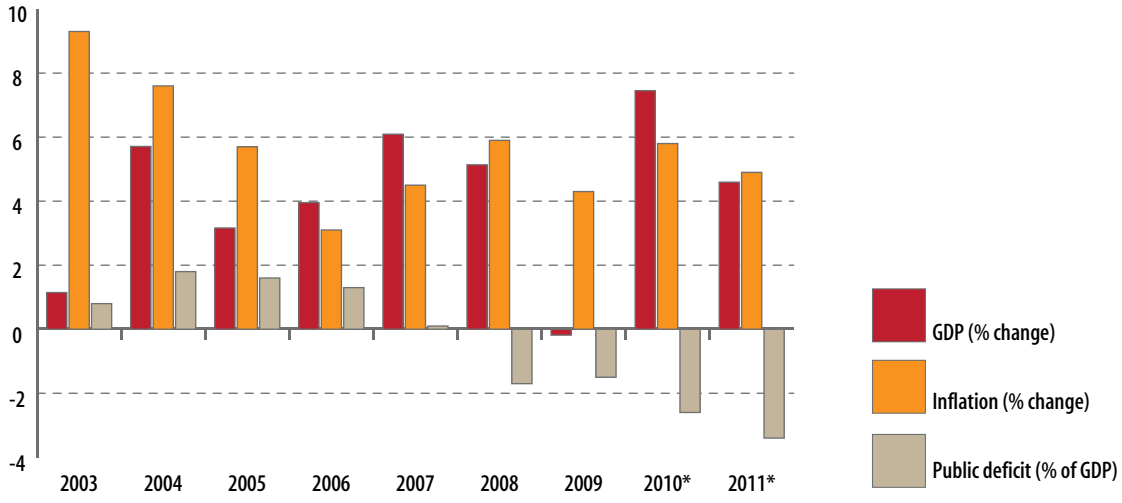
Brazil and the new government: Risks and uncertainties of economic policy

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As with the arrival of each New Year, a change in government is marked not only by the passage of time but also by expectations stimulated by the current circumstances. Despite the apparent continuity in economic policy and practice that the continuation of the Workers Party in the presidency might suggest, the changes should go beyond the mere gender difference of the departing President Lula and Dilma Rousseff as the imminent head of the country.

At a roundtable, "Brazil and the New Government," in November there was a marked difference of views between economists from the Brazilian Institute of Economics (IBRE) and those from the market. The former are moderately optimistic about the possibility that the new government will cause no major disruptions in current economic policy, although there are risks related to how consistent fiscal and monetary policies to control inflation will be. Market economists are more pessimistic; they do not believe that inflation can be tamped down simply by tightening fiscal policy. The Central Bank, they believe, is not concerned enough about interest rates.

The IBRE outlook is moderately optimistic but underscores risks of a larger public deficit.



*Projections

IBRE optimism

According to the scenario its representatives presented at the roundtable,[1] IBRE is projecting that in 2011 growth in gross domestic product (GDP) will fall from 7.5% in 2010 to 4.6%; inflation (measured by the Consumer Price Index Expanded) will fall from 5.8% to 4.9 %; and the external current account deficit will rise from 2.6% of GDP this year to 3.4%. IBRE expects that the Central Bank will hold its nominal benchmark rate at 10.75%, and the average nominal exchange rate will move from R$1.8 per US dollar to R$1.7.

This outlook — more optimistic than market projections — is based on two fundamental assumptions, explains Silvia Matos, one of its authors: "The new government will be able to tighten public expenditures, and the Central Bank will continue to have the autonomy to raise the benchmark interest rate, if necessary."

Other assumptions of the IBRE outlook are a minimum wage of R$550 (US$324) and a primary surplus (nominal deficit excluding interest payments) target of 3.3% of GDP — above the current goal of 3.1%. "If the government does everything right, including keeping fiscal policy tight, the Central Bank benchmark rate may stay at the current level and inflation will slowly decline — although it would meet the inflation target only in 2012," says IBRE's Samuel Pessoa. But if a tighter fiscal policy does not force inflation to yield, interest rates would have to rise. This is where the assumption of Central Bank autonomy has an effect: The Central Bank would have to raise its benchmark rate even though respected Central Bank governor Henrique Meirelles has departed.

The IBRE outlook is based on the information that was available in mid-November, including the market's evaluation of potential GDP. While most analysts believe the global crisis undermined potential GDP, the IBRE economists believe the negative impact was limited to the reduction in investment. Although the IBRE outlook on growth in output is in the same range as that of market analysts (between 4.3% and 4.4%), the IBRE estimate is slightly higher

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IBRE predicts that there will be no new cycle of rising commodity prices because China's economy is slowing down. "Smaller Chinese demand for agricultural products will push down their prices, benefiting the domestic market. If not, the conditions for inflation in Brazil will be more adverse," says Matos.

Risks

The IBRE outlook does not ignore potential risks. The first is reduction of the primary surplus. "When there is a primary surplus — when tax revenues exceed expenses — the government affects aggregate demand because it takes more income from society than it returns in the form of spending. This is important to the extent to which actions of the public sector operate to increase or reduce inflation," says Pessoa.

This aspect of government policy becomes more relevant now that there are worrisome signs of resurging inflation. Public accounting gimmicks used by the government — such as giving revenues from its sale of future oil to the state-owned oil company (Petrobras) — do not

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help to reduce the demand of households and firms and therefore do not suppress price rises.

The IBRE outlook assumes that the Rousseff government will fulfill its promise to hold the primary surplus to 3.3% of GDP without resorting to accounting gimmicks; 3.3% is well above the 2% seen in 2010. Although there is no reason to doubt the promise of the President-Elect, the fact is that fulfilling the promise will require an impressive fiscal adjustment of 1.3% of GDP.

The target could be particularly difficult to achieve if fiscal risks increase public expenditure by R$54 billion, reducing the primary surplus by 1.4% of GDP. Among the threats are the increase of 56% in judiciary workers' salaries; compensation to states for their losses because of VAT tax exemptions to exporters (the Kandir law); the increase in the minimum wage to R$570 with consequent impact on pensions; and salary adjustments for the military, firefighters, police officers, and Supreme Court justices.

A lower primary surplus means higher inflation, especially if interest rates are not raised. Matos comments that "Realization of these risks has a direct effect on the need to raise the Central Bank benchmark rate to at least 12.75%," adding, "We believe that the decisions of the Central Bank continue to be guided by technical criteria, and therefore the monetary authority will maintain its credibility and help curb market expectations, as has happened so far." Questioning Central Bank credibility would surely put price stability at risk.

Although the IBRE outlook assumes that inflation expectations will not transcend the inflation target, market analysts believe that this assumption is no longer valid given the recent surge in what the market expects for inflation in 2011, which according to a Central Bank survey is 5.2%. Pessoa, however, thinks that "The appointment of the new economic team and commitment to a high fiscal surplus without accounting gimmicks may help to anchor expectations close to the inflation target."

However, the use of accounting gimmicks in 2010 after statements from members of the economic team that the primary surplus target would be achieved poked holes in the current administration's fiscal policy. Pessoa says, "Rebuilding credibility will be very difficult. In retrospect, it would have been better if the government in the middle of 2010 had

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recognized the impossibility of achieving that year's fiscal target, explained the reasons, and laid the groundwork for a more ambitious target in 2011."

Considering that the Workers Party surprised Brazilians in the past by continuing the macroeconomic policies of the Fernando Henrique Cardoso government — primary surplus, floating exchange rate, and inflation targets — it is prudent to wait for the next meeting of the Monetary Policy Committee (Copom) January 18–19 to see how the Rousseff economic team will face the inflationary threat. "The ideal scenario is that tighter fiscal policy would be consolidated in the first year of government, when there is greater political support for tough measures," Matos said.

The baseline scenario is constrained by political factors. Pessoa remembers that a "social contract of Brazilian social democracy" has characterized economic policy for the past 16 years; taxes have increased on average 0.4 percentage point of GDP annually since 1999, the minimum wage has risen faster than inflation, and social programs have expanded. This has resulted in very low domestic savings and investment rates and in growth of 4.5%, which is mediocre for an economy like Brazil: "This raises the question of whether the social contract is durable going forward."

Market pessimism

Market analysts are more pessimistic about the new government policy mix of high interest rates and tightening public spending to curb prices. At the roundtable Alexandre Schwartsman, Santander Bank chief economist and former director of the Central Bank, expressed disbelief that inflation can stay below the target in 2011 with only a fiscal adjustment. He believes that the Central Bank is already lagging at raising interest rates.

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Another former director of the Central Bank, Itau Bank chief economist Ilan Goldfajn, also feels that tighter monetary policy is necessary to keep inflation around 5.5% next year. Affonso Celso Pastore, former Central Bank governor, agrees. He says a rise in interest rates will be critical to manage the expectations of economic agents and avoid losing control of inflation.

IBRE's Armando Castelar observes that addressing the overvalued exchange rate, something the next government can hardly escape, will mean more pressure on prices. As the *real* weakens against the dollar, import prices, and consequently domestic prices, will rise. At the same time, domestic prices will no longer benefit from the external environment because rich countries will gradually rise away from deflation .

[1] Silvia Matos, Samuel Pessoa, and Gabriel Leal de Barros, "IBRE Macroeconomic Outlook" (Brazilian Institute of Economics, Getulio Vargas Foundation, November 2010).