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"Brazil will have to undergo a profound transformation"

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THE POLITICAL AND ECONOMIC uncertainties that besiege the beginning of President Dilma Rousseff's second term suggest that 2015 could be a year to forget. Armando Castelar, IBRE coordinator of applied economic research and former head of research for the National Development Bank (BNDES), points out that in addition to fiscal discipline the government will need a clear vision and message on how to restart growth."Today the only economic news is bad news, and this will make things worse because the economic adjustment will be slow. We can expect at least two years of difficult macroeconomic news," he says. Castelar emphasizes that it is imperative that the government have a positive agenda of reforms focused on streamlining taxes and bureaucracy and accelerating concessions, among other items. "To accomplish this, however, the government needs to reject ideology. And we see no clear signal of this happening so far," he says.

***The Brazilian Economy*—A few months ago, expectations about 2015 focused on what fiscal adjustment the new economic team would make. However, unfolding investigations into a kickback scheme involving Petrobras management, politicians, and vendors have added further political instability. How will this affect the economy?**

Armando Castelar—Some time ago we predicted that 2015 would be a difficult year. Economic policy mistakes have been building up and

they could not be corrected before the elections. … Moreover, China has slowed, which means less favorable commodity prices for Brazil, and the United States is accelerating, which means higher interest rates for Brazil. …

It appears that 2015 will be even harder than we expected.First, the necessary economic policy adjustments were exacerbated in an election context. Second, the Petrobras issue is very serious from both a political and an economic point of view. It is compromisi ng the health of the country's whole oil and gas sector. As Petrobras is stripped of cash, it may affect payments to suppliers, and the entire supply chain that depends on Petrobras. Also, until Petrobras can publish its balance sheet, it cannot borrow money to invest—and Petrobras is responsible for a significant share of fixed investment in Brazil. And finally, what is happening with Petrobras may make it even more difficult for all oil sector companies to borrow money abroad. Today the international financial market is already keeping emerging exporters of commodities at arm's length because of low commodity prices. When you add what is happening with Petrobras, no one wants to get involved with Brazil's oil sector. Another question is how infrastructure works will be affected, given that some large building companies are involved in the Petrobras scandal.

Some compare the challenges of 2014 to the ones of 2003, the first year of the Lula administration. Do you agree?

The current situation is similar to 2003 because inflation was high. But it is much more difficult. In 2003, the problem was related more to concerns about what as president Lula would do. As a result the exchange rate depreciated a lot, driving inflation up and consequently raising public debt, which was largely denominated in US dollars. When Lula took over, he adopted policies even more orthodox than his predecessor, President Fernando Henrique Cardoso, increasing the primary budget surplus and raising the interest rate sharply. In six months, however, people were convinced that there would be no dramatic policy change; he would follow the economic policy inherited from Cardoso. So the currency strengthened against the U.S. dollar, bringing down inflation and public debt. It was relatively quick, and relatively painless. In 2003 there was no need to correct controlled prices, as there is in 2015. The Cardoso administration had corrected controlled prices in 2002. Now, however, we need to curb services inflation to make up for higher controlled prices and the exchange rate devaluation. However, bringing services inflation down will necessarily increase unemployment and reduce income. … This is much

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harder to do; it will directly affect the well-being of families. It is a different situation from 2003. The social cost will be much higher because it will take longer to reduce service prices. And you have a much more complicated political situation than in 2003 … At that time President Lula skillfully blamed the previous government for the difficult situation. This is not possible now; the Workers' Party has been in power 12 years. … And President Rousseff today is much more committed to ideological issues.

Do you think that an intensified political crisis could jeopardize Congressional support for the economic adjustment?

In her first term, particularly in mid-2013, President Rousseff was very popular. This made it easier to deal with Congress. The situation now is different. Her election victory was tight, and the difficult economic situation and the Petrobras scandal may affect her popularity. This will require greater ability to manage the party coalition, and it is not clear to me how this will be done. On the other hand, I do not think the major measures that need to be made require congressional approval, and in times of crisis governments can usually approve things more easily. I think many of the measures to be taken to clean up public finances will not need opposition support—I do not believe that there will be a governability risk.

Considering the complex scenario for economic adjustment, what are the growth challenges this year?

It is not simply a matter of economic adjustment—bringing inflation down, in an economy that has been overheated. Brazil will have to undergo a profound transformation in its consumption-led growth: both private and public consumption are at a very high level, totaling 85% of GDP over the last four quarters. … Domestic saving is 13% of GDP, the lowest level since the 1950s. That all has to change. We have to move to investment- and export-led growth. That will not be a trivial process. It involves restoring business confidence to invest and improving the competitiveness of exporters.

Macroeconomic adjustment is part of this process, but if we do not address other growth-related problems the speed and the extent of the economic recovery will be less. There are many obstacles to investment that are not macro-related, such as complex tax laws, infrastructure, labor regulations, and bureaucracy. It is essential that the government not get stuck on macroeconomic policies. … The government urgently needs to build a positive policy agenda, starting with streamlining taxes and bureaucracy, labor reforms, and accelerating infrastructure concessions and public-private partnerships.

What about the external outlook?

The United States is clearly recovering. The question is how lower oil prices will affect the US economy, which varies between slightly good to very good. Americans spend much on fuel, cars, and heating, and a fall in fuel prices means that people have more money to spend. On the other hand, since today the United States also produces a lot of oil and many of the jobs created recently have been in major oil-producing states, lower oil prices may reduce growth a bit. Still, I believe on balance lower oil prices will help the United States. The U.S economy will continue accelerating, and interest rates will rise in 2015. This is generating great turmoil in international financial markets, with the currencies of commodity-producer countries such as South Africa and Russia devaluing a lot. In Japan, Shinzo Abe's election victory will give new stimulus to the country. Japan has a yen devaluation policy, and Japanese industry is becoming very competitive. … The difficulty Europe has in making major monetary easing as Japan is doing will bring about relatively weak growth. China's growth has slowed to 7%, where it should stay for some time. It is still a good performance; there is no crisis there.

And emerging countries?

Countries like India and Indonesia will gain from the oil drop. For some time India's economy has had very high external current account deficits. With the fall of oil prices, the deficit will disappear. With a new prime minister who is apparently quite committed to addressing the size of government, and lower oil prices, the country should do relatively well. South America

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is feeling the drop in commodity prices. The economies of Peru, Chile, and Colombia have slowed from 5–7% to 3%. [Because of economic policy mistakes,] Venezuela and Argentina are in a much worse situation. … Argentina has elections next year and is more likely to get out of its trap. Venezuela's political situation is more complicated. Mexico is closely linked to the US economy, and should benefit from US recovery. On the other hand, it is still seen as an oil economy. The world will continue to grow slowly, but with different stories for different countries.

How do you think the economic team will manage the exchange rate against a stronger U.S. dollar?

The exchange rate has been significantly devalued. However, it is likely that the economic team will have difficulty in carrying out all the needed price adjustments in 2015. … If the government adjusts controlled prices and lets the exchange rate devalue, it will be correcting a distortion in the economy that has lasted too long. Central bank policy of selling large amounts of foreign exchange

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swaps until recently prevented the exchange rate from devaluing more [and helped to contain inflation]. It will be hard to continue this policy as the US dollar strengthens. I believe the central bank will let the exchange rate devalue, and consequently let inflation rise. Inflation in 2015 will be the fault of the departing economic team. The question is whether the government will have the will to actually contain inflation.

How will exchange rate devaluation affect industry and exports?

In the long run, of course, devaluation of the exchange rate will be good for industry. In the short term industry will benefit industry less because imported inputs will be more expensive. But on balance exchange devaluation will be positive. The projected trade surplus for 2015 is mainly attributable to falling imports. We do not know how much commodity prices will fall this year. … Let's see what will happen; this story of falling oil prices is frightening.

What reforms are needed?

In times of crisis it is good to make major reforms—reforms are important for society as a whole to get out of the crisis—but reforms cause problems for vested interests. There is room to make such reforms as accelerating the granting of infrastructure concessions, simplifying taxes, and amending rules, particularly the ones that make Petrobras the only operator of oil concessions, to foster more activity in the oil sector. Again, the government has to have a positive agenda for reforms, including improving investment and the business environment to encourage growth. Also, the government will have to communicate its pro-growth policies more clearly. Today the only economic news is bad news, and this will make things worse because the economic adjustment will be slow. We can expect at least two years of difficult macroeconomic news.

What reaction do you expect from society?

I believe there will be more active popular participation because the standard of living will decline. Households have high debts and their earnings will stop growing, and possibly even fall. They will have to cut spending, struggle to borrow again, and honor their debts. … We will witness more social unrest … Therefore, the government urgently needs a positive agenda of reforms that provide hope beyond the difficult years ahead. For this, however, the government needs to reject ideology. And we see no clear signal of this happening so far. ■