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BRAZIL STILL IN TROUBLED WATERS

FERNANDO J. CARDIM DE CARVALHO

Contents

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Preface

Five months after Michel Temer assumed the presidency following the impeachment of Dilma Rousseff, he and his advisers have seemingly abandoned the cautious approach to economic policy that might have been expected given his politically tenuous position. The most headline-catching measure has been the imposition through constitutional amendment of a radical, two-decades-long public spending freeze, purportedly aimed at sparking an increase in business confidence and investment.

In this policy brief, Fernando Cardim de Carvalho explains why this fiscal strategy is based not only on a flawed conception of the drivers of private-sector confidence and investment but also on a mistaken view of the roots of the current Brazilian economic crisis—that is, it runs athwart both theory and reality, and is unlikely to succeed. However, given the political instability that continues to imperil the policymaking process in Brazil, there is no clearly viable path to implementing an alternative policy approach that would have a genuine chance of returning Brazil to economic health.

For critics of Rousseff and her administration, the assumption was that an economic recovery could be launched by implementing fiscal discipline and addressing governance issues. According to this theory, adopted by the Temer administration, these policies—and in part the very removal of Rousseff—will increase confidence among investors, which would then overwhelm any economic drag caused by austerity and lead to that elusive yet much-sought-after policy achievement: an "expansionary fiscal consolidation."

The most dramatic of the collection of measures initiated by the Temer government was a constitutional amendment, now ratified, that freezes real federal expenditures at their 2016 level for the next 20 years (or at their 2017 level in the case of minimum health and education spending). Cardim de Carvalho describes the amendment as politically savvy, since the government has been able to claim that no specific expenditure item has been sacrificed. However, the notion that this amendment, and its attendant penalties, will be credible—that is, regarded as durable—in the eyes of relevant economic agents should be met with skepticism, he suggests.

More important, Cardim de Carvalho critiques the understanding of business "confidence" and its macroeconomic impact that animates the government's hopes for an expansionary fiscal consolidation. The real driver of *positive* short-term expectations—and thereby private investment decisions—is the experience of rising sales and profits. But there are no policy changes or trends evident in the Brazilian economy that could generate such results, the author observes. There are no measures in place that could slow down the recession that began in 2015, let alone signal a path to recovery and growth. If anything, Cardim de Carvalho writes, negative short-term expectations are likely to rule the day (and the years ahead).

This leaves us, he notes, with whatever confidence effects might be generated by the perception of a change in political leadership and improved governance. But Cardim de Carvalho points out that uncertainty remains very high with regard to the stability of the current government. The corruption scandal that brought down his predecessor is still stalking Temer's advisers, members of his cabinet—and the president himself. It would not be surprising, the author notes, if Temer did not last out the remainder of his (adopted) term.

Finally, the idea that the current economic crisis stemmed chiefly from a failure to control public spending—which seems to have become the received view—does not match with the current economic reality or the recent history of the Brazilian economy. Cardim de Carvalho gives a brief accounting of the roots of the crisis that reinforces how implausible it is that the Temer government's fiscal strategy will succeed.

According to Cardim de Carvalho, public investment is a crucial lever for lifting the country out of its current economic mess. But the ongoing political crisis and current policymaking environment, he laments, make an increase in public investment unlikely.

As always, I welcome your comments.

Jan Kregel, *Director of Research*
February 2017

Introduction

President Dilma Rousseff was initially suspended on May 11, 2016, when the Senate agreed to open impeachment procedures against her, as prescribed by Brazilian laws. Vice President Michel Temer temporarily took over as "caretaker" president while the Senate examined the accusations. The whole process ended on August 31, 2016, when, as a result of a plenary vote in the Senate, Rousseff was definitively deposed and Temer became president in her place for the rest of the term for which they were elected (to end in 2018).[1]

Temer's interim presidency was certainly peculiar. Although legally there is no such figure as a caretaker president, with limited authority to decide on policy matters, an interim president is expected to respect the transitory nature of his or her mandate. It was generally considered that the exercise of power by Temer should be confined to routine decisions necessary to run the administration while a final decision by the Senate was reached. It is true that many others argued that the deepening economic crisis demanded immediate action; that one could not wait until the end of August, when the impeachment process was scheduled to end, to begin governing.

Be that as it may, Temer, breaking national and international precedent, has aggressively pursued a different course since his first day as acting president, replacing ministers and central bank governors. For all practical purposes, Temer began to govern in May, not in August 2016. On the occasion, he announced his *long-term* policy strategy centered on a strengthened version of Rousseff's austerity policies.

The country was in fact experiencing a dramatic economic decline in the first half of 2016, which could continue for a long time. Rousseff's administration had been paralyzed for about a year. Political corruption scandals were threatening to engulf all levels of government. Uncertainty as to the immediate future was pushing the country toward an abyss and there seemed to be nothing anyone could do to stop it. Fear of social disorder and violent conflicts when the social safety net finally collapsed fed the worst-case scenarios entertained by a growing number of people.

Temer's team seemed to believe that, under these domestic circumstances, Brazilian society was ready to accept *any* political change that could somehow promise improved governance. The incoming political group that surrounded Temer seemed to believe that by promising fiscal discipline they could achieve that most elusive of goals: an expansionary fiscal consolidation based almost entirely on the generation of positive confidence effects among consumers and, more important, businesspeople.

Today, five months after Temer was officially raised to the presidency, it is increasingly clear that the new government has lost its bet on a quick recovery based on such confidence effects. It seemed at first that the new administration could benefit from a "natural" exhaustion of long-duration contractionary processes, when firms begin replacing inventories and making unpostponable investments, signaling some stabilization if not actual recovery. This prospect, if real, has clearly not yet materialized. Output is still declining, unemployment is still rising, investments are still not being made, and, due to falling tax revenue, the fiscal situation is, if anything, worse than before.[2] Besides, the political crisis, far from being attenuated, let alone resolved, is still developing, including in circles that are very close to the president. Temer's popular appeal, which was never very wide, has shrunk to levels comparable to those of Rousseff.

Temer's Anticrisis Policies

During the last months of Rousseff's presidency, public opinion turned against her macroeconomic policies: fiscal imbalances were quickly elevated, in the minds of critics, from playing a supporting role in the recession to its main cause. According to her opponents, the crisis was to be explained as a result of the loss of confidence on the part of businesspeople in the future of an economy afflicted by those imbalances. Since, for her critics, blaming fiscal deficits and bad governance seemed to be enough to explain the crisis, balancing the budget and improving governance would equally be considered enough to increase confidence and, therefore, lead to recovery and growth.[3] Improved governance could not be shown right away, but the idea was that the nomination of authorities popular among market participants would issue a strong signal in that direction. Rousseff's opponents proposed that controlling fiscal deficits should be the object of immediate measures: shrinking deficits would decelerate the growth of public debt until its complete stabilization, alleviating the upward pressures it exerted on interest rates. The new government's view was succinctly expressed by Henrique Meirelles, Temer's new finance minister, in his testimony in the Chamber of Deputies:

> To the extent one is able to control the uncontrollable growth of public spending to service the debt, we will have an increase in confidence; as a consequence, the recovery of investment; and as a consequence of that, economic growth; consequently, higher employment; and as a consequence more resources available for private investment and consumption. (Câmara dos Deputados 2016a; author's translation)[4]

Accordingly, the new administration's attention was focused on the design of a credible fiscal austerity program, including measures to reduce fiscal imbalances and structural reforms to make balanced budgets sustainable in the future. The fact that the Brazilian economy was going through what was its worst recession on record was an obvious complication. Temer's new team, however, seemed to have no idea how to deal with it, other than repeatedly stating its expectation that confidence would quickly recover once Rousseff was definitively ousted and businesspeople realized that, with regard to Temer and his team, "this time was different." In other words, to paraphrase Paul Krugman, the "confidence fairies" would almost single-handedly transform a set of contractionary policies into an expansionary fiscal consolidation.[5]

While he was still interim president, Temer had announced a set of structural reforms conceived to eventually balance the federal budget. The most important of these reforms was the proposal to freeze real federal expenditures at the 2016–17 level for 20 years. From year to year, nominal federal spending would only be allowed to rise to compensate for inflation.

To ensure that those limits were credible, the proposal was enshrined in a constitutional amendment, which was approved by Congress last December. A proposed reform of social security has already been presented to Congress, but it will only be considered after the end of the summer recess, in March 2017. Other reforms are still being drafted, particularly in regard to labor markets and the tax system.

The Spending Freeze Amendment

Temer's proposal to amend the constitution was certainly an innovation. The amendment does not mandate balanced budgets or set targets such as limits on primary deficits. Rather, it freezes total real spending for 20 years at the levels reached in 2016 (in the case of some specific expenditures, the base year will be 2017; see below).[6] Nominal expenditures are to be adjusted to the variations in a consumer price index so as to keep them fixed in real terms during the period. At the end of the first 10 years, the federal administration can propose a change in the index used for the adjustment, but other than that, the adjustment does not seem to leave any room for manipulation.[7]

The Brazilian constitution already included amendments setting floors to some public spending, particularly in the provision of health services. Those limits were set as a proportion of nominal GDP, so they had to be modified by the new amendment. Now *minimum* expenditures in health and education will be frozen at the levels reached in 2017. The amendment admits some exceptions to the freezing clause, most of which are considered politically impossible to remove (like, for instance, transfers to subnational levels of government); but there was clearly an attempt to be as expansive as political conditions allowed, so that the proposal could not be construed as favoring any group at the expense of others.

Crucial to this type of initiative is the delineation of sanctions in the event the amendment is violated. A list of sanctions is provided in the amendment; most of these take the form of constraints on operations, such as hiring new personnel, raising salaries, restructuring careers in public service, and the concession of subsidies to private agents.

The proposal was politically savvy. By setting global limits (and definite floors for spending in health and education), administration officials can respond to critics (as they have done) that, since no specific item is being sacrificed by the initiative, any priorities set by society can be pursued and supported with more resources, as long as nonprioritized expenditures are sacrificed in equal measure. In this manner, the government has deflected criticism of its fiscal policies, shifting the debate from total government expenditures as such to the setting of priorities for the use of public resources.

But the government also scored a point in the priorities debate by arguing that the amendment makes spending on health and education impervious to business fluctuations. Past legal provisions setting minimum outlays as a proportion of nominal GDP exposed health spending to the vagaries of the macroeconomy. But setting minimum expenditures in real terms, so the government argues, makes them insensitive to the business cycle.[8] In fact, government officials argue that having a stable mandatory real minimum expenditure instead of a deficit target creates a new automatic stabilizer, to the extent that falling revenues during recessions will imply the emergence of government deficits. In expansion periods, on the other hand, deficits should fall and eventually disappear.

Establishing such a rule for 20 years was supposed to increase its credibility in the eyes of private sector agents. The concern here was the possibility of "cooking the books," or adopting so-called creative accounting measures such as postponing some expenditures from one fiscal period to the next. Of course, practically nothing prevents an opposing constitutional amendment from being adopted in the future. Brazil has had many constitutions since it became independent in 1822, and the latest, promulgated in 1988, already includes dozens of amendments. So the actual longevity of this most recent amendment is an open question. Credibility, however, may be threatened more by circumvention than open violation. It is generally believed that the ingenuity of legislators in finding ways to outmaneuver legal restrictions may be limitless. On these matters, one need only remember that the Fiscal Responsibility Act, which was established to impose harsh penalties on violators in the public sector, is still in force. Yet it was unable to prevent violations, as the present fiscal situation at all levels of government shows.

The voting process on the amendment proceeded at an unexpectedly easy pace for the Brazilian government. In part, this may be due to the fact that a freeze of real fiscal expenditures is a momentous but relatively remote subject for the general public—and, in fact, for the representatives and senators themselves. It is reasonable to assume that the legislators who supported the amendment may not have thought it through, or that they may expect to find ways to circumvent the constraints imposed by it when the time comes to vote actual benefits for their constituencies. In addition, since this was the first relevant matter to be put to Congress after the conclusion of the impeachment process, members of the parties supporting the government may have felt obligated to make this support visible to the general public.[9]

Other Structural Reforms

Be that as it may, structural reforms in areas such as social security and labor markets will be more politically challenging for the government. In these cases, proposals are likely to be evaluated less for their intrinsic technical virtues than for their immediate concrete implications, in terms of wage compensation, access to social services, and the rules governing retirement. One would expect much more attention being paid to these matters and far more intense political mobilization against proposals that are perceived to directly reduce individual benefits. The increased sensitivity to these issues "in the streets" should cause representatives to deal much more cautiously with proposals whose main purpose is to cut expenses, in the case of social security reforms, or reduce labor costs, in the case of labor market reforms. Not surprisingly, the government seems divided on both questions, repeatedly postponing the submission of proposals to Congress. Government "hawks," mostly located in the finance ministry, try to push for more radical proposals, while the "doves," represented by career politicians in closer contact with Congress, push only for those reforms that are politically acceptable. Currently, it is unclear which path Temer will follow.

The Brazilian Recession

In any case, the government has so far not announced any measures destined to accelerate recovery or to attenuate the economic decline in progress since early 2015. Even confidence fairies would have a hard time trying to sell a plan that does not offer any glimpse of support for the expansion of output and employment other than hoping for a spontaneous surge of optimism by businesspeople. In fact, even if one is inspired by alleged examples of successful expansionary fiscal consolidation,[10] Temer's main, and practically only initiative so far—the spending freeze amendment—can only lead, even in the most favorable of circumstances, to balanced budgets in a more or less distant future. Is it reasonable to expect that confidence fairies can actually carry such a burden? Probably not (and, so far at least, they have not). This absence of positive effects should not, however, come as a surprise.

The Confidence Fairies

First, it is important to remember that uncertainty remains very high, in part due to the instability of Temer's government. There is still significant risk of a decision by the electoral courts to annul the Rousseff/Temer ticket's victory in 2014 for reasons of fraud. But this is not the only threat he has to face. Temer's closest advisers and members of his cabinet are constantly in the news for their alleged involvement in the corruption scandals that are rocking the republic. Finally, there is widespread disbelief that Temer himself, who has presided over his party for the last 10 years—a party notorious for its shady dealings and deeply involved in all the scandals uncovered so far—could be unaware of what his colleagues were doing. The administration lives in perpetual fear that future investigations may uncover evidence against Temer himself. For all these reasons, even if the conclusion of the impeachment process and the removal of a very ineffectual administration provide some relief, there is no assurance that Temer himself will be able to lead the political process until the next presidential election in 2018.

More important, the hopes of the Temer administration that confidence would be sufficient to turn the economy around seem to have relied on a mistaken view of what confidence means. Confidence is generally confused with expectations of positive outcomes, but as John Maynard Keynes explained in chapter 12 of *The General Theory*, these are two different things. One has to form expectations as to the consequences of a given course of action in order to decide whether to pursue it or not. In this sense, expectations can be "good"—that is, they can entail outcomes that are judged to be favorable to the decision maker—or "bad." Confidence has to do with something else: namely, the decision maker's trust in the relevance and veracity of the information and thought processes employed to generate the expectation. In simple terms, businesspeople, consumers, etc., may, for instance, *confidently* hold *negative* expectations about the consequences of a given policy and refrain from following it. If one discounts for a moment the uncertainties referred to in the preceding paragraph, one can imagine that the conclusion of the impeachment process and transfer of presidential power increased the confidence that Temer's administration would survive until 2018, without necessarily creating favorable expectations as to the efficacy of the administration's proposed policies. In practical terms, most people seem to expect that Temer will somehow overcome the current political uncertainties and remain in power until the next election. This by itself does not translate into confidence that the policies he has proposed will generate the impulse the economy needs to recover. Short-term expectations—those that explain production and employment decisions—are not likely to react, even under the best conditions, to mere changes in political mood. It is the actual *experience* of increases in sales and profits that feeds positive short-term expectations. There is nothing in the short-term horizon, however, to generate such favorable expectations. In fact, at the moment, businesspeople probably hold negative short-term expectations with a high degree of confidence.

Of course, if short-term expectations are unfavorable to decisions to expand production and employment, there cannot be much to expect from private investment. As long-term expectations are more uncertain than short-term expectations, confidence in them on the part of the decision maker plays a more significant role. Still, it is unlikely that even those businesspeople that are optimistic with regard to future demand would invest when productive capacity remains idle in the present. Even assuming that the prospect of a more orderly political system in the future may help to strengthen the confidence that shocks can be efficiently managed if they take place, the idea that this, instead of the expectation of actually earning profits, is sufficient to induce private agents to invest is not convincing. In sum, businesspeople are generally happier with Temer in the presidency than they were with Rousseff, but this is not enough to lead them to expand production, let alone resume investing. In fact, this is precisely the view expressed by the Instituto de Estudos para o Desenvolvimento Industrial (IEDI), a think tank maintained by leaders of the Brazilian manufacturing sector, in one recent edition of its newsletter, *Carta*. Comparing the current crisis with that of 2002, it states that

> in fact, there are no dynamic elements capable of placing the economy in the way to recovery. What was valid in 2002 is also valid now: consumption is weak, credit is locked, exports are declining, and investment is in wait for lower interest rates, higher capacity utilization, and some reaction on the demand side. An important difference is that the current crisis has already been dragging for a longer time. (IEDI 2016a; author's translation)

In sum, Temer's policy package as presented so far consists only of restrictive policies that do not signal to private businesspeople any path to recovery, let alone growth. It is not reasonable to expect that private production and investment would recover on the strength of Temer's political leadership attributes, which are, frankly, very limited. It should not, therefore, be a surprise that after a brief period in mid-2016 when the recession seemed to have been contained, more recent data point to resumption of the contraction, and hopes of a recovery have been shifted to 2018. Besides, the notion that the crisis was caused by loss of control over fiscal spending and could be reversed if control were restored belies a complete inability to understand the present conditions of the Brazilian economy.

Central Aspects of Current Economic Conditions in Brazil

Like many other countries, Brazil's economy was hit by the shock waves of the US financial crisis at the end of 2008, as an immediate result of the Lehman Brothers failure. A diversified set of expansionary policies was adopted by the Brazilian government in 2009, including the expansion of public investment and investment by state-controlled firms; credit supplied to consumers for the purchase of durable goods; credit provided by public banks for private investment and construction; and subsidies to private businesses. These policies were reinforced by the expansion of the Chinese economy, which translated into a growing demand for raw materials and processed agricultural goods produced in Brazil. As a result, the Brazilian economy registered a 7.5 percent GDP growth rate in 2010. However, contrary to the widespread (domestic as well as international) view, the high expansion rate was confined to that year. After 2010, GDP growth rates declined steadily, and by 2013, with the loss of steam in China, the Brazilian economy seemed to be heading toward stagnation. By 2015, stagnation had given way to open recession, which is still going on. The causes of the recession are multiple and complex. Some of them developed within the public sector; others reflected developments in the private sector itself. The summary that follows is not intended as a full explanation, or even a full description, of the crisis. The goal is to show how narrow the chances are that a policy strategy such as that designed by Temer will be successful in turning around the Brazilian economy.

Governance and Policy Choice Problems

The year 2014, in which Rousseff was reelected president for the period 2015–18, was also the year when a cascade of corruption allegations in the federal government and government-controlled firms captured the attention of the general public. The most important target of these accusations was Petrobras, the oil company that is majority-owned by the federal government, but they rapidly spread to other sectors of the administration and to private firms that operated as suppliers to those companies, particularly firms in the heavy construction sector. Even though President Rousseff managed to be reelected, with the direct support of former president Lula da Silva during her campaign, her administration—if not herself personally—was tainted by the perception, accurate or not, of widespread corruption. This proved fatal to the chances of Rousseff adopting the expansionary fiscal policies needed to break free of the stagnation trap in her second term. The predominant political interpretation of the state of the union by late 2014 was that the government had lost control of its budgetary situation because of the large-scale exchange of favors between the administration and private firms. Although the strong and abundant evidence that was released related specifically to corruption in the relations between Petrobras and its suppliers, benefiting both companies and government officials, a more speculative view became widely accepted: that all of the policies of the Rousseff administration (and perhaps in the administrations before hers) were similarly tainted by corruption and consisted of similar exchanges of favors between private and public agents.

The nature of policies employed by the government after the 2008–9 shocks strengthened the presumed veracity of such impressions. Both Lula da Silva and Rousseff, in fact, largely refrained from adopting classical Keynesian expansionary policies in the post-2009 period. Without the protection of restrictive commercial and financial policies, traditional expansionary policies were likely to lead to current account deficits rather than domestic growth. Monetary policies that relied on maintaining high interest rates as the sole instrument to control inflation tended to overvalue the domestic currency. Moreover, while the Chinese economy was expanding rapidly, trade balance surpluses accumulated and, together with high interest rates, led to exchange rate overappreciation. The impacts of overappreciation were felt as a contractionary pressure on the manufacturing sector—the sector most sensitive to external competition—rather than on the economy as a whole, creating an illusion of strength that disguised the increasing dependence of the Brazilian economy on Chinese demand.[11]

When the Chinese economy lost steam in the early 2010s, the difficulties faced by the manufacturing sector became an important factor to explain Brazil's economic downturn. Knowing that traditional expansionary fiscal policies would probably only make the current account position even more fragile, the government opted for *supply* policies, apparently in the expectation of being able to compensate domestic manufacturing firms for their competitive disadvantage relative to foreign manufacturers. Financial and fiscal subsidies were generously offered to domestic firms to reduce their costs

Table 1 **Public Investment by Federal, State, and Municipal Governments (as a percentage of GDP)**

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
2.16	1.53	1.68	1.65	2.00	1.78	2.18	2.26	2.67	2.18	2.17	2.11	2.46	1.71

Source: Orair, Siqueira, and Gobetti (2016)

and increase their profits. These policies, however, performed poorly in terms of supporting a return to growth (private businesses seemed to take advantage of the policies to reconstitute their profits but did not commit to actual recovery of production, much less increased investment).[12] They did, on the other hand, have one important negative impact in the eyes of the public, in that such policies seemed intended to enrich specific businesses. Moreover, credit policies directed at strengthening the international position of some large firms (creating the so-called national champions) helped crystalize the perception that the goal of government economic policies was to distribute favors among the "king's friends" rather than to protect national interests. In other words, supply measures of the type adopted in Brazil in the years that followed the 2009 shock seemed designed to favor private firms that are now accused of colluding with government officials to rob the treasury. To make things worse, and in all probability to thwart public scrutiny, treasury officials actively engaged in what became known as creative accounting, apparently to circumvent legal or regulatory constraints on the ability of government to offer subsidies to private firms. Ironically, those practices themselves became the object of intense scrutiny by the press, which presented them to the public as evidence of bad faith in government practices.[13]

Under such conditions, President Rousseff herself seemed to become persuaded that promoting fiscal austerity was the only way to recover some measure of control over the state machine. Notwithstanding her campaign assurances to the contrary, she announced the change of course shortly after her reelection was confirmed. To make the announcement credible, she replaced her previous finance minister by a former International Monetary Fund (IMF) official known for his orthodox views on fiscal policy. Nevertheless, with her government fatally weakened by the accusations and an administrative machine in disarray, the loss of political support among her hardcore constituents after she signaled the turn to austerity proved to be fatal. Throughout 2015, legislative opposition (met by token support from her own party) gradually paralyzed the Rousseff government. Uncertainty as to how the political crisis was to be resolved increased dramatically. The level of economic activity fell, and with it, so did tax revenues, making budget deficits even more acute. A vicious circle was created in which the fall in the level of economic activity worsened the fiscal situation, making tougher austerity measures more likely, which intensified contractionary pressures, and so on. As Orair, Siqueira, and Gobetti (2016) document, the government signaled its commitment to austerity with a substantial cut in public investment (excluding investment by firms controlled by the federal government) of about 0.5 percent of GDP in 2015 (Table 1).

Orair, Siqueira, and Gobetti (2016) also show that during her first term in office, Rousseff expanded government spending mostly in the form of offering various kinds of credit and tax subsidies to private businesses, many of which were not in fact included in the budget, while cuts tended to be concentrated in investments (after the peak reached in 2010). The authors calculated the fiscal multipliers associated with various forms of government spending and determined that offering subsidies was the least effective means to expand the economy in any phase of the cycle, while fiscal multipliers associated with public investment and the payment of social benefits were among the highest in periods of economic contraction. This result explains why there was so little positive response to increased government spending in 2013 and 2014 and such a strong negative response to the cuts in 2015.[14]

A parallel, but to some extent independent, movement in the same direction was the reduction of investments by state-controlled firms, particularly Petrobras. Engulfed by governance problems and paralyzed by corruption investigations, Petrobras's investments had already fallen significantly in 2014 (Afonso and Fajardo 2015). Considering that by that time investments by Petrobras had reached about 10 percent of aggregate gross formation of fixed capital, such a policy could not but have a heavy impact on overall levels of activity.

Rousseff's removal from power seemed to have left only one path open to her replacement. In a politically precarious situation himself, Vice President Temer decided for a *fuite en avant*: he doubled down on fiscal austerity. Temer's intention can only be guessed at, of course, but having assumed office with a very tenuous hold on power, he seems to have put all his chips on the creation of a situation where his removal would most certainly lead to even heavier turbulence in the economy. But it is far from clear whether this was really a winning bet. His position remains politically fragile (his closest aides were forced to leave the government under charges or suspicion of corruption), his popularity is now as low as it was when he replaced Rousseff, and, as observed, he does not seem to have a clue about what can be done to pull the economy into recovery, other than appealing to confidence fairies.

Difficulties in the Private Sector

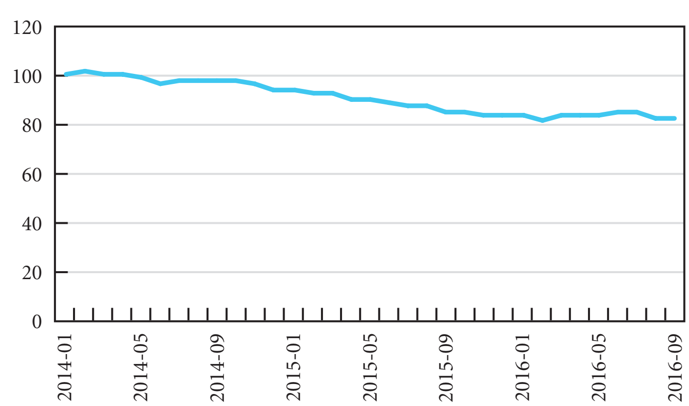
As difficult as the situation of the public sector is, one cannot say that the private sector is itself in much better shape. In fact, recovering growth in the manufacturing sector has been a challenge since the late 1980s. Since the Real Plan of 1994, which brought with it a practically permanent tendency toward exchange rate appreciation, the sector has steadily shrunk, to the point of creating deindustrialization concerns.

As Figure 1 shows, manufacturing output has plunged since 2014. In the early months of 2016, the devaluation of the local currency, the real, helped to increase the profitability of exporting firms. However, exchange rates have been very volatile, exposing exporters (as well as importers) to significant risks. Moreover, after years in which high domestic interest rates encouraged larger firms with access to international financial markets to borrow abroad, the possibility of currency mismatches between assets and liabilities—similar in effect to those maturity mismatches that worried Hyman Minsky—has been created.

In fact, a 2016 survey of large firms, both corporations and limited partnerships, indicated a significant increase in financial fragility, particularly among industrial firms. Financial costs have climbed as a result of rising domestic interest rates since 2013 and the devaluation of the real, which increases the burden in reals of debt denominated in foreign currencies (CEMEC 2016). Less well known was the persistent decline in profitability that has plagued a large number of these firms—a decline explained by the inability to shift increases in production and financial costs to prices, due to international competition.[15] The fall in aggregate demand since 2015 represented an important additional brake on profitability, but the sector was already under pressure due to the competition of imports under conditions of domestic currency overvaluation.

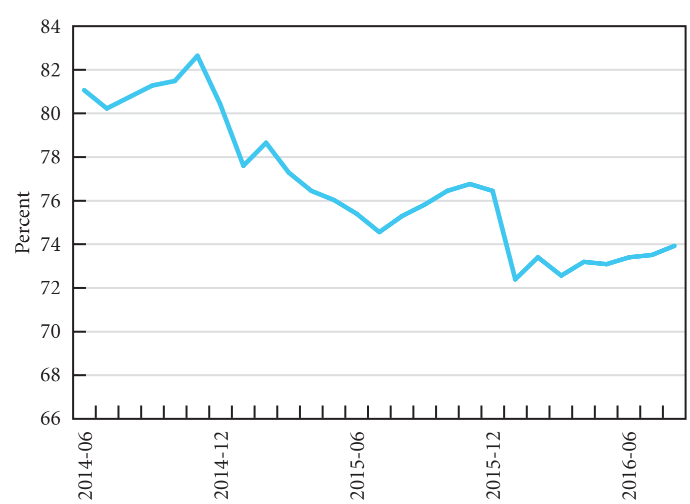
The fall in profitability affected investments in the industrial sector, since retained profits are (together with long-term credit from the Brazilian Development Bank [BNDES]—also currently under scrutiny by prosecutors) the main source of finance for investment. But declining profitability was not the only indicator pushing investment strongly downward: falling demand for industrial goods made production capacity

Figure 1 **Manufacturing Production Index (2012=100)**



Sources: Instituto Brasileiro de Geografia e Estatistica (IBGE), with author's elaboration

Figure 2 **Capacity Utilization in the Industrial Sector**



Source: FGV IBRE (2016)

Table 2 **Gross Formation of Fixed Capital: Rate of Growth with Respect to the Same Quarter the Previous Year (in percent)**

2015Q2	2015Q3	2015Q4	2016Q1	2016Q2
–12.9	–15.0	–18.5	–17.5	–8.8

Source: Central Statistical Office of Brazil (IBGE)

increasingly redundant in the period 2014–16. By 2016, capacity utilization had reached 73 percent (Figure 2), about *10 points lower* than the values recorded from 2009 to 2013. With the growing redundancy of installed productive capacity and no sign of reaction in demand from any quarter, it cannot come as a surprise that investment would plummet.

The drop in manufacturing output, plus the reduction in investments by federally controlled firms and the increase in idle capacity, certainly accounts for the persistent decline in gross formation of fixed capital in the recession period that began in 2015 (Table 2).

The fall in demand fed by the recession has made a difficult situation even more serious. As shown by CEMEC (2016), net profits are currently lower than the service of debts: the ratio between them fell from 2.79 in 2010 to 0.58 in 2015. The sum of net profits and cash as a ratio of financial costs plus short-term debt, which reached 1.82 in 2010, fell to 0.77 in 2015.[16] Such figures suggest that firms have to not only roll over debts but also capitalize unpaid interest costs, something that characterizes a Ponzi position. To the extent that austerity threatens revenues even further, it is not recovery that is a matter for concern, but rather an actual crash.

Are There Alternatives?

No one can take seriously the idea that the recession that Brazil has been experiencing since 2015 was caused by *excess* fiscal expenditures and can be effectively neutralized by confidence effects resulting from credible commitments to balancing budgets. If anything, the opposite idea—that stagnation was transformed into an open recession mostly because of attempts to implement austerity policies in 2015—may be more accurate. In any case, manufacturing firms have been afflicted by increasing constraints represented by falling profitability and increasing competitive pressures, and it is not clear how confidence fairies could act to attenuate or solve these problems.

It is a fact that the loss of confidence in the ability (and, in fact, the disposition) of the government to control its expenditures was deepened when extensively used creative accounting practices were revealed by the press in 2014. The combined effect of corruption charges, the exposure of budget manipulation, and the perception that fiscal policy was being used to reward supporters in the private sector was too powerful. The damage to the Rousseff government's credibility seemed to have become so serious that the president abandoned her campaign rhetoric and began presenting herself as a champion of austerity, which she proposed as being essential to achieving higher growth rates than those of the last two years of her first term. Her successor followed her down the same path.

The fact remains that the impasse can only be broken by the government. That, at least, was the main message on antirecession policy left to us by Keynes and Michał Kalecki, among others. Some intervention by the government is obviously necessary in the Brazilian situation in order to increase profits and capacity utilization and, thus, to create the favorable expectations that will lead to expanded production, and eventually to increased investments. The confidence fairies have to be given some material to work with.[17]

In a previously published policy note (Cardim de Carvalho 2016b), I argued that the political situation engendered in the last three years dramatically limited the possibility of implementing traditional countercyclical fiscal policies. In the current political climate, any expansionary policy proposal has to overcome the prevailing prejudice that policies are being designed to favor a specific group. Besides, the constraints discussed in that policy note remain operative, preventing the appeal to the type of policies adopted in the aftermath of the 2009 recession. To extend consumer credit in order to expand private consumption of durables is no longer an option, given the increase in household indebtedness in recent years and the poor prospects for employment. The use of public banks to extend cheaper credit to firms also does not seem to be an option after the corruption scandals. There was already not much to expect from international trade expansion, even before the election of Donald Trump, with his protectionist views.

What is left is public investment. When that policy note was published, it was argued that an increase in public investments would only be feasible in the context of a political agreement in which other constituencies would temporarily delay their demands so that governments could focus spending on infrastructure investments. As Orair, Siqueira, and Gobetti (2016) show, investment spending by the government exhibits the highest income multipliers, especially during recessions. Besides, public investments stimulate domestic production more directly, minimizing adverse impacts on the balance of payments. Since the publication of the policy note, political constraints have become even more rigid, with the impending promulgation of the constitutional amendment freezing government expenditures. Of course, as a political expression of Newton's third law of motion, reactions against the amendment are only beginning to find expression among civil servant unions and consumers of public services, particularly in health and education. Most of the criticisms leveled against the amendment, however, focus on its long-term impacts on the provision of social services to the detriment of compensatory fiscal policy goals. As of now, it is very uncertain how the country is going to solve such an impasse. Meanwhile, the recession deepens, and the confidence fairies seem to be looking for asylum elsewhere.

Notes

1. In principle, Temer should complete Rousseff's term. However, both Rousseff and Temer were also named in an election fraud investigation being conducted by Brazil's electoral court. If found guilty, Temer will be removed from power as well, and replaced by a new president elected by Congress.
2. Recent forecasts, which originally pointed to some stabilization in 2016 and recovery in 2017, were changed to predict another deep fall in output in 2016, followed by a slight stabilization in 2017. For instance, the IMF, in its projections for Latin America made public in October, is expecting another fall in GDP of 3.3 percent in 2016, followed by positive growth in 2017 of only 0.5 percent (IMF 2016, 21, Table 1). Many Brazilian businesspeople consider this an overestimation.
3. The argument was strengthened by the failure of the 2014 expansion of government spending to lead to a growing economy.
4. The report from which the quote was obtained does not reveal whether it was taken from a written document presented by Minister Meirelles or from a transcript of his presentation. The translation was made without any attempt to improve style.
5. In all fairness, whether Temer or his team believes in fairies or not is irrelevant. One has to acknowledge that appealing to *traditional* expansionary policy strategies at this moment became almost impossible as a result of not only the demonization of active fiscal policy that is now conventional wisdom but also the disorganization of the state apparatus promoted by Rousseff. Having said that, it is undeniable that the Temer administration does not show any glimpse of which kind of pro-growth measures it could adopt to attenuate the contraction.
6. The text submitted by the government to the Chamber of Deputies can be found (in Portuguese) at Câmara dos Deputados (2016b). The report recommending its approval, with some changes, can be read (in Portuguese) at Câmara dos Deputados (2016a).
7. In fact, given the lags involved in the indexing process, if consumer price inflation increases from one year to the next, real spending will actually fall, while the converse happens if inflation decelerates. The government is assuming, however, that inflation will decrease from its current peak to something close to the inflation targets pursued by the central bank. If the assumption turns out to be correct, such differences will be insignificant.
8. Again, of course, this means that in periods of falling tax revenues other expenditure items will necessarily fall to allow spending on health and education to grow.
9. It may be of some import to note that political support for Temer is given by practically the same parties that nominally supported Rousseff, minus the Workers Party and a few satellites, plus the half-hearted support of PSDB (Brazilian Social Democratic Party), the main opposition party to the former president. Voting favorably for Temer's constitutional amendment may have been a way to show that their support had shifted from Rousseff to Temer for political reasons, instead of immediate personal interest.
10. As is well known by now, these supposed exemplars of expansionary austerity have mostly turned out to be the result of mistakes made by researchers rather than instances of actual success in promoting growth by trying to eliminate fiscal deficits in moments of crisis. See, for instance, Perotti (2014).

11. For data covering the period under discussion see Cardim de Carvalho (2016a).
12. An excellent study of the spending policies adopted by the federal government in the period—a study that corrects for the widespread manipulation of accounting practices that became a trademark of Rousseff's first term in office—is Orair, Siqueira, and Gobetti (2016), from which most of the data on public finances referred to in this section are taken.
13. A devastatingly effective article published in *Valor* in late 2015 describes in detail the accounting liberties taken by the treasury, and documents the discomfort of career officials with such practices. See Perez (2015).
14. Official treasury results for 2015, at first sight, suggest that government spending expanded in 2015. As Orair, Siqueira, and Gobetti (2016) convincingly show, however, the growth in expenditures was limited to late 2015 and consisted of bookkeeping transfers between the federal government and other governmental entities to compensate for past creative accounting, as ordered by federal auditors. If such fictitious transactions are appropriately excluded from the available data, it is possible to conclude that fiscal policy was contractionary in 2015.
15. The fall in profitability was documented by CEMEC (2016) and also by IEDI (2016b). The latter study informs us that the net profit margin of the largest corporations fell from 8.3 percent in 2010 to 0.5 percent in 2015.
16. It is important to note that Petrobras and Vale (which extracts minerals for export) are, due to their particularly difficult current positions, excluded from this data to avoid skewing the figures.
17. Writing in June 1930, Keynes stated, "As regards psychology, I maintain that if I am right that a large capital programme would increase the profits of business men[;] this would, after the first blush, have more effect on them than anything else" (Keynes 1981, 361). Keynes explained the idea in more detail during a meeting of the MacMillan Committee later that year:

> In conclusion I should like to say about Government action of this kind, that obviously it cannot be a permanency. You cannot be permanently stimulating local authorities to anticipate their programme, and you cannot permanently be going ahead at a great pace with public developments. Nevertheless I think the first impetus forward must come from action of this kind, that it must be Government investment which will break the vicious circle. If you can do that for a couple of years, it will have the effect, if my diagnosis is right, of restoring business profits more nearly to normal, and if that can be achieved then private enterprise will be revived. (Keynes 1981, 146–47)

Kalecki, in a paper originally published in 1938, observed that such impasses could be broken by expanding net exports (not a very promising option in the present conditions) or by what he called "domestic exports"; that is, sales to the government:

> The starting of "domestic exports" thus stimulates the upswing in the same way as a surplus secured in foreign trade. It is followed by such an increased production and in the profit per unit of output that a rise in aggregate profits takes place which is equal to these "exports". This in turn acts as a stimulus for the expansion of investment activity. (Kalecki 1972, 18)

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