Gustavo Franco

The need for “economic common sense”

Solange Monteiro and Bertholdo de Castro

FORMER PRESIDENT OF THE CENTRAL BANK Gustavo Franco, one of the creators of the Real Plan, reminds us of the daunting obstacles to economic stability in 1994. He also reminds us of when inflation reached its lowest point at the end of 1998. Today, he says, there is a relentless pursuit of economic policies to sustain economic growth worldwide, and the formula is “perhaps well-known but difficult to carry out.” Today, Franco would be pleased to see something done about the policy setbacks of the last two years.

The Brazilian Economy—Is the Real Plan exhausted?

Gustavo Franco—You would have to go back as far as the Old Republic in the early 1900s to find inflation so low. If in 1993 you had said that inflation, which was at 45% a month, would in four years reach 1.6% a year, half the population would have said that was impossible—and the other half would have said it was taking too long.

What can be done to foster growth?

This is the billion-dollar question. I remember in 1995, when I was director of the central bank and we were thinking about how to foster development, I argued that once past the first phase of the Real Plan we could see inflation gradually falling, and it would be important to carry out other reforms, such as fiscal consolidation. … We promoted privatization not merely to resolve a fiscal issue of state-owned enterprises being unprofitable but also, and primarily, to recover investment capacity in the steel, telephone, and railway sectors that were being privatized. … But something happened that we had feared: Many of my colleagues on the Real Plan warned that it was possible to bring inflation down, with wonderful effects, but if politicians did not carry out reforms, inflation would come back. … We also felt that though initially political support to promote reforms was great, riding on the euphoria of the plan, it would run out gradually.

What reforms are needed now?

Around the world, people are seeking the perfect formula for economic growth. The formula is known, but it is difficult to implement. Very few countries have grown sustainably. (Perhaps in Asia.) Accelerated growth is more complex than stabilization; it involves collective coordination, incentives, and correct government policies, in the right measure.

In Fernando Henrique Cardoso’s second term, there was less political support to push ahead with reforms; initial turbulence with the devaluation in early 1999 weakened the government. In 2003, when the Lula administration came in, there was a perceived threat that the president could become Hugo Chavez and destroy the Real Plan. By 2004 the economy had survived the
political transition and, with a much improved international environment, the political climate became less risky. Maintaining the same economic policy allowed the new government to introduce pro-growth measure, such as payroll loans. It was a spectacular moment in terms of favorable international commodity prices and population demographics. ... The 2008 crisis interrupted the consumption-led economic growth brought about by propitious demographics [more workers entering the labor force], ample credit growth, and favorable commodity prices. ... Investments and savings continued to be low. In the Rousseff administration, consumption-led growth has slowed sharply, because household debt has no more room to grow.

Why does Brazil not grow now? Fixed investment depends on a favorable business environment. According to the World Bank’s Doing Business report, Brazil ranks far down at 120th among 180 countries. The ranking covers all the very basic needs for development, including time it takes to open and close a company, time spent to fulfill tax obligations, labor law, protection of property rights, and access to credit.

Today we have high interest rates, inflation, a looming downgrading of Brazil’s investment grade by international rating agencies, and elections. Do you think the new government will carry out reforms?

Whoever wins in October, including Rousseff herself, I hope will bring back economic common sense. There is a well-established international set of good policy practices that either we do or do not. In the last two years we followed Argentina and Venezuela, and we got close to [their] dysfunctional results.

We have the Asian countries’ successful examples, but ... [in all cases of successful growth] they had reforms, often contentious, that created institutions to foster economic growth as opposed to traditional ones.

South Korea is an example of growth through investment in education. Why is education not part of the debate?

Brazil spends a lot on public education but spends it badly. Here discussion of more investment and improvement in education becomes a discussion on teacher salaries. Not that teacher salaries are not important, but education management is the crucial issue, especially in elementary and secondary education. But there is absurd teachers’ union opposition against setting goals, plans, and meritocracy in education. We do not have proposals for national education reform. There were important initiatives in the Cardoso administration, such as the National High School Exam, which introduced meritocracy. Increasing the productivity of investment in education is much more important than increasing the education budget.

What should we expect in the immediate future?

I would be pleased to see the policy setbacks of the last two years reversed. Fiscal policy has deteriorated a great deal, pushing inflation up and forcing the central bank to fix it the wrong way, by increasing interest rates. We are abandoning a trend toward lower interest rates. This is the fault not of the central bank but of lax fiscal policy. This has to be corrected in the first year of the new administration in 2015, not in an election year. It would be great if we, as a country, had already moved beyond adolescence on fiscal and monetary affairs. I thought we had, but the last two years seem to prove the contrary.