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Policy Note

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THE NARROW PATH FOR BRAZIL[1]

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Introduction

Brazil is mired in a joint economic and political crisis, and the way out is unclear. In 2015 the country experienced a steep contraction of output alongside elevated inflation, all while the fallout from a series of corruption scandals left the policymaking apparatus paralyzed. Looking ahead, implementing a policy strategy that has any hope of addressing the Brazilian economy's multilayered problems would make serious demands on a political system that is most likely unable to bear it.

Brazilian real GDP is estimated to have contracted 3.8 percent in 2015. Meanwhile, annual inflation reached 10.7 percent in 2015—way above the Central of Bank of Brazil's target rate of 4.5 percent, or even the 6.5 percent ceiling of its policy band (IPEA 2016). The overnight cost of bank reserves in the interbank market (SELIC) is currently 14.25 percent. The exchange rate to the US dollar is around R$4, a 50 percent increase over a year ago. Fiscal space for implementing recovery policies is practically nonexistent, with fiscal deficits reaching 10.3 percent of GDP and the gross public debt ratio at 66.2 percent of GDP.[2] Unemployment has been growing rapidly and the outlook for 2016 is not promising, to say the least, with the International Monetary Fund (IMF 2016) projecting a further contraction in GDP of 3.5 percent. Concerns about the solvency

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of large firms that have sharply increased their foreign indebtedness in recent years intensified with the steep devaluation of the real in 2015.

Managing such a situation would be a tall order, even for an efficient administration counting on popular support. Such support, however, is in short supply. President Dilma Rousseff, whose approval ratings have been consistently in the single digits since the beginning of 2015, is currently facing an impeachment process. President of the Chamber of Deputies Eduardo Cunha, who initiated the process and is third in line for the succession, is himself widely expected to go to jail in the near future for his own role in large-scale corruption schemes. An unusually high degree of uncertainty, even by local standards, surrounds the question of who is going to be "in charge" in the near future—and of how they will be able to govern.

With respect to the causes of Brazil's economic infirmity, the domestic debate has pitted analysts who believe the crisis is due exclusively to past, pre-2015 policy mistakes against those who place all the blame with the government's decision to implement fiscal austerity policies last year. In fact, both causes contributed to the crisis. The Brazilian economy had become much more fragile than many would have liked to believe. And while the announcement of austerity did its damage, the depth of the economic crisis had an additional, more proximate cause: the political breakdown of the federal government in 2015.

The problems facing the Brazilian economy are real and urgent, but the degrees of freedom to design consistent policy responses, whoever ends up in power, are limited. For all practical political purposes, Brazil is stuck with fiscal austerity. A shift to a smarter austerity, featuring an increase in public investment paired with less damaging spending cuts and revenue increases, could limit the negative impact on aggregate demand. But it would also require navigating a delicate series of trade-offs—a feat the political system seems incapable of performing for the foreseeable future.

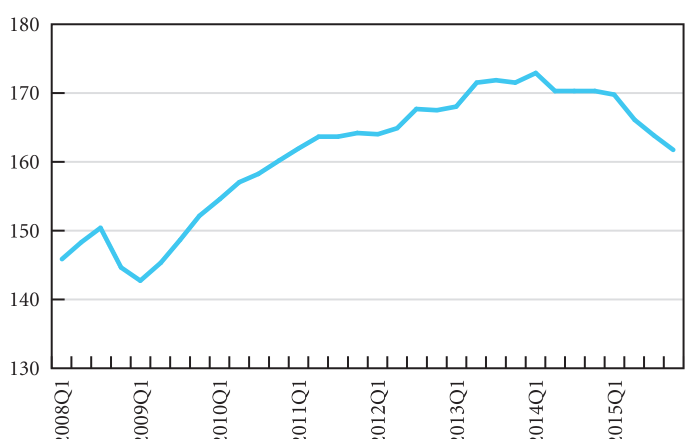
Causes of the 2015 Output Collapse

Before assessing possible remedies, we need to understand how the Brazilian economy has reached this juncture. Many have pointed to the austerity policies announced by Finance Minister Joaquim Levy, appointed by Rousseff in December 2014 for her second term, as the most obvious culprit for the collapse of output in 2015. There is, however, much more to this story.

Public debate about the recent performance of the Brazilian economy relies on the notion that it recovered fairly quickly from the 2008–9 recession and had successfully maintained its growth momentum until 2014. The reality was somewhat different. The "Chinese growth rate" Brazil reached in 2010 (7.5 percent) was an isolated phenomenon, not the beginning of a new trend, as many people then seemed (or wished) to believe. By 2011–12, the economy had already lapsed into virtual stagnation, despite the continued implementation of countercyclical policies. As one can see in Figure 1, quarterly GDP growth was faltering by 2011 and ceased completely in 2012. One can debate whether the 2010 recovery was due to the particular countercyclical policies chosen by then President Lula da Silva or to China maintaining its imports from the Brazilian economy, but whatever worked in 2010 was no longer working so well a little later, and had stopped working altogether by 2012.[3]

The Brazilian economy had been losing steam for quite some time *before* Minister Levy assumed his post, despite the expansionary character of government policies adopted in the post-2009 period. Austerity policies were certainly a factor in the contraction verified over the course of 2015, but the fact remains that the economy was much more fragile at the beginning of 2015 than many were led to believe. The good times the country enjoyed during most of Lula da Silva's two terms in office, despite the 2009 recession, were explained much more by the Chinese pull and by abundant international liquidity than

Figure 1 **Real GDP Index, Quarterly Levels (1995=100)**



Source: IPEAData

by enlightened policymaking.[4] In fact, truly enlightened policymaking would have meant taking advantage of the good times to reduce the country's renewed dependence on one major buyer for exports of raw materials, thereby strengthening the domestic economy's foundations—something that was not even tried.

The government also had to face the emergence of corruption scandals in 2014. The biggest of those scandals involved the largest firm in the country: Petrobras, the oil company of which the federal government is the largest stockholder.[5] The corruption scandals had a negative impact on the Brazilian economy through direct and indirect channels. The direct impact was the dramatic reduction of investments in Petrobras[6] and infrastructure works, due to the wholesale indictment or conviction of practically all business leaders in the heavy construction industry.

The indirect impact was that the accumulation of accusations against current or former members of the government weakened Rousseff's hold on power, despite her reelection. But Rousseff's political losses suffered as a result of the corruption scandals were not her only problem. The change in her policy stance—announcing an austerity package after spending the whole electoral campaign declaring her opposition to it—weakened her position even with her own political base. Talk about impeachment or annulment of the elections in fact began even before she was inaugurated for her second term in January 2015. The political disintegration of the new government became crystal clear in the first quarter of 2015, when the impasse was made explicit: the president could not command enough political support to effectively govern, while the opposition could not gather enough political support for shortening her term in office by legal means.[7] It was clear to many that the country had suddenly become impossible to govern—with more than three years to go before new elections would be held, in 2018. Under such heightened uncertainty, it should not come as a surprise that many important decisions by households and businesses were postponed and the economy gradually ground to a halt.

The preceding considerations should not be construed as suggesting that austerity policies should be let off the hook as a cause of the steep contraction in 2015. One can easily identify a contractionary "announcement effect" surrounding the first statements made by the finance minister in December 2014, which were reaffirmed after Rousseff's inauguration the following month. Nevertheless, the irresistible force of the new minister met the immovable object of congressional opposition and was found wanting.[8] Most policies were rejected out of hand, some had their reach or intensity diminished, and others were simply indefinitely postponed for future discussion. In other words, the possible contractionary effect of announcing austerity policies was quickly replaced by the perception that perhaps no policy at all could be implemented by Rousseff's administration.[9]

But the public pressure on the federal government to harden its fiscal stance was maintained or even increased, especially when the public became aware of the extent to which the fiscal accounting had been willfully manipulated in recent years to show an improvement in performance. Unable to pass any legislation that could rationalize expenditures or increase revenues, the federal government resorted to the least efficient method of austerity possible: self-imposed cuts in expenditure in the sectors least likely to put up significant resistance. The only significant *policy* change in the spending profile was the sharp cut in credit subsidies offered by public financial institutions, ultimately financed by the treasury.

As fiscal policymakers were gripped by paralysis, the only federal institution publicly perceived to be working was the Central Bank of Brazil (BCB). An inflation rate way above the official target, however, forced the bank to raise overnight interest rates in the interbank reserves market, which reached 14.25 percent by the end of 2015. The principal loser from such a rise is, again, the treasury, since a considerable share of public debt is indexed to the SELIC interest rate raised by the central bank.[10] There is clearly very limited, if any, political room for an expansionary policy—fiscal or monetary—to counteract the contraction being experienced since early 2015.

The Narrow Path Forward

Assuming that a solution can be found for the political crisis, is there any possible policy strategy that could stop the decline of the Brazilian economy?

The first matter of business must be to ensure that the devaluation of the real endures. While the extent to which the recent devaluation will help to engineer a sustained recovery is unclear, there is little doubt that a return to the overvaluation characteristic of the post-1994 period would kill any such possibility.

Though not a trivial task, it is not an impossible mission to keep the real around its current levels. The external value of the Brazilian currency has always been highly dependent on events taking place outside the country. Recently, two factors have been particularly relevant in the determination of exchange rates: monetary policy in the United States and sales of grains and raw materials to China.

Trend movements in the exchange rate closely followed the decisions made by the US Federal Reserve in the years after the subprime crisis. Quantitative easing policies led to the most recent bout of overvaluation for the real. Devaluation began, on the other hand, when Fed Chairman Ben Bernanke first raised the possibility of policy reversal. Although the pace of the tightening of monetary conditions in the United States is still uncertain, few analysts believe that there will be a return to the previous policy. Moreover, emerging countries like Brazil have become less attractive to financial investors due to domestic problems and the deceleration of growth in China.

Exporting agricultural and mineral commodities to China was the main cause of the rapid expansion of exports in the 2003–9 period. In fact, export revenues grew so strongly in that period that many analysts (most notably, Luiz Carlos Bresser-Pereira) revived the "Dutch disease" concept to show how those revenues were overvaluing the real and making it impossible for exporters of manufactured goods to remain competitive. The fall in China's growth rates and, perhaps even more important, the reorientation of its growth strategy took the gas out of Brazilian commodity exports, again suggesting that the exchange rate levels observed recently may last for a prolonged period.

On the domestic side, one can argue that the BCB reached its limits (or came very close to them) when it took overnight interest rates to a little over 14 percent by the end of 2015. Aside from some economists connected to financial institutions, a large share of the economics community—orthodox and heterodox—is convinced that further increases would not make any difference in the fight against inflation but could further compromise, perhaps fatally, the attempts to contain fiscal expenditures. A sharply devalued real could still attract a more intense capital inflow from investors chasing domestic assets at bargain prices. In the near future, however, political instability seems to have discouraged a large number of investors.

However, the devaluation of the real per se may not have the expected expansionary effect on the economy, at least for a while. According to many analysts, Brazil's long period of exchange rate overvaluation may have led to a wave of deindustrialization that reduced the size of its domestic manufacturing sector. If this is true,[11] then the subdued reaction even now to devaluation should be explained by the decimation of the sector that is usually the more sensitive to such forces.[12] A change in relative prices is expected to have a strong and immediate impact on competitiveness when capacity already exists and the only decision to be made is how far to use it. After years of deindustrialization, some import substitution may take place, but expanding manufacturing output may be harder and take longer than one has seen in similar occasions in the past (e.g., in 1999). In addition, to stimulate investments in manufacturing, businessmen have to believe the devaluation will be long-lasting. One obstacle to reawakening animal spirits is stubbornly high inflation, which continuously erodes the gains obtained by devaluation.

So far, one can observe some signs of revival through small-scale import substitution, particularly by businesses that have started producing for themselves some of the components they need. The reaction of exports has been more subdued. International trade growth remains weak. Expanding exports requires dislodging some competitor, which is always more difficult than increasing shares of an expanding market. The recession has led to a sharp reduction in imports, on the other hand, which has increased *net* exports but does not signal, per se, a way out of the recession itself.

Domestic policymaking, therefore, has an essential but exceedingly difficult role to play in the present moment to end the recession and generate a recovery. High inflation and restricted fiscal policy space drastically limit the government's options. So far, government authorities seem to have chosen a cautious path. The only important announcement referred to measures to increase credit supply, which can hardly be expected to be effective in the current situation. The problem is clearly *not* lack of credit but lack of demand. Households will probably not increase their debts, especially when facing the specter of unemployment. Businesses in need of credit are probably the ones trying to roll over current debts rather than seeking to finance new purchases of labor or raw materials, let alone investment goods. Private borrowers, households and businesses, are already in debt, and uncertainty about future incomes would likely create an adverse selection problem, whereby only those willing to take loans without caring about risks will present themselves in the market. Banks themselves may have second thoughts about increasing their exposure to indebted borrowers.[13] In any case, scattered evidence coming from bank managers suggests that credit is already available but that there are no takers.

Officially, austerity remains the chosen strategy, despite the deepening recession. One has to realize, however, that no other *politically* feasible strategy seems to exist. Corruption scandals, repeated attempts to disguise the fiscal impacts of supply-side policies, and the generalized perception that government officials were managing public finances without any rationality or responsibility have made classical expansionary policies impossible to sell politically. Moreover, high inflation helps paralyze any initiative designed to stimulate the economy through willful generation of fiscal deficits.[14]

Relying on private agents to promote a recovery from a normal recession (let alone a deep recession like the one Brazil is going through) is a mistake. To expect consumers to increase their debts in order to spend on consumption when rising unemployment is a concrete threat and there are signs that current loans are already hard to liquidate seems hopeless.

Any revival of aggregate demand has to come from investments, but it is also difficult to see why private businesses would increase investment when they evidently see little reason to fully utilize the equipment they already have. Investment, therefore, has to come from "outside," on the initiative of either the government or foreign investors, or both in association. The obvious destination is investment in infrastructure, of which the country is in dire need.[15]

Joint projects with foreign investors, through public–private partnerships (PPPs) for instance, are one possibility, although such partnerships may be more difficult to create than is usually supposed. How to define the roles and rights of each party to the partnership is not a trivial problem to solve, and both governments and private investors are usually suspicious of each other. Besides, in many PPPs the government builds and private investors manage the facilities by concession or some other form of contract. This type of solution would not be helpful, since the current situation is characterized precisely by the difficulty the federal government faces in increasing its expenditures.

The alternative that seems to be left is for government itself to take the initiative but to compensate for the added expenditure by making cuts in other outlays that have a smaller "multiplier effect." It is well known that, in this respect, public investments are more efficient than expenditures aimed at promoting consumption: while part of the increase in consumers' income will leak into increased saving, investment is entirely spent. Spending on subsidies is even less efficient at increasing output and employment. Public works and infrastructure investments—usually the expenditures that are sacrificed when there are pro-austerity pressures—should be precisely the priorities when there is a need to revive the economy. If total expenditures cannot be increased, it is the other areas of government spending that should shoulder the cuts.

A Cautionary Conclusion

The proposal to increase public investment at the cost of other expenditures brings us full circle back to the political crisis. Reducing fiscal deficits while increasing investment requires either raising taxes, cutting other expenditures, or, more likely, a combination of both. Even in the best political conditions, it is certainly a difficult equation to solve. If taxes are going to be raised, which taxes should be increased and who should pay them? If expenditures are to be cut, which ones should be reduced?

Again, the Brazilian situation seems insoluble. No group accepts the idea of higher taxes, unless other people are chosen to shoulder them. Likewise, no group accepts a cut in those expenditures of which they are the beneficiary. In fact, in the post–military regime period, the practice of earmarking fiscal revenues to specific expenditure items has become widespread. Some of this earmarking was even embedded in constitutional provisions. Only skillful negotiation led by a trusted political leadership could obtain current sacrifices from participants with a view to achieving better results in the future. Unfortunately, there does not seem to be the slightest possibility that such a negotiation could happen in the near future. The government does not seem capable of doing it. All initiative was lost when avoiding or beating an impeachment process became its first and practically only priority. On the other hand, no legitimate organized opposition exists to present demands and lead a negotiation on behalf of the people. The country has no "elders" to appeal to, no statesmen of recognized stature who deserve the trust of the nation.

Under such circumstances, until Brazil gets closer to the presidential elections scheduled for 2018, there seems to be no plausible alternative to the continuation of the recession and political uncertainty.

Notes

1. For a more extensive treatment of these issues, see Cardim de Carvalho (2016).
2. Cf. BCB (2016). The debt-to-GDP ratio may not be considered excessive, especially if one compares it with the ratios exhibited by advanced economies in the postcrisis period. Moreover, it is important to keep in mind that public debt is mostly denominated and payable in local currency. Nevertheless, the pace at which debt has been growing lately and the wide use of accounting tricks by the government to disguise it have powerfully eroded public trust in the federal government, constraining its fiscal policy choices.
3. Jan Kregel (2009) has already pointed out the significant fragilities of the Brazilian growth strategy.
4. One piece of evidence to suggest that the countercyclical measures played only a minor role was the poor performance of the manufacturing sector—toward which most of the policies were directed. The sector, which does not have China as an important market, barely registered a recovery at all (see Cardim de Carvalho 2016, Figure 2). Of course, one might argue that had the government chosen not to act the situation could have been even worse.
5. In fact, Petrobras is not just an oil company. It was created as a result of intensely nationalistic feelings in the early 1950s, manifested in mass demonstrations and even violent conflicts with the government. To many, it is a symbol of nationhood.
6. Petrobras has been responsible for about 10 percent of investment in Brazil.
7. The situation was made more complicated by the ongoing investigation into government corruption, which threatened (and still does) to end in jail terms for some of the highest political authorities in the land, including members of the opposition.
8. The majority of representatives in the Chamber of Deputies are not actually Rousseff opponents. However, even her supporters saw the chance of improving their bargaining power with the president by resisting the proposed policies.
9. One dramatic example was the proposal to reintroduce a tax on payments made through the financial and banking system, known by its Portuguese acronym, CPMF. Opponents of the government declared their vote against the tax right away. Supporters of the government just postponed any decision. What was supposed to be an urgent need in the beginning of 2015 will possibly be examined at some point in 2016, with little chance of being approved.
10. The SELIC interest rate is the Brazilian equivalent of the US federal funds rate.
11. This "deindustrialization" thesis is the object of intense controversy in Brazil.
12. The concentration on exports of raw materials would, in addition, explain the low sensitivity of exports to exchange rate devaluations.
13. Information published by the central bank in its October 2015 *Financial Stability Report* (BCB 2015) suggests that banks did not yet have reasons to be concerned about nonperforming loans. Graph 2.3.4, page 23, shows that the nonperforming loans of private banks remained fundamentally stable from early 2014 to mid-2015 (lastest information available) but well above the ratio observed in public banks in the same period. Of course, the information describes the period before unemployment began to rise and the economy accelerated its fall.
14. For a discussion of the forces behind the inflationary trends in Brazil, see Cardim de Carvalho (2016).
15. Both John Maynard Keynes and Michal Kalecki insisted on the importance of public investment as the initiator of a recovery. See, for instance, Keynes (1982, pp. 148, 151, and 158) and Kalecki (1971, chapters 2 and 3).

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