

At the peak of UNCERTAINTY

The worsening political crisis raises more doubts about whether the Brazilian economy can pull through.

Solange Monteiro

DECEMBER BEGAN WITH more bad news: On the economic front, IBGE, the government statistics agency, announced that for the third consecutive quarter GDP had again contracted, forcing analysts to rethink their projections for 2015 and 2016. The political shock was even greater. First, Worker's Party (PT) members broke with the Speaker of the House Eduardo Cunha (Brazilian Democratic Movement Party, PMDB) and supported revocation of Cunha's mandate in the Ethics Committee of the Congress for corruption. Cunha then launched the impeachment process against President Dilma Rousseff based on allegations that she broke fiscal laws by window-dressing government accounts ahead of her re-election last year. Meanwhile, the Superior Electoral Court had before it the petition of the Brazilian Social Democratic Party (PSDB) contesting the election of President Rousseff and Vice President

Michel Temer (PMDB), on the grounds of abuse of political and economic power.

Although in 2015 there have been 28 requests for impeachment, the chances of the process advancing had been considered negligible. Octavio Amorim of the Brazilian School of Public and Business Administration (Ebape/FGV) pointed out that since the cabinet reshuffle in October, the idea seemed to have lost support, postponing the risk of impeachment to March 2016, when its prospects might be affected by how the economy is performing and whether there would be street protests during the Congressional recess. The initial reaction of the markets was positive, signaling hope for an end to the government management paralysis that had compromised the reform agenda this year.

But optimism dissipated as politics grew more volatile. Jairo Nicolau, political science professor at the Federal University of Rio de Janeiro (UFRJ), describes the situation as having moved from one of the most diffuse and unproductive periods of Congress to another even less productive. "What we saw in 2015 was a voting game … presidential veto, congressmen vote to overturn the president's veto. Substantively, Congress did very little, when it was critical that it work," he says. "For 2016, considering that the impeachment process would take much of the first half of the year, plus election of the Speaker of the House, more politicians tangled up in the state-oil company corruption scheme, and municipal elections in the second half of the year, there will be little time left for Congress to act. Congress may not disrupt the economy, but it will not help it."

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The PSDB petition before the Supreme Electoral Tribunal may be a fast response to the political impasse, but it is subject to appeal to the Supreme Court, which may postpone any kind of political resolution. Thus anxiety about how the political future will affect the economy is spreading uncertainty and lowering the confidence of both businesses and consumers; there are also doubts about whether the economy, plunged into deep recession with a growing deficit, has the capacity to regenerate itself.

Armando Castelar, IBRE coordinator of applied economics, points out that successful exits from past crises were due to rapid and consistent action, explaining that "In 1998–99, President Fernando Henrique Cardoso made a strong fiscal adjustment, amounting to almost 4% of GDP; that raised the tax burden but delivered on the fiscal targets. In 2002–03, President Lula applied an even more orthodox policy, further raising the primary surplus, cutting spending and investment, and reforming the civil service pension fund." Renato Fragelli, professor at the FGV Graduate School of Economics (EPGE), comments that the list of accumulated economic corrections at the end of the first Rousseff term demanded unquestioned leadership, which did not materialize.

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Quick spin

The quest for political resolution is even more pressing considering the staggering speed at which the economy is deteriorating: Regis Bonelli, IBRE researcher, explains that while in the 12-month period through March 2014 Brazil's GDP expanded by 3.2% in the 12 months through September 2015 it contracted 2.3%. He adds that "In a year and a half, Brazil had a drop in economic activity of 5.5 percentage points—quite severe for such a short period." IBRE expects that economic activity in 2015 will drop 3.6% and another 3% next year, but a great deal depends on resolving the political impasse and reaching a consensus to address the growing fiscal deficit.

The current recession, which began in the second quarter of 2014, is one of the longest of the nine identified since 1980 by the IBRE Business Cycle Dating Committee. After 1995, recessions shortened; they now average 2.8 quarters.

Castelar emphasizes that "the current crisis did not start with external financing problems. The external balance of payments deficit was reversed quickly, … [But] we have a significant worsening of the fiscal situation. We went from a

Brazil: IBRE baseline scenario for 2014-2016

	2013	2014	2015 Est.	2016 Proj.
Real GDP growth (% change)	3.0	0.1	-3.6	-3.0
Inflation (% change)	5.9	6.4	10.5	7.6
Central Bank policy rate (end-period, %)	10.00	11.75	14.25	14.25
Exchange rate (average, Reais per U.S. dollar)	2.2	2.4	3.8	4.3
Primary balance surplus (% of GDP)	1.7	-0.6	-1.0	-1.2
External current account balance (% of GDP)	-3.1	4.4	-3.6	-2.6
Trade balance (US$ billion)	0.3	-6.1	15.0	28.5
Export (US$ billion)	242	225	189	191
International reserves (US$ billion)	376	374	380	380

Source: Institute of Geography and Statistics (IBGE), Central Bank of Brazil, IBRE staff projections.

primary surplus of 1.8% of GDP in 2013 to a deficit of 0.6% in 2014."

The fiscal deterioration was not entirely due to the political stalemate between the administration and Congress, says Rubens Penha Cysne, EPGE director. He notes that President Rousseff's second term began with important measures to correct imbalances resulting from the "New Economic Policy" of her first term: "The administration began to argue forcefully for fiscal surplus targets, adjusted administered prices, and there was an improvement in the foreign exchange rate that eliminated concerns about financing the current account deficit," he explains. IBRE estimates that the external current account deficit will decline to US$40 billion this year, 2.8% of GDP, from 4.2% of GDP in 2014.

But more was needed, especially in cutting government spending. In November, IBRE projected fiscal primary deficits of 1% of GDP for 2015 and 1.2% of GDP in 2016. IBRE now estimates that recurrent revenue potential, such as the tax on financial transactions, and nonrecurring revenues from sales of assets could add R$78.4 billion to the government coffers. "This adds only 0.1 percentage point of the primary balance—much less than is needed to stabilize the gross public debt," says Silvia Matos, IBRE researcher.

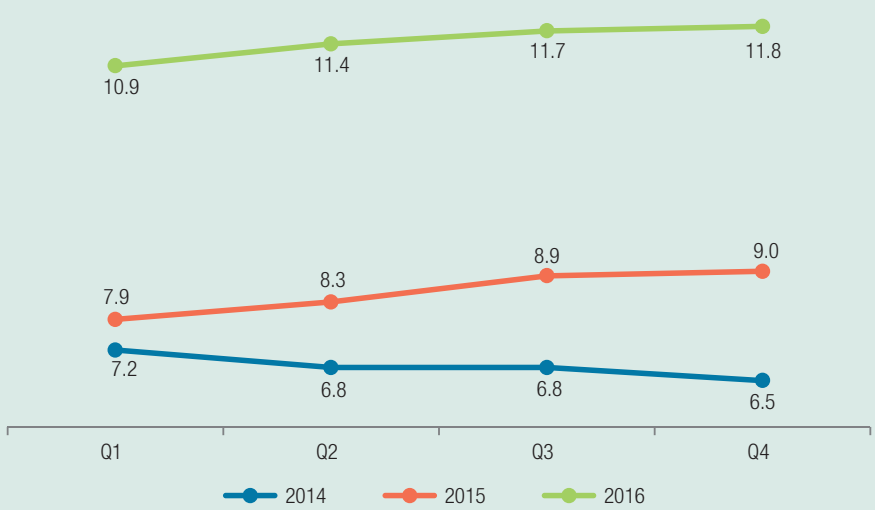
"The longer we put off a more robust fiscal adjustment, the more the economy suffers."

Silvia Matos

Part of the fiscal deficit results from President Rousseff's first-term policies of cutting taxes and contributions. IBRE researchers José Roberto Afonso and Vilma da Conceição Pinto estimate that the cost of these tax cuts has doubled since

Bad news: Unemployment increases

(Quarterly average, %)



Sources: IBGE and IBRE.

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Livio Ribeiro

the beginning of Rousseff's first administration, from R$209 billion to R$408 billion, or 6.5% of GDP. Another part is related to the social policy adopted in the Constitution of 1988. Since then, central government spending has grown by 0.4 percentage points of GDP every year. "Of this increase, 70% can be explained by cash transfer policies. It's a very high level, and fixing it will require significant constitutional reforms. The longer we put off a more robust fiscal adjustment, the more the economy suffers," Matos says. She explains that for a time social spending was financed by tax increases and the higher tax revenue during the commodity price super-cycle, which proved unsustainable. Without fiscal adjustment, IBRE estimates that gross public debt will reach 82% of GDP in 2017, up from 67.5% this year.

Without a clear horizon for resolving the fiscal crisis and with confidence plummeting, IBRE expects capital investment to fall by 26% for 2014–16. "There's nothing structurally speaking to suggest that 2016 will be better than 2015," says Livio Ribeiro, IBRE researcher. "The only thing that we can highlight is that the external sector is recovering—but that is associated much more with the collapse of domestic demand than with sales." For 2015 IBRE estimates 4.1% growth in exports and a 13.7% drop in imports, and for 2016 a mere 2.2% growth in exports and a 14% contraction in imports.

The main sectors that will contract substantially in 2016, according to IBRE, are manufacturing 9.5%, construction 5.9%, and services 1.6%. Depressed household consumption, which represents 62% of total demand, is another factor worsening the economic stagnation. Household consumption fell by 3.4% in 2015 and will further decline by 3.2% in 2016. Matos notes that "Household consumption was greatly protected because of a booming labor market and rising incomes. But in 2016 the crisis will get to the streets." She expects unemployment to shoot up from 8.5% in 2015 to 11.5% in 2016.

Despite the slowdown in economic activity observed in recent years, employment increased because of a booming labor market based on low growth in the working-age population. "With the improvement of workers' income, many young people left the labor market to study because they did not need to work to supplement the family's income," recalls Naércio Menezes of the Brazilian Institute of Capital Markets. Compared with the crises in 1998 and 2002, which began with unemployment close to 10%, that rate was much lower, below 7%, when the current crisis started.

Another factor that makes this crisis different is that social protection is much broader than in previous crises. Fragelli points out that "Although some benefits have been reduced this year, such as the more restrictive unemployment insurance rules, we still have many social programs, and an unemployment rate of 10% of the economically active population today has a much lower impact on the well-being of the population than 15 years ago." Matos adds that the share of social benefits in Brazilians' incomes went from 14% in 2000 to 25% in 2014. Also, the number of beneficiaries has risen faster than the working population: "In 2000 we had about 30 million beneficiaries for 70 million workers; now we have 70 million beneficiaries for 92 million workers," says Matos.

Nelson Marconi of EESP-FGV believes that whether the lower-consumption economy will recover will depend on external factors: exports and concessions. "Exports take some time to react to exchange rate devaluation, but they should increase next year," he says. Regarding infrastructure, this year the government has focused on managing the short-term political

The impeachment factor

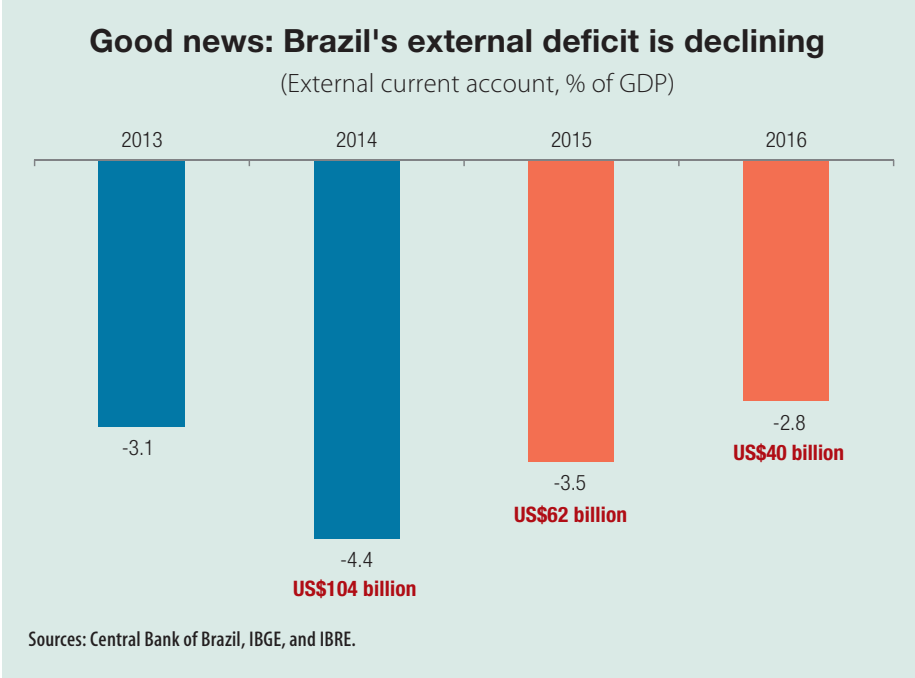


The prospect of the country's leadership changing before the 2018 presidential elections and the ethical problems of the Speaker of the House of Representatives, Eduardo Cunha, have generated a variety of scenarios about what the proceedings to impeach President Dilma Rousseff might mean for the economy in 2016. For Octavio Amorim of Ebape-FGV, the initial positive reaction of markets to the news of the impeachment proceedings reflects a hope that the president will step down and Vice President Michel Temer (Brazilian Democratic Movement party, PMDB) will take over and form a broad coalition that could mitigate the current political deadlock. "In this scenario," Amorim says, "Temer should emulate the government of Itamar Franco, a model of a great agreement, without the participation of the Worker's Party [PT]." He points out that the PMDB party may become more interested in this alternative if during the impeachment proceedings certain minimum conditions for a new government occur. These conditions, he says, "include support from the Brazilian Social Democratic Party (PSDB), and Temer agreeing to not run for re-election in 2018 and committing to rather institutional behavior in the presidency."

If Rousseff wins the impeachment battle, Amorim outlines three possible scenarios. In the first, she would again seek the national agreement that failed in 2015, allowing fiscal adjustment. Although this is a positive scenario, Amorim recognizes that it is the least likely option, since "this type of agreement is not in the Rousseff DNA—it would give even more power to allies and the opposition."

The second scenario would be consolidation of the president's cabinet reshuffling in early October, which has shown some results, such as maintenance of the president's vetoes of measures that would worsen the state of public finances, and approval of the fiscal deficit target for 2015. Amorim considers, however, that this arrangement would be very unstable because it depends on what happens with the economy, which is likely to worsen, and with the corruption investigations at Petrobras. Also, "it would only ensure President Rousseff's short-term survival, without necessarily moving ahead the fiscal adjustment, or enhancing the popularity of Rousseff and the PT ahead of the 2018 elections."

The third scenario, inspired by former President Lula, would be to soften the short-term fiscal adjustment and ease restrictions on credit to the states. That would make the economic situation much more difficult. But "this scenario," Amorim says, "might … recover the support of social movements, businesses, and financial markets that had previously supported Rousseff." He emphasized, however, that the outlook for all these scenarios is highly uncertain.



situation but has failed to look at structural issues as it should. "But the concessions require little fiscal resources and can stimulate economic activity," Marconi says, "as long as the government ensures legal certainty and the rules are clear."

Long term

The recovery of the economy, however, depends on the political outcome. "We already know what to do," Fragelli says, but "we economists have nothing more to say because there is nothing to be done without political authority." He calls for a broad pact to relieve the decision-making paralysis. Otherwise, he says, "We are about to lose another three years of growth, and at best we will end up in 2018 with the same income per capita as in the first term of President Rousseff."

IBRE research associate Braulio Borges believes that reversing the current scenario requires a long-term adjustment agenda: "The market already has a rather skeptical view about there being a reasonable outcome in 2016. But we could have an improvement in the perception of Brazil risk not only if next year's budget is approved with a fiscal primary surplus, but also if there are medium- and long-term reforms that signal a more robust fiscal situation in the future."

EPGE's Cysne agrees with Borges that resumption of economic growth must be powered by medium-term planning: "It is necessary to establish a horizon, for example, from 2016 to 2020, moving decisions from short-term to medium-term. This requires a certain audacity but could promise a much better future than what we see today." Fragelli believes that the worsening of the economic crisis could open a window of opportunity for reforms, especially of social security, that yield long-term results.