The importance of getting the price right

IF A MARKET ECONOMY IS to work efficiently, prices and interest rates have to accurately reflect supply and demand; otherwise distortions in the economy will multiply, undermining productivity, innovation, and growth.

This issue analyzes one of the prices set by government: the minimum wage. The policy of keeping it rising well above inflation and productivity is controversial, though not totally without merit: After more than a decade, the policy has reduced inequalities in labor income, improved the lives of 48 million people, and fueled consumption-led growth. Especially in recent years, however, the policy has also raised labor costs far above productivity, and public spending has also shot up because pensions and other welfare benefits are indexed to the minimum wage.

Despite their widely differing views on the policy, a consensus is emerging among experts on the need to slow adjustments to the minimum wage and peg it to productivity rather than GDP growth. One proposal is to adjust the minimum wage to the average wage, which would better reflect the increase in labor productivity.

Also suggested was setting minimum wages according to the average wages in each state to better reflect local labor productivity. In the Northeast, the unemployment rate is 9% of the workforce, compared to 3% or 4% in Rio de Janeiro state. One of the reasons for high unemployment and informal labor in the Northeast region compared to the Southwest is probably that the minimum wage has been outstripping productivity there. In large and diverse countries like the United States and Canada, the local authorities establish minimum wages. In Germany, the minimum wage is often set by sector through collective bargaining agreements.

The government also controls other prices; regulated fuel prices, for example, have implications for domestic consumption of fuel, the external trade balance, and the financial position of the state-owned oil company Petrobras. A transparent formula for fuel prices is also long overdue.

Finally, the government subsidizes interest rates on loans for productive investment. The most important is the lending rate of the National Development Bank (BNDES), which is far below market rates. To finance this subsidy, the Treasury borrows at market interest rates and lends what it borrows at lower rates to the BNDES. Armando Castelar, researcher at the Brazilian Institute of Economics, estimates the cost of this subsidy at 1% of GDP a year, which will go up if the BNDES lending rate is not adjusted. Castelar believes that the low BNDES lending rate encourages companies to borrow from BNDES to invest rather than investing out of their own resources, which instead they use to buy profitable government bonds. This may explain why subsidized credit has not been able to raise anemic productive investment in Brazil, which is near the bottom for emerging countries.

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The next administration will have to move swiftly—the sooner the better—to correct the minimum wage, fuel prices, and interest rates, and this will put pressure on inflation. How controlled prices and interest rates are adjusted will need to be managed with care. Adjustment of controlled prices should be transparent, and fiscal and monetary policy will both have to be tightened accordingly.