Brazil's new cycle

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IN THE PAST FEW YEARS BRAZIL has been able to implement a few market-friendly adjustments in response to deteriorating market sentiment, but the process has been excessively incremental and mired in poor execution and low government credibility. To make matters more complicated, a combination of mixed signals on economic management and President Dilma Rousseff's relatively strong political position reduce the odds that there will be an earnest push to improve investor confidence before the presidential election in October. The road for Brazil's economy in 2014 is definitely looking bumpy.

President Rousseff's comfortable lead in the polls and the success of much of the infrastructure concessions agenda will probably continue to give the government enough confidence to maintain the current policy course. Record-low unemployment numbers should also help in terms of popular support, at least until the election. However, while "muddle through" mode may buy Brasilia some time before international credit agencies decide to downgrade Brazil's rating, it will not dispel the specter of a sovereign downgrade.

Until there is an actual downgrade, though, throughout most of 2014 the government is likely to keep fending off pressure for more spending while at the same time striving to boost revenue. Its measures could include pressure on corporations to settle unpaid taxes, let previously granted tax breaks lapse, and gradually reduce lending to state-owned banks. However, no meaningful fiscal adjustment that would lower or even stabilize the country's debt-to-GDP ratio (a fiscal primary surplus close to 2%, according to most analysts) can be expected this year.

Much of the success of Rousseff's incremental strategy will therefore depend on her own political standing and the pace of economic activity. If economic recovery remains tepid, a gradual shift toward more constructive policies will not be enough to stem growing market pessimism. Combined with domestic pressure from Congress for more spending ahead of the election, a possible court ruling against banks that may generate billions of dollars in new government liabilities, and the ongoing changes in U.S. monetary policy, these events constitute what analysts are now calling a perfect storm.

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Despite these risks, Rousseff is poised to retain much of her political capital and win a second term without having to make any major reforms before the elections. However, regardless of who wins the election, slow growth would make the trade-offs for a post-election fiscal adjustment increasingly difficult. Besides making the government's job of boosting revenue harder—which would add even more pressure on fiscal policy—lower levels of economic activity sooner or later are bound to affect the president's approval ratings, which could well increase the governance challenges she would face in a second term.

What does all this mean? It means that regardless of who wins this year's presidential election, Brazil is entering into a new cycle of politics. If the economic environment becomes less favorable, the government's goal of addressing the rising demands of the burgeoning middle classes will become more difficult. The years of high growth and very high approval ratings that fueled policy complacency have come to an end. While the country is not on the brink of default or near a major 1980s- or 1990s-style economic crisis, the risk that Brazil will be left behind other emerging countries is rising. On energy and trade policies, among others, this is becoming quite clear.

The obvious conclusion is that the opportunity cost of muddling through on important policy decisions is also rising. Definite progress has been made (though slowly) on attracting private investments in transport infrastructure, but the lack of transparency about fiscal policy is still a source of concern. Moreover, a laundry list of other structural reforms—energy reform (last month's column), a more proactive trade policy, and measures to lower and simplify taxes and lower labor costs, among others—is long overdue. If not by conviction, out of necessity the next president will be forced to move forward on a reform agenda.

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Unfortunately, there is a chance, though still small, that Brasilia's sense of urgency to implement structural reforms will diminish once again if economic activity picks up this year, however slightly. Even a broken clock, it's said, is right twice a day. ■

While "muddle through" mode may buy Brasilia some time before credit agencies decide to lower Brazil's rating, it will not eliminate the specter of a sovereign downgrade in coming months.