [↑](#footnote-ref-8)
9. This and other MP and FP’s measures were Rousseff’s attempt to limber the New Macroeconomic Consensus macroeconomic policy practiced in Brazil. The Brazilian media called that attempt the New Macroeconomic Matrix. [↑](#footnote-ref-9)
10. The BCB also issued a so-called ‘reverse exchange rate derivative’ to curb the currency appreciation. As this tool is commonly used to avoid devaluations of the exchange rate, the one used to restrain valuations was called ‘reverse’ swaps. [↑](#footnote-ref-10)
11. These hedge contracts do not deliver American Dollars to their holders and so they do not let the foreign reserves volatile. The BCB pays in *Real* the amount equivalent to the change in the value of the exchange rate. Nevertheless, the contracts are a liability of the BCB and so they impact the public debt and the FP. [↑](#footnote-ref-11)
12. Aggregate investment had lower quarter variations from 2012 onwards, as IBGE (2017) reports: 2011, 7.37% of quarterly average variation, 2012, 2%, 2013, 4.85% - a soft recovery -, 2014, - 1.47% and 2015, -10%. [↑](#footnote-ref-12)
13. General government circumscribes counties, provinces and Union. However, Union, i. e., the Federal government, owns the clear majority of debt. In Brazil, more than 95% of the gross debt was a liability of the Union over 2006-2016. [↑](#footnote-ref-13)