2010, the year of Lula

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In its July 22nd meeting, the Monetary Policy Committee (COPOM) cut the Selic rate — the interbank market interest rate — to 8.75% a year. Critics of COPOM consider this reduction too little too late. The ideal moment for policy changes may only be determined after the shock and its impact on the economy have been assessed. This assessment involves a certain degree of subjectivity; there is no possibility of being conclusive.

As far as the interest cut is concerned, one should compare the real interest rate with the natural rate — the rate consistent with full employment and the inflation target. The central bank's real policy rate is currently 4.1% a year, taking into account an inflation forecast of 4.5% for the next 12 months. The natural rate in an open economy is the equivalent of the external real interest rate. For the sake of this exercise, let's use the rate on 10-year US Treasury bonds for the external interest rate. This rate is slightly above 3.5%, and Brazil's country risk is in the neighborhood of 250 points (2.5%). Thus, the estimated external real interest rate in Brazil would be 6.1% a year (3.5% plus 2.5%), without taking into consideration US inflation, which is currently negative. There can be no doubt that Brazilian monetary policy is in an expansionist mode.

How long will the Central Bank be able to keep the interest rate below the natural rate? Only a few months, as long as the economic recovery does not start to put pressure on prices. The information at hand shows that the expected interest rate for the next 12 months is higher than for the next six months. In other words, the market forecast is that the current interest rate will be short-lived. The upside is that the Brazilian economy may start showing robust signs of recovery in the 12 months ahead, restoring the full employment seen before the financial crisis.

The fiscal surplus is the one instrument of fiscal policy the government can control. Data made available by the government on fiscal policy for the first half of 2009 reveal a primary fiscal surplus of 2.44% of GDP (fiscal balance less interest payments), compared with 5.86% of GDP for the same period last year. There is no doubt that Brazilian fiscal policy in the first half of the year was expansionist — it resulted in a 3.42% reduction of the primary surplus.

Critics of Brazilian fiscal policy argue that a great part of this expansion was fueled by an increase in current expenditure that they fear is permanent rather than temporary. This expenditure will not disappear once the crisis is gone. The second complaint is that, from a social point of view, it would have been better to have a countercyclical fiscal policy based on increased public investment.

Those arguments were ignored, and fiscal policy was used to counter the global financial crisis *tsunami*. Political economy may help explain why policy makers made this choice. The President's Workers' Party has always received massive support from civil servants. It is therefore only natural that the party acknowledge this support by increasing current expenditure for, among other things, the civil servant wage bill. With regard to public investment, the government's Growth Acceleration Plan (PAC) has run into problems in trying to fulfill its promises and the project calendar has been systematically delayed. It would therefore be extremely difficult for the government to increase investment in the very short run.

According to the Chinese zodiac, 2010 is the year of the tiger. For the Brazilian economy, both monetary and fiscal policies seem to indicate that 2010 will be the year of Lula.

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