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FINANCE MINISTER AND CENTRAL BANKER OF THE YEAR

The return of Poland's middle-distance champion

Long, long ago, when half the world was ruled by men who still believed in state control of the economy, Poland took the gamble of letting the market decide the price of goods. That dose of shock therapy in 1989 became a model for Eastern Europe. The man who imposed it became one of the region's leading economic thinkers. Now he is back at the helm of the Polish economy. James Rutter talks to Leszek Balcerowicz about history, movies and the trials of coalition government.

CENTRAL BANKER OF THE YEAR

Gustavo Franco's bold use of power

Brazil long needed a heavyweight in the central bank chair and now it's got one. Gustavo Franco earned his spurs in last October's Asian meltdown. His policy regime, especially the use of capital controls, is being studied around the world. Brian Caplen reports

Brazil's textbook response to last October's Asian crisis turned central bank governor Gustavo Franco into a figure of world renown. The doubling of interest rates together with fiscal cuts kept Brazil stable and gave credence to the current policy regime - fixed exchange rate with crawling devaluation and capital controls in an otherwise market-oriented environment - that Franco is associated with.

The Russian crisis is putting Brazil to the test again and the final outcome remains uncertain. While no-one is invincible, Brazilians can rest assured that in the current turmoil they have an experienced technician at the helm, who is cool in a crisis and not afraid to use the full weight of his powers to see off trouble.

"Gustavo Franco advised the president at the time of the Asian crisis that the government had to go for a very orthodox response," says an analyst with a Brazilian investment bank. "This earned him huge respect in the markets."

But Franco's resolute stance has not always made him popular. "Gustavo Franco believes deeply in what he stands for and is prepared to fight with all his strength for it. He doesn't mind making enemies," says a seasoned Brazil watcher.

Franco became central bank governor on August 20 1997 and had been in the job only three months when the Asia crisis hit. But his experience at the central bank goes back much further. He became the bank's director of international affairs in September 1993 after spending five months as deputy secretary of economic policy in the finance ministry. He was one of the architect's of the 1994 Real Plan which brought years of hyperinflation in Brazil to a close.

Not one to resort to dry technical jargon, Franco describes the unfolding drama of Brazil's reaction to the events in Asia in human terms. "Watching the storm coming, you have different levels of reaction," he says. "The crucial decision is to upgrade your alert status one notch further. The interest-rate increase was level one in which we had to react on the macroeconomic mode - selling reserves and the like. We had to do something macroeconomic that would affect the domestic economy. The second level of reaction was fiscal policy, to sit with the finance minister [Pedro Malan] and then with the president [Fernando Henrique Cardoso] saying that its one thing for the central bank to use its weapons to defend the currency, but the other thing needed is for the nation to use other means to defend itself from external financial shocks. Fortifying our macroeconomic fundamentals was a crucial thing to do. The decision was to build that fiscal package [of spending cuts] - that was an $18 billion effort, slightly over 2% of GDP - and then we had a complete response."

Franco recalls it as being a terrible week but laughs: "It was fast. These moments of financial uneasiness appear suddenly, but they go away very quickly."

And as Franco points out, this was not the first tense period he has lived through at the central bank. There was the Mexican peso crisis in 1995 and before that some nervous moments associated with the Real Plan.

The great achievement has been to have a coherent policy framework that acts as a reference even when markets are in turmoil. In Brazil the starting point for this was curing inflation and reducing the role of the state in the economy.

"Fighting inflation is not like reducing a fever with a cold bath," says Franco. "It's a serious disease and you need a long time to provide a definite cure. We knew that hyperinflation represented a crisis in our development model - to use big words - and we had to redefine the development process. Two major changes had to be made, one was changing the role of the state in the economy, that's another name for balancing the budget. The other thing was changing the relationship between Brazil and the rest of the world - that is, opening the economy for trade and foreign investment."

Brazil is still having difficulties with the first of these. The fiscal deficit between January and May was 6.5% of GDP made up of a primary surplus of 0.8% and interest payments of 7.4%. One Brazilian banker says: "The country is haemorrhaging money."

A recent report by ING Barings describes the seriousness of the situation: "As recent events in Russia are clearly demonstrating, a large government budget deficit financed through the issuance of short-term treasury bills can breed - given a pegged exchange rate regime - a genuine balance of payments crisis. Rising yields on treasury obligations do not always succeed in enticing debt holders to remain invested. Should there be a loss of investor confidence then, even if treasury bills are payable in domestic currency and the investor base is mostly local, the central bank could quickly find itself facing a wave of demand for foreign exchange that it may not be able to satisfy - at least not at a given, set price."

Franco, a former academic who has both an MA and a PhD from Harvard, and whose many books and articles include one entitled "Fiscal reforms and stabilization: four hyperinflation cases examined", agrees that the central bank cannot remain passive in the face of deficits. But he argues that the fiscal situation is not as serious as many observers have stated while current-account deficits are a result of openness and capital surges. He complains that the impact of global flows on the economy is making it harder for Brazilian politicians to sell the globalization concept to the people in an election year.

"Looking at our fundamentals - our fiscal numbers - they are not very much different from the average European case," he says. "Take away the spending by states and provinces from our fiscal numbers - which is a European practice - and we have a deficit of 3.5% of GDP which almost meets the Maastricht criteria. We know that we don't have a track record: that's something we have to build. But the other thing is that we have invested in the concept of being an open economy, in the concept that it is productive and useful to participate in the world economy in a more intense way. It's annoying to then receive from the world economy negative energies. For the man in the street who has heard so much about the good things of globalization, all of sudden globalization is bringing bad stuff, it doesn't help."

Brazil is wedded to both capital controls and a fixed exchange rate as mechanisms for controlling the macroeconomic environment. "We have always thought we should use capital controls upside down to avoid excessive entry [rather than flight] because that's what makes you vulnerable when things go wrong," says Franco.

"It's actually a 19th-century experience," he believes. "Countries like Brazil, Mexico, Argentina - even Australia for that matter, they experienced capital surges in the past and it affects you heavily if you have entries like 3% of GDP for five consecutive years. That drives your exchange rate and your current account towards deficit, very naturally, and if you are passive to that big influence you start experiencing something that in Britain was called Dutch disease. You have a windfall of foreign exchange; it appreciates your exchange rate; you quicken your exports; bring imports in. But all of sudden this windfall disappears and you are left with a big current-account deficit and no support."

Franco adds: "The lesson to draw from the Asian situation was that for us it was very good to have had the capital controls because lots of hot money had left the country before the Asian crisis. When it hit us we had a loss of reserves of between $7 and $10 billion depending on how you measure it, and it could have been more if we didn't have the capital controls."

Similarly, Franco rejects the idea of a free floating currency which he sees as being only applicable to major reserve currencies. There will be no changes after the election, he says. "This country has a regime that is pretty much what we see in other economies of similar economic importance in the world. We have a system of mini-bands and also this lip service to broader bands that most countries have. Reality shows that central banks worldwide do not like to see much volatility in exchange rates. Ideas of having bands of 10% up and 10% down - these are unrealistic. Everywhere we see those big bands they don't work. What works is an interval much smaller of 1%, 2% at most, which the central bank works to keep spot rates inside. That's reality. That's the most common case. Take away the big reserve currencies, all the others work like that.

"We have to avoid opening the current account deficit. That is only natural when you are receiving too much capital. If we stay passive, the trend is to suffer from Dutch disease. Look at Chile, it's a bit like that. Foreign direct climbed to more than 100% of the current-account deficit in Chile. They started to promote capital outflows to avoid excessive build up of reserves. In our case, foreign direct investment is now climbing to 80% of our current-account deficit and if we just stay passive we become too vulnerable."

Franco is noted in Brazil for his proactive approach to financial markets. While in the past investment banks made money out of central bank inefficiency, today they know they may be punished for stepping out of line.

"People love him for the stability he has brought," says one Brazilian analyst. "People hate him for being a tough cookie. He is ready to use the power of the central bank to punish institutions that are speculative in manner."

One recent scrap with the markets was when investors were demanding what the central bank regarded as too high a price for fixed-rate bonds. The response was to move more to floating-rate bonds as were used heavily during the inflationary years.

"The market is a bit spoiled by indexed bonds of several types [bonds indexed to exchange rate, interest rate and price indices] because it's a cheap hedge," says Franco. "When people get nervous about the exchange rate, or Asia is giving us problems, the one way to hedge yourself against anything is to display a preference towards dollar-indexed bonds. For the government it is a fiscal opportunity because you sell these bonds better than otherwise and charge a premium. It's like selling insurance. The same goes for moments like right now in which there are interest rate uncertainties. Then we sell interest-rate-linked bonds under very good conditions. It becomes cheap for the government."

But aren't Brazil's dollar-indexed bonds rather like the tesobonos that got Mexico into trouble in 1995? "I think the tesobonos experience has given dollar-indexed bonds a bad reputation," says Franco. "There was a fiscal situation that imposed a process of explosive growth in public debt, or shortening of maturity, which by its nature had nothing to do with dollar indexation."

Franco's term of office as governor is not a fixed one. He is appointed by the president and can be fired by him at any time. Franco would prefer to see fixed terms for governors and argues that central bank independence in Brazil is increasing as the bank's reputation improves. "The question of central bank independence and stability goes both ways," says Franco. "Usually people tend to think that independent central bankers help enforce stability. But it's also the case that stability enhances central bank independence."

ALSO HIGHLY COMMENDED

Pedro Malan

Finance minister, Brazil

Determination and coordination: those were the words one banker used to characterize Brazil's finance minister. Pedro Malan's policies have continued to improve his country's fiscal outlook and his reactions to the crises of the past year have been timely and attuned to the actions of the central bank.

During the Asian-crisis induced market panic in October, the central bank raised interest rates and the finance minister then rapidly made spending cuts to compensate for this. The combination staved off devaluation. Brazil was the first South American country to react to the crisis. On October 29 the central bank doubled interest rates. On November 10 Malan's fiscal package was introduced. The timely reaction and the united approach assured investors. "The president announced a push forward with structural reforms not just of the central banker, not just the executive federal government. It was the response of the country," explains Malan. "The worst scenario is to act like a passive victim with a wait-and-see attitude. Countries have been paralyzed by that before."

Foreign investors have noticed the commitment: in the last year investment inflows have been $17 billion (the year before that they had been $1 billion). In the next year $20 billion in investments is expected. Malan attributes this success to the stability of the country and its obvious signs of progress. "We are not a Johnny-come-lately when attracting foreign investors. There are no border conflicts, no ethnic rivalries, no dialects, and no fundamentalist religious movements in Brazil. There is a democracy in the process of consolidation, there is political stability and there is macroeconomic stability. This is increasingly being perceived."

The Brazilian "dream team" - Malan and central bank governor Gustavo Franco - have a rapport unparalleled in South America. "Gustavo was one of my best students," says Malan. "We often talk several times a day". They complement each other well in style as well as policy. "They are very united," says Carlos Kawall, chief economist at Citibank Brazil. "Malan has the most experience with relation to the economic community because he was a representative to the World Bank. He concentrates on the fiscal accounts and the budget. He is the more experienced economist and is well respected, very balanced. Franco is more polemic, takes a more aggressive tone to government's critics, and is younger. He is the think-tank behind the FX policy."

Last month Malan celebrated his fifth anniversary at the helm of Brazil's economy - a period evenly split between being central bank governor and finance minister. He proudly reports: "This will be the fifth consecutive year of declining inflation in Brazil. It is the sixth consecutive year of sustained growth. There has been a remarkable increase in productivity in the Brazilian economy over the past few years. We think we are creating the conditions for sustained growth with low inflation for many years to come".

Even though the Real Plan (the economic stabilization programme implemented in 1994) hasn't been as successful as hoped for, the finance ministry is not being blamed. The problem lies with state governments' autonomy and structural problems in the social security system over which the ministry is only now beginning to have some control. Malan has made important progress in adjusting the states' fiscal situation by making state governments indebted for their large, previously rolled-over security debts. There are now legally binding contracts in place that involve some commitment to payment. Malan and his ministry have been honest and unabashed about what they must work on in the future. "To be frank the big problem that is still unresolved is the social-security issue. It is the challenge we face, but we are working hard to solve it."

Yannos Papantoniou

Finance minister, Greece

Luis Angel Rojo

Central banker, Spain

Gyorgy Suranyi

Central banker, Hungary