How to read Brazil’s crisis response

João Augusto de Castro Neves, Washington D.C.

CONCERNS ABOUT Brazil’s economic growth and the policy environment have risen in recent months. After another round of disappointing economic data (in the first quarter of 2012 GDP grew by 0.2%, far below market projections), investors are beginning to wonder if the B in BRICS has lost its appeal as a promising emerging market.

Two main questions are driving this bout of market pessimism. First and more general, has Brazil’s economic growth model reached its limit? Second, will the Dilma Rousseff administration seek growth at all costs—a strategy that would entail a less market-oriented and more interventionist stance and possibly a different economic policy mix?

It is difficult to formulate a definitive answer for either question. Forecasts for sustainable growth of the Brazilian economy have become less favorable because of rising labor costs, the sluggish pace of public investment, and the effect the continuing crisis in the Eurozone is having on commodities prices. Yet even though economic growth prospects for Brazil this year are bleak (markets project that GDP growth will be less than 3%), there are reasons to believe that the pessimism over the policy environment in Brasilia may be overstated.

With concerns about industrial production growing, the government in May announced a package of measures to stimulate the economy. Among them are reductions of the tax on consumer loans and the industrial products tax on auto sales, a lowering of bank reserve requirements with the funds released earmarked for auto loans, and cheaper lines of credit from the BNDES for working capital and acquisition of trucks and machinery. The final cost of

castroneves@eurasiagroup.net
the package in terms of lost revenues is estimated at R$2.7 billion (about US$1.4 billion) this year, but the costs could rise since the administration has signaled that similar measures will soon follow.

The decision to conduct one more round of stimulus measures only weeks after the government announced the second version of the Great Brazil program, which certainly provided benefits to industry, suggests that the administration is increasingly bearish on growth, both domestic and international.

Although the effectiveness of some of these measures may be questionable, it would be a mistake to interpret these recent steps as evidence of a de facto decision to pursue economic growth at all costs. While additional measures to incentivize the economy should be expected, the fiscal policy strategy is still intact. Rousseff’s focus is on delivering on the primary fiscal surplus target (3.1% of GDP in 2012) as a means to support the monetary easing being pursued by the central bank. Ultimately, her overarching goal is to reach lower interest rate equilibrium for the rest of her time in office, which could mean that the fiscal environment ahead will be more favorable.

In the short term, this policy path is likely to result in slower growth, but given Rousseff’s high approval ratings and with no concern about national elections any time soon, that seems like a bearable cost. Longer term, however, these policy choices might not be enough to guarantee higher and sustainable growth. To achieve that, she would have to go beyond lowering interest rates and tackle some of the other drags on growth that constitute the well-known Brazil cost, such as the high tax burden, expensive labor costs, poor infrastructure, and low productivity.

With the political calendar abbreviated by a wide-ranging congressional inquiry on corruption, the mid-year legislative recess, and local elections in October, there is not likely to be any major reform on the agenda for the rest of the year. Whether the reform agenda will go forward in 2013 will depend fundamentally on (a) Rousseff’s popularity, and (b) Brazil’s fiscal situation. While the former is fundamental if there is to be a more reliable government coalition in congress, the latter usually determines whether an administration is willing to pursue reforms, such as tax reform, that could result in a revenue shortfall.

If both factors are present, chances are good that the government could abandon its muddle-through approach to problems and embrace a more long-term growth strategy. Unfortunately, there is nothing to do but wait and see.

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