Rousseff’s next step

João Augusto de Castro Neves, Washington D.C.

IT APPEARS IN HINDSIGHT that one of the administration’s main economic policy objectives in President Dilma Rousseff’s first two years in office was to aggressively lower Brazil’s perennially high interest rates. But driving the benchmark rate to its lowest level ever came at a price: In addition to arousing speculation about political interference with the central bank’s operational autonomy, the government’s focus on monetary easing as a means to spur economic activity has not been very effective. Average GDP growth during Rousseff’s term so far has been the worst since President Fernando Collor’s tenure in the early 1990s.

The decision to lower interest rates only makes sense if it is not an end in itself but the beginning of a process to tackle the elements that constitute what is too well-known as the “Brazil cost.”

Given the current scenario of economic uncertainty, Rousseff’s challenge for 2013 is twofold. Since her economic policy priority was to lower interest rates to more civilized levels, the challenge now will be to keep rates low despite growing inflationary pressures. Macroprudential measures—such as credit restraint—will most likely be the government’s first choice of action to contain prices, but recent history suggests that such measures alone might not be enough to keep inflation at bay.

The recent debate about a looming energy crisis may further complicate matters. If keeping domestic fuel prices artificially low—which severely depressed Petrobras’s investment capacity—was not hard enough, this year there will now be pressure from the need, in order to reduce the risk of energy rationing, to relieve a scarcity in hydroelectric energy by resorting to more expensive thermoelectric energy. The irony here is that the combination of low growth and scarce energy was the main reason for the downfall of the opposition PSDB a decade ago.

The president’s other challenge is obvious: get the economy up and running.

castroneves@eurasiagroup.net
Again. Since lower interest rates and sector-specific stimulus measures have not been enough to spark investment, however, an appropriate administration response to that challenge is not obvious. If on the one hand the government seems to have acknowledged the need to resort to the private sector, as is the case with transport infrastructure, on the other its proclivity for intervening in the economy, as was the case with banks and the power sector, raises concerns about regulatory risks. So far, most foreign investors are looking to Brazil despite government policy, not because of it.

Granting the Rousseff administration the benefit of the doubt, it is possible that, notwithstanding the chatter, a sequential strategy is in place for the long term. Certainly, the decision to lower interest rates only makes sense if it is not an end in itself but the beginning of a process to tackle the elements that constitute what is too well-known as the “Brazil cost.” Recent overtures in the transport sector highlight concern with another component of the Brazil cost: poor logistics. And the Science Without Borders program only marginally addresses yet another element: the lack of skilled labor. Still, although all are limited or in need of fine-tuning, the fact that these policies exist at all is at least a sign that the government realizes what Brazil’s main challenges are.

So what would be the ideal next step in a long-term strategy for the rest of Rousseff’s term? The short answer: tax reform—specifically, reform that lowers the country’s increasingly high tax burden and simplifies the tax code, which would reduce compliance costs for businesses. The roadmap is obvious. In addition to further lowering payroll taxes to industrial sectors, merger and reduction of federal levies (PIS-Cofins) is being considered. More arduous would be harmonizing the state-based value-added tax of all 27 states. But even here a conjunction of factors seem to favor reform, among them the need for states to revalidate existing tax incentives, favorable conditions for renegotiating state debt with the federal government, and Rousseff’s high political capital.

That last factor, incidentally, is crucial not just for congressional support. Since any substantial tax reform would ultimately entail loss of revenue for the central government, it would inevitably translate into a substantially lower fiscal primary target (it is currently 3.1%). The government’s task, therefore, would be to credibly convey the idea that it is not abandoning yet another leg of the macroeconomic tripod. A lower primary target should not fuel more government spending but would certainly lead to a lower tax burden that would allow the private sector to invest more.

For a government that waves to the private sector with one hand while holding a rock in the other, this is not a trivial task.