The urgency of economic adjustment and an uncertain political situation will make 2015 a hard year for Brazilians.

Solange Monteiro

DRAMATIC EVENTS in the second half of 2014 transformed the scenario at the turn of the year in Brazil into a big question mark. The fierce presidential race, the deterioration of economic indicators, and allegations of corruption at state-owned oil company Petrobras heightened the already anxious expectations about 2015. Can the course of the country be corrected under the same leadership amid political tensions?
In the face of generalized skepticism, reelected President Dilma Rousseff has focused on reviving the government’s credibility. To ward off the threat that Brazil will lose its international investment grade rating, the new economic team has proposed an ambitious fiscal goal: achieve a primary surplus of R$66.3 billion, 1.2% of GDP—R$55.3 billion to be contributed by the federal government and the rest by states and municipalities—even though the surplus in 2014 was zero. In contrast, IBRE is estimating a conservative primary surplus in 2015 of just 0.6% of GDP.

Though perhaps unrealistic, the initiatives were welcomed. “Ministers Joaquim Levy and Nelson Barbosa’s message of greater transparency in public accounting, dismantling of expensive operations, reducing subsidies, limiting the operations of state-owned banks, and increasing savings to support sustainable growth is very positive,” says Mansueto Almeida, Institute of Applied Economic Research (IPEA). But Regis Bonelli, IBRE coordinator of macroeconomic projections, noted, “It was only a speech. The challenge is just beginning.” He believes there are still doubts about the scope of such a turnaround in economic policy.

Revenues and expenses
The first impactful announcement was the tightening of pension benefits for surviving spouses, unemployment insurance, and salary bonuses for low-income workers; it indicated that

Can the course of the country be corrected under the same leadership amid political tensions?

Brazil: IBRE baseline scenario for 2014-2016

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth (% change)</td>
<td>7.5</td>
<td>2.7</td>
<td>1.0</td>
<td>2.5</td>
<td>0.1</td>
<td>0.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Inflation (% change)¹</td>
<td>5.9</td>
<td>6.5</td>
<td>5.6</td>
<td>5.9</td>
<td>6.4</td>
<td>6.8</td>
<td>6.0</td>
</tr>
<tr>
<td>Central Bank policy rate (end-period, %)¹</td>
<td>10.8</td>
<td>11.0</td>
<td>7.3</td>
<td>10.0</td>
<td>11.0</td>
<td>12.5</td>
<td>11.5</td>
</tr>
<tr>
<td>Exchange rate (average, Reais per U.S. dollar)¹</td>
<td>1.8</td>
<td>1.7</td>
<td>1.9</td>
<td>2.2</td>
<td>2.4</td>
<td>2.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Primary balance surplus (adjusted, % of DP)²</td>
<td>1.5</td>
<td>2.4</td>
<td>1.6</td>
<td>0.7</td>
<td>-0.6</td>
<td>0.3</td>
<td>3.0</td>
</tr>
<tr>
<td>External current account balance (% of GDP)</td>
<td>-2.3</td>
<td>-2.1</td>
<td>-2.2</td>
<td>-3.7</td>
<td>-4.1</td>
<td>-3.7</td>
<td>-3.2</td>
</tr>
<tr>
<td>Trade balance (US$ billions)¹</td>
<td>20.2</td>
<td>30.0</td>
<td>18.0</td>
<td>2.6</td>
<td>-3.9</td>
<td>8.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Export (US$ billions)¹</td>
<td>202.0</td>
<td>256.0</td>
<td>243.0</td>
<td>242.0</td>
<td>225.0</td>
<td>214.0</td>
<td>235.0</td>
</tr>
<tr>
<td>International reserves (US$ billion)</td>
<td>288.6</td>
<td>352.0</td>
<td>378.0</td>
<td>373.5</td>
<td>381.0</td>
<td>370.0</td>
<td>370.0</td>
</tr>
</tbody>
</table>

Source: Brazilian Institute of Geography and Statistics, Central Bank of Brazil, IBRE staff projections.

¹Actual values thru 2014.
²Recurring government primary balance surplus defined as budget balance excluding interest payments on public debt, extraordinary revenues from dividends and concessions, and some investments of the Growth Acceleration Program.
“Of the 5 percentage points of GDP increase in primary expenditure in the last 16 years, 4 percentage points related to transfers for social programs.”

Silvia Matos

the government recognizes the pressure of social spending on the budget. “Of the 5 percentage points of GDP increase in primary expenditure in the last 16 years, 4 percentage points are related to transfers for social programs,” says Silvia Matos, IBRE coordinator of macroeconomic projections. In announcing the measure, Planning Minister Nelson Barbosa said that it could generate savings of R$18 billion in 2015—about 34% of the total cost of these three social benefits.

Some economists question that estimate. Almeida says, “In the case of unemployment insurance, the calculation is uncertain because unemployment is expected to rise.” IBRE researcher Gabriel Leal de Barros points out that those receiving salary bonuses and unemployment benefits together represent 40% of all recipients of public transfers in Brazil: “Today there are about 28 million beneficiaries, compared with less than 10 million in 2000.” As for pensions for surviving spouses, IBRE staff estimates that the savings will be relatively small: R$940 million in 2016, rising to R$5.5 billion in 2019, at constant 2014 prices. Nevertheless, the decision to correct the excesses in the generosity of the Brazilian pension system is considered both right and bold.

Also on the expenditure side, economists are optimistic about a substantial reduction in subsidies, which in seven years have doubled to 1% of GDP. In addition to Finance Minister Joaquim Levy’s hint that aid to the electricity sector will end, it is also expected that the low income housing program, My House My Life, will be curtailed. “The program has grown in recent years; it could be reduced to a size more compatible with the reality of the economic adjustment,” Matos says. IBRE staff estimate that government contributions to My House My Life could decline from 0.35% GDP in 2014 to 0.20% this year.

Public investment could also be cut but, says IPEA’s Almeida, “This is a measure that requires courage and high popularity, since it involves denying support to mayors and parliamentary projects.”

On the revenue side, the controversy focuses on how much margin the government will have to increase the already formidable tax burden of 36.5% of GDP—about 3.0 percentage points higher than the average of OECD countries and 16.7 percentage points higher than the Latin American average. Almeida points out that raising taxes has been common practice in Brazil since inflation was stabilized in 1994: “Expenditure was previously financed by inflation, which has been replaced by tax revenue; during hyperinflation the Brazilian tax burden was 25% of GDP. Samuel Pessôa, IBRE researcher, believes raising taxes will be inevitable given the large imbalance of public finances. “Public expenditure has grown by 8% at constant prices since 1997, and for a long time for a number of reasons, revenues
grew in parallel,” he says. Among the reasons were productivity gains that accelerated growth, and the commodity boom, which boosted collections of import taxes. “These factors no longer exist,” Pessôa says. “What remains are a high primary deficit and explosive public debt.”

Finance Minister Levy has not ruled out tax increases. Barros believes that type of initiative could be important if it targets tax exemptions granted in recent years. “Tax exemptions represented 0.1% of GDP in 2010 and 1.9% in 2014. That’s a huge leap,” he says. He identifies the main exemptions as payroll tax relief, the levy on payments to foreign suppliers of technology and technical assistance (Cide), the Tax on Industrialized Products (IPI), and the Tax on Financial Transactions (IOF), which applies to loans to individuals. Matos believes some of these exemptions have generated significant distortions in recent years.

IBRE estimates that for 2015 eliminating the Cide, IPI, and IOF tax exemptions could raise additional revenues of R$15.3 billion in 2015, and fewer investments and subsidies could reduce spending by R$27 billion. Cuts in salary bonuses and unemployment benefits would save another R$7.7 billion.

The government economic team would also like to reduce injections of Treasury capital into state-owned banks. At the end of 2014, the government raised interest and reduced the ceiling and maturities on loans made by the National Development Bank’s (BNDES), aiming to gradually reduce Treasury’s transfers to the BNDES. At the present juncture, it is known that any sudden move could generate adverse results. In the last seven years the Treasury’s share in the capital of the BNDES shot up from 7.5% to 52.8% in 2014. Contributing less to state-owned banks’ capital can only be positive, but although cuts are necessary, support to state-owned banks should be lowered gradually because they are so dependent on Treasury funds and they have an important role in financing infrastructure projects.

IPEA’s Almeida adds that central government spending is still growing faster than GDP despite Minister Barbosa’s goal of limiting spending growth to GDP growth. “This year, we expect a rise in the minimum wage of 2.6%—much higher than expected GDP growth of about 0.5%. Since the minimum wage affects almost 50% of federal government expenditures, public spending will clearly grow above GDP,” he says.

**Political gridlock**

Maintaining the discipline to carry out these measures, moreover, will be an endurance trial for the government. If successful, the effects of this effort in the short term will be negative, such as increased interest rates, less economic activity, higher unemployment, and falling real wages. “To deal with the social pressures that arise during economic adjustment, the
government will have to demonstrate its confidence in its economic team and sell its economic policy well,” says economist José Marcio Camargo of the Catholic University of Rio de Janeiro. The government will have to persuade society to pay now to see economic growth resume in 2016. Almeida warns that “When it comes to adjustment almost everyone is in favor. But we do not know what will happen when, for example, the businessman knocks on the BNDES door and does not get the 80% credit expected, but only 50%, and has to chase more expensive funding. We should expect increased pressure on the government.”

The government will also have to negotiate the approval of Congress for measures critical to the fiscal adjustment. “Any victory will be tight, since the Workers’ Party lost 18 representatives and one senator in last year’s elections,” says Otavio Amorim Neto of the Brazilian School of Public and Business Administration of the Getulio Vargas Foundation (FGV). It will also be a test of the strength of the coalition supporting the government. Although President Rousseff is not accustomed to making political deals, she is aware of the current political situation. Pessôa points out that the ministers appointed suggest that more power will be shared within the coalition than in the president’s first term. But it remains to be seen whether the opposition will be willing to support the government on initiatives that it considers consistent with its agenda. Another factor that may create uncertainties for fiscal adjustment is the investigations into the kickback scheme at Petrobras: since this involves politicians, it could complicate Congressional voting on vital economic measures.

Pro-growth policy
The government announced budget cuts expected to total 22.8 billion of reais (US$8.4 billion) early this year. The announcement of cuts in non-priority discretionary spending is very positive and a step in the right direction; however, new tax and fiscal measures will be required to achieve the target of 1.2% of GDP,” said Barros. However, Matos points out that in the event that the government fails to meet the 1.2% fiscal primary surplus goal, but it carries out the principal measures firmly, it should meet with market approval. “No one is expecting miracles, and the economic team can still have the benefit of the doubt; the important thing is the certainty of the policy course,” she says. She notes, however that the government has yet to spell out clear policies for resuming growth. Barros adds that “Fiscal adjustment is the most urgent issue at hand—but without a growth strategy it will be much more difficult to reach the 2% primary surplus target for 2016.”

Barros highlights the need to tackle the productivity issue by making investments in infrastructure and education in a priority. “It is also necessary,” he adds, “to think about reversing government micromanagement of the economy—such as fixing rates of return for concessions and the use of tax policies as a tool to control prices—and establishing clear guidelines and predictability for economic policy.”

Although the government acknowledges the importance of productivity and infrastructure,
it has yet to draft clear guidelines on how they will be addressed. “It’s a complex policy agenda, and I do not see that it has been discussed as it should,” said Matos. Economist Claudio Dedecca of the University of Campinas agrees: “We see a justified concern to act quickly to balance public finances, but we do not see a clear agenda for the administration’s four-year term.”

Camargo sees a historical lack of long-term thinking, pointing out that “In Brazil, we see growth as the agenda for tomorrow. It is not. Growth is a long-term agenda, which demands reforms in the labor market and credit market, reduction of state participation in the economy, and tax and political reforms. Structural reforms are needed to revive credibility for Brazilian policies. Short-term measures will not work.”

Dedecca argues that, along with economic adjustment, a positive government initiative would be to lay out for society and Congress the strategic issues and stimulate debate to gain support and legitimacy for carrying out decisions. “In recent years,” he explains, “we have seen the country call for political and tax reforms that have not yet been mentioned by ministers, despite being essential for the resumption of Brazilian development.” He argues for transparent monitoring of policy implementation to support discussion and policy revision. Barros agrees: “In general, we do not evaluate the results of public policies. This should be included in government multiyear plans.”

IPEA’s Almeida points out that these first announcements of the economic team do not make clear what support the government will provide to industry. Renato Fragelli of the FGV Graduate School of Economics adds that “We have deep inefficiencies and structural problems affecting industry as well as a tendency to raise taxes. Sectors like agribusiness can survive even if you tax them. But industry won’t survive if you tax it too much. In Brazil, the only industries that can definitely survive are those focused on the domestic market, using average technology—not exporters of industrial products.”

“Growth is a long-term agenda…. Structural reforms are needed to revive credibility for Brazilian policies. Short-term measures alone will not work.”

José Marcio Camargo

The economic outlook for 2015

Compared to 2014, IBRE staff forecast GDP growth of 0.6% in 2015, with increased activity in agriculture and the electricity sector compared to 2014, and a slight increase of 0.1 percentage points in the services sector. Expected to improve their results but remain in negative territory are construction, at −1.2%, and manufacturing at −1.6%.

José Julio Senna, IBRE coordinator of monetary studies, does not believe that more severe monetary policy will be used to contain inflation, which is projected for most of the year to be close to 7%. He predicts that “The government will use monetary policy sparingly, relying more on fiscal tightening.” IBRE is forecasting an exchange rate of R$2.80 per US dollar in 2015 and R$3.00 in 2016.

In the new scenario of low oil prices, in the short term the economic effects should be positive, since Brazil is a net importer of oil and oil products. Lower prices for oil and its derivatives would therefore help to reduce the external current balance deficit and eliminate the need for significant adjustment in fuel prices. However, over time they might have a negative effect on investment in deep sea oil exploration.