Politics, the global outlook, and economic adjustment

Fernando Dantas, *Rio de Janeiro*

IN MID-AUGUST, BRAZIL'S ECONOMIC TEAM must have breathed a sigh of relief after an extremely tense second quarter. At the time, it seemed that the U.S. economic recovery would dramatically increase interest rates in the U.S., extending indefinitely the turbulent devaluation of the Brazilian real and the currencies of other countries dependent on commodity exports.

At the same time, many feared a forced hard landing for China, the second largest world economy, whose growth could fall below 7%, which would affect prices for Brazil's commodities exports and complicate the financing of its growing external current account deficit. Finally, the street demonstrations in June seemed to have slashed the political capital of President Dilma Rousseff, raising the danger that the economy would become ungovernable. Prospects for growth in 2013 and 2014 were also dimming.

Today the outlook seems a little better. The *real* has been behaving more reasonably in terms of rising long-term U.S. interest rates, even before the September meeting of the Fed's monetary policy committee, the FOMC, which announced that it would not start to tighten monetary policy any time soon. This caused the yield on 10-year U.S. Treasury bonds to drop from 2.84% on September 17 to 2.65% on September 30, while the real appreciated from R$2.26 to R$2.22 against the dollar.

There are signs that the Fed's monetary policy will be dovish for longer than financial markets recently thought. This view was reinforced by the appointment of Janet Yellen as chairman; she has said that it is too early to roll back monetary easing.

China, too, has released a number of favorable economic indicators recently, and its country's leaders have shown themselves more willing to avoid an abrupt slowdown of the economy.

In Brazil, finally, the president's popularity has partially recovered, and the economic indicators have been better than the market expected: higher second-quarter GDP and retail sales in July, the Central Bank's index of economic activity in July, and lower unemployment in August.

External deficit risks

Good external and domestic news has increased the chances that Brazil will not undergo a dramatic adjustment of the external balance before the presidential elections in 2014. The external current account deficit in 12 months reached 3.6% of GDP in August and is likely to reach close to 4% of GDP if

there is no adjustment. In the past, a current account deficit of 4% of GDP would often trigger severe external financing crises. But although Brazil today is economically much stronger and possibly less vulnerable, there are still reasons for concern.

The economy's growth potential seems to have dropped from 3.5–4% during the Lula administration to 2%–3% in his successor's administration. The lower its growth, the less capacity the country has to sustainably repay the external financing necessary to cover external current account deficits.

According to IBRE researcher Armando Castelar, Brazil will at some point have to make the adjustment, after having exhausted the possibilities of the consumer-led growth that prevailed during the Lula administration. Castelar explains that reforms by the Cardoso administration in the 1990s made the Brazilian economy more efficient. After Lula was elected president in 2003, he retained the basic economic policy, and between 2004 and 2010 as Brazil's political risk fell and China's appetite for Brazil's commodities grew, growth accelerated.

There was a credit boom, but high unemployment and a devalued *real* at the beginning of Lula administration moderated inflation pressures. At the same time, imports shot up to meet growing domestic demand and helped to contain inflation. "Those were times of euphoria," recalls Castelar, noting that while employment and real incomes rose, inflation and interest rates fell. Higher tax revenues allowed for increasing public spending.

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Unsustainable policy

Castelar explains, however, that consumption-led growth was unsustainable, since the resulting currency appreciation and higher incomes undermined industry's competitiveness, debt grew faster than incomes, export prices could not rise forever, and there were limits to how much the external current accounts could deteriorate.

As growth faltered, the Rousseff administration attempted without success to prolong the boom through a new policy template: monetary and fiscal policy both became expansionary, the exchange rate was devalued, credit was expanded to finance consumption, and an industrial policy of "picking winners" was adopted. Becoming much more interventionist, the government granted specific tax exemptions to stimulate consumption of cars and durable goods.

In 2012 it was clear that the Rousseff administration's new policies were not producing the desired results — growth was slow and inflation high. At the same time, the surprisingly buoyant labor market, with low unemployment and rising wages, ensured the president's popularity.

In general, the consensus was that economically and politically the problems were manageable and that re-election of

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President Rousseff in 2014 was almost a foregone conclusion. In the first half of 2013 high inflation, reflected in a slowdown in consumer spending, slightly undermined the president's popularity, but the consensus remained.

Then a period of great difficulties came, from May through July. Concurrent worsening on several fronts related to the ability of Brazil to finance its external deficit led to the view that the country was being forced to adjust, which could have significant ramifications before the 2014 elections. The government has every interest in postponing the adjustment, but if there were a drastic loss of funding, that would not be possible.

For some, adjustment of the economy and external accounts means correcting distortions introduced into the Brazilian economy in an attempt to extend the boom of the Lula administration years or through a misguided ideological approach. Samuel Pessôa, IBRE researcher, argues that adjusting the Brazilian economy would involve less management of the exchange rate, a more forceful attack on inflation, and correction of artificially controlled prices, such as fuel. It would also be necessary to reduce lending by the National Development Bank, reopen the economy, end selective tax exemptions, and reshape concessions policy to make the contracts more attractive to the private sector.

Change in relative prices

José Júlio Senna, head of the IBRE Center for Monetary Studies, explains that the external current account deficit can be adjusted by making a substantial change in relative prices, which is the flip side of a real depreciation of the exchange rate, because "internationally tradable goods, especially manufactured goods, have become more expensive relative to nontradable goods, mainly services."

Between July 2011 and August 2013 the Brazilian real fell 50% against the dollar, but the relative price of tradables to non-tradables fell only 6.8%, making nontradable goods relatively more expensive.

The Brazilian economy has shown resistance to adjustment of relative prices. This may or may not be due to factors related to public policy. The fact is, however, that such adjustments are painful. It is not likely that at this point in time adjustment would be politically feasible; the government will not embark on it unless it becomes absolutely necessary.

External adjustment—a substantial reduction of the current account deficit, with a change in relative prices—involves the loss or at least containment of incomes and worker consumption.

However, for the change in relative prices to crystallize, it is necessary to prevent a spillover of inflation from tradable to nontradable goods. Therefore, monetary and fiscal policies have to be tightened, which will affect workers by containing income, consumption, and credit.

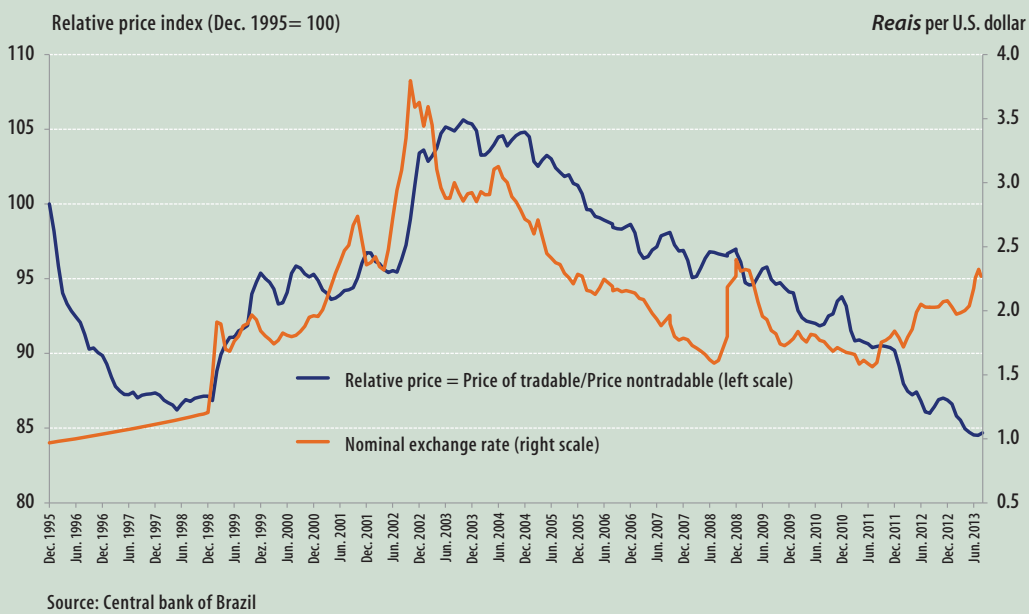
Curb consumption

Another way to reduce the external deficit is to cut domestic consumption and investment so that the country imports less and produces more surpluses for export. On the other hand, an increase in the relative price of tradables (induced by devaluation of the nominal exchange rate) makes them more profitable than nontradables. This is especially true because wages are a major factor in the cost of tradable goods.

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The increased competitiveness of internationally tradable goods affects manufactures in particular, since

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Source: Central bank of Brazil

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commodities are more affected by international prices than by the exchange rate. Thus, the change in relative prices diverts investment and production to tradable goods, especially manufactures, allowing income and consumption to recover, with economic acceleration driven by external demand.

Pessôa calls attention to the fact that, by reducing the income of workers in favor of capitalists, who expand their margins in tradable goods, the change in relative prices actually increases the country's savings, since shareholders have more propensity to save than workers. Higher savings, in turn, makes the real exchange rate more sustainable and compatible with the process of enhancing investment due to the high profitability of the tradable sector. "Investment rises without the current account deficit doing so," says Pessôa.

External adjustment of this kind can be highly unpopular, especially in the beginning, because it would involve reducing worker incomes, increasing fuel prices, and reducing protection of domestic industry. That is why many analysts assume that Rousseff and her economic team will try to kick the can down the road until after the elections, and wait to promote deeper changes in the economy until 2015. The recent relief in the U.S., Chinese, and domestic economic indicators and returning presidential popularity reinforce this idea.

To Castelar, however, "there is a chance that, instead of making the adjustment in 2015, the government may double its bet" on current policies. He points out that adjustment of the economy carries very high political costs that may be unpalatable even after the election because initially it would reduce economic activity, raise unemployment, cut public spending, and raise interest rates and fuel prices.

Cumulative costs

Castelar notes that many of these costs are cumulative, and in some cases may rise due to unpredictable cyclical changes. For example, as U.S. monetary policy eventually normalizes, Brazilian interest rates will also have to rise, and the implicit subsidies in BNDES loans will increase. The more time it takes to bring inflation down to the 4.5% target, the more the credibility of the central bank suffers, and the higher inflation expectations become. That would make the job of the central bank all the more difficult and costly in terms of economic slowdown and rising unemployment. That is why Castelar warns that "adjustment may not make sense from the point of view of political logic, even in 2015."