“The government has already spent its ammunition”

Affonso Celso Pastore
Former president of the Central Bank

Solange Monteiro

IN RECENT YEARS, Affonso Celso Pastore has occasionally been called a pessimist, as when he said the Brazilian economy was heading toward stagflation. Today, he defends that diagnosis and calls for the country to correct economic policy in 2015 whatever the cost. The former Central Bank governor (1983–85), now chairman of the Business Cycle Dating Committee of the Brazilian Institute of Economics (Codace), says that the next government will have to make tough choices to balance the economy and restore the confidence of international investors in Brazil. “The government usually mentions that it is constrained because it received a cursed legacy. But this election year it is reaping a very bad thing that it planted itself,” he concludes.

The Brazilian Economy—In February the U.S. Federal Reserve ranked Brazil as the emerging country that is second most vulnerable as U.S. monetary policy normalizes. Do you agree?

Affonso Celso Pastore—I agree. … Nevertheless, Brazil is less vulnerable today than in the past, when it had no reserves and had unsustainable public debt. In 2002–03 when there was a crisis of confidence, the primary surplus was insufficient, gross public debt was 75% of GDP, and it was uncertain whether new President Lula would maintain fiscal discipline. Brazil’s risk premium skyrocketed to 2,500 points, causing capital flight and exchange rate devaluation. … Now Brazil is much less vulnerable—all emerging markets are much less vulnerable today. All have accumulated international reserves and reduced their debt.
Is the government making the necessary policy corrections to reverse this situation and put Brazil back on the path of sustainable growth? Let’s put it this way: the government diagnosis was that Brazil was not growing because of a lack of demand. It tried to stimulate demand by reducing the primary fiscal surplus and loosening monetary policy. When demand grows above a country’s total production of goods and services (GDP), it increases net imports and the external current account deficit.... So we have a current account deficit of 3.7% of GDP, and we may say that is not large, [but] what is relevant here is whether capital inflows are sufficient to pay for the deficit. ... For the past 12 months, capital inflows into Brazil were slightly below the current account deficit....

What will determine Brazilian currency value going forward is the amount of international capital inflows. ... In my view, the United States will continue to attract capital—capital that is moving away from emerging countries. Brazilian currency found temporary relief at the end of February, but I believe that when the U.S. recovery picks up, the Brazilian currency will be under pressure again. So the outlook is for further currency devaluation, inflation, and low growth.

In an article published last February, former President Lula stated that Brazil is now a global competitor and that international investors have a more objective and less pessimistic view of the country. Do you agree? He’s living in a world different from the one I’m looking at. The data do not corroborate President Lula’s view. Fixed investment is falling. The recent national account figures confirm that. With the uncertainty that lies ahead, it will not be possible to raise fixed investment. I also think that potential GDP growth is falling.

Was the government wrong to judge that the country was prepared to live with low interest rates?

The government made a huge mistake. ... [At the time the central bank cut interest rates,] what was happening was a temporary global cycle of lower interest rates. Interest rates fell in the United States, Europe, worldwide. Except that in Brazil the rate fell more than it should have. Interest rates started rising again globally, and now Brazil must raise its interest rates. When the central bank began to cut interest rates, we had inflation of 7% a year. Do you think that was a deal well done? This was a very crude, rudimentary monetary policy blunder.

What more could the government do now?

The government has already spent its ammunition. Will it now lower interest rates to boost growth this year and accept inflation above 6.6%? Will it raise interest
rates to prevent inflation from straying above 6.5% and accept growth below 1.2%? The government usually says it is constrained because it received a cursed legacy, but in this election year it is reaping a very bad harvest that it planted itself. I do not know what the government will do, but it will have to make choices, and not easy ones.

**Industry lost competitiveness because there were no structural reforms. We must tackle the problem as it exists and not seek the easy way out. …**

Despite the currency devaluation, we still have a unit labor cost that is too high.

Even with devalued currency and a stimulus package, Brazilian industry has shown no signs of recovery. What went wrong?

For 2002–08, unit labor cost was constant, and growth in wages was equal to the growth of labor productivity. … Since 2010, however, the unit labor cost has been rising and is now 17% to 18% above its historical average. As unit labor cost rose, profit margins in manufacturing fell. You look at this and ask: how can industry be well? Some people say industry needs a devalued exchange rate. Yet the exchange rate devalued, but the unit labor cost rose even more . . . The government has carried out a policy of income redistribution, raising wages, but labor productivity has remained constant.

Do you think the president elected this year will see the need to change economic policy in 2015?

Whoever wins will have to change economic policy. The changes in policy will have costs, but depending on how the changes are done—if they are done correctly—the cost will be temporary and the country will resume growth. If government persists in flawed policies, there will still be costs but without growth. The dilemma is not whether the government will do something but what it will do.

With high interest rates and no structural reforms, how do you see the medium-term outlook for industry?

Industry lost competitiveness because there were no structural reforms. We must tackle the problem as it exists and not seek the easy way out. One can no longer use the argument that the Brazilian real is overvalued, as it was in 2011. A huge exchange rate correction took place. Nevertheless, we still have a unit labor cost that is too high.

Do you think it will be possible to roll back the stimulus policy based on tax exemptions for some sectors?

Brazil will have to increase the primary fiscal surplus, and to do that we have to raise taxes or cut spending, or both . . . . The way things are done in this government is that who complains more wins more. The industry lobby can afford a trip to the capital city, Brasilia, to speak directly to President Rousseff . . . . It is very possible that with the
industry lobby pressing the government, it will not roll back tax exemptions. So this tax benefit will have to be paid by someone else. One way or another, we have to raise taxes or cut spending, or both.

In Brazil low productivity is a fact. Some economists point out that part of the problem is the government’s disregard for education. I agree absolutely. To quote Paul Krugman, “productivity is not everything, just almost everything.” Almost all economic growth is productivity. People say we have to increase investment, but if there is no increase in productivity, the country does not grow. And from the point of view of increasing productivity, investment in human capital is not everything but it’s a good chunk of the story. Countries that have managed to break the inertia and grow, like South Korea, succeeded because they invested in education. When you invest in education, you solve two problems: economic growth and income distribution. If you direct investment in education to low-income people, you increase their productivity, their incomes will rise much faster, and you are improving income distribution. Socially, investing in education is extremely profitable. Highly desirable. This is the first part of the story. … It is necessary to create an educational system that eliminates social and economic differences. We have to pay teachers more, but the pay needs to be based on performance.

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