**Bitter fruits of fiscal disorder**

Aggravation of political and fiscal tensions weakens the country, delaying expectations that the economy will recover.

_Solange Monteiro_

**SINCE THE BEGINNING OF THE YEAR** it has been clear that 2015 was not looking promising. Still, at that time few foresaw the failure to achieve political consensus on the necessary fiscal adjustment and the further deterioration of public finances, which in recent months have pushed the economy onto a faster downward trajectory. Analysts warn that the outlook could even worsen unless the government overcomes the decision-making paralysis that is now alarming markets. In the IBRE Seminar on the Brazilian Economic Outlook in early September, economists pointed out how the political tensions and the gloom over public finances are depressing expectations of Brazilian growth this year: GDP is expected to contract by another 3%, rather than the 1.8% estimated as recently as June. For 2016, the forecast for GDP has been revised from modest growth of 0.5% to a drop of 2.1%. Yet despite the recession, inflation is still high: the IBRE forecast for 2015 has been revised up from 8.8% to 9.6%. Although that takes into account increases in gasoline and diesel prices announced late in September, it does not consider possible tax increases.

IBRE economists estimate that economic activity will contract by 0.8% in the third quarter of 2015 and another 0.6% in the fourth. Silvia Matos, technical coordinator of the IBRE Macro Bulletin, said that the main factors weighing on the economy are climbing industry inventories, the labor market slowdown, particularly in the service sector—IBRE is projecting total unemployment of 9% by yearend—and a continuing lack of business and consumer confidence. Aloisio Campelo, IBRE Deputy Superintendent of Economic Cycles, said that although some sectors are benefiting from a more competitive exchange rate through exports and import substitution, that has been largely offset by the lack of domestic demand. For 2015, manufacturing
is expected to fall by 9.7% and construction by 8.4%. On the demand side, household consumption is expected to decline 2.4%, investment by 13.6%, and imports by 10.8%.

Armando Castelar, IBRE Coordinator of Applied Economics, noted that such problems as the economic slowdown in China, the deterioration of the fiscal situation, and the need to adjust controlled prices are not new: “We have been highlighting these factors for at least two years. What is striking now is the speed and magnitude with which things are happening.”

Octavio Amorim, professor at the FGV Brazilian School of Public and Business Administration, listed political events that have undermined the prospects for economic reforms: The decision of Eduardo Cunha, Speaker of the House of Representatives, to join the opposition after being involved in the investigations of corruption at state-oil company Petrobras; the resignation of Vice President Michel Temer as the administration’s political coordinator; and the plunge in President Rousseff’s popularity. Amorim believes that any possible political scenario—transferring power to the PMDB party and Finance Minister Levy; presidential resignation or impeachment—will involve a loss of power for the president and the Workers’ Party, and will make it even more difficult to dispel the tensions.

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Octavio de Barros

Brazil’s risk as measured by Brazil’s 5-year CDSs has been the main determinant of the exchange rate devaluation since March 2015.

Source: Bloomberg.
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Brazil risk
José Marcio Camargo of the Catholic University of Rio de Janeiro explained that the political gridlock has led the government to hesitate between carrying out the fiscal adjustment or opting to keep popular support, which would mean accommodating the fiscal deficit by letting inflation rise. “Today the president does not know which way will keep her in power, so she opted for the middle way. This means that the government is not picking a direction, which leaves us under the threat of complete paralysis,” he said. Such uncertainties have heightened the perception of risk, as was reflected in the exchange rate at the end of September hitting over R$4 per U.S. dollar. José Julio Senna, head of the IBRE Monetary Studies Center, thinks that the worsening of the political situation since July was a decisive factor in the steep depreciation of the real against the dollar. “Between December 2014 and March this year, the Brazil exchange rate reflected the recovery of the U.S. economy; as the U.S. dollar has strengthened, the prices of commodities have fallen, increasing the Brazil risk because it is an exporter of commodities,” he explained. Since March, however, the Federal Reserve Bank has come to believe that the performance of the U.S. economy has not been as good as expected and the dollar has weakened slightly—yet devaluation of the Brazilian currency continued because of Brazil’s political gridlock. “Brazil’s risk measured by Brazil’s 5-year CDS [credit default swap] has risen from about 150 points in 2013 to 400 today. In an economy like ours, the country’s risk determines the exchange rate,” he said. “The problem now is entirely ours.”

For Senna, unless there is a political U-turn and measures to control public debt, monetary policy will not be effective and can contribute little to economic recovery: “A bad fiscal scenario affects the country’s risk, which devalues the exchange rate, which increases inflation, leading the central bank to increase interest rates, which raises the public deficit, which increases the public debt, which in turn increases country risk—and the cycle is perpetuated.”

The government’s announcement on September 14 of R$26 billion in cuts in public spending and tax increases of R$40.2 billion was not applauded by economists: “It’s a small adjustment, focused on postponing spending. ... To give an order of magnitude, the Social Security deficit alone is projected at R$200 billion in 2016,” Matos said. Octavio de Barros, director of the Department of Research and Economic Studies of Bradesco Bank, noted that carrying out fiscal adjustment during
a recession is complicated because when economic activity is reduced, so are tax collections. “We have a historical imbalance between public expenses and revenues that needs to be addressed, preferably by creating clear rules for increased spending. Fiscal imbalance brings about uncertainty, exchange rate devaluation, and postponed growth,” he said.

Because Congress still has to approve the fiscal measures announced, IBRE did not take them into account in estimating the 2015 fiscal primary balance. IBRE researcher Vilma Pinto said the public sector primary deficit is projected to remain at 0.6% of GDP in 2015 and increase to 0.9% in 2016. The new measures are not expected to have any significant effect on inflation this year but will push it up in 2016. “The CPMF tax [Provisional Contribution on Financial Transactions] is an increase in tax revenue that will have some effect on prices, even if it happens only once,” said Salomão Quadros, IBRE Deputy Superintendent of General Price Indices. For next year, among possible pressures on inflation, he mentioned a higher CIDE [Economic Domain Intervention Contribution] tax and a new round of exchange rate devaluation.

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**Differences of opinion**

Even with the fiscal and inflation pressures on the economy in the next few years, Bradesco’s Barros is hopeful that some factors may stimulate economic growth starting in 2016, such as wage stabilization reducing labor costs, and a steep devaluation of the exchange rate encouraging exports. Castelar agreed that the external balance should improve but noted that as
productivity enhancement through tax and labor reforms, better education policies, and economic openness; and infrastructure, with more focused National Development Bank activities, better incentives to capital markets, and a more secure legal context. “The house did not fall,” Barros said. “Brazil has sound fundamentals—and enormous opportunities.”

Sounding a more negative note, Claudio Frischtak, president of InterB Consulting, emphasized, however, that there is no possibility of turning the economy around until the gridlock between Congress and the executive are resolved and the fiscal problem addressed: “Today we see very strong opposition by the population to raising taxes. Moreover, today Congress can reject tax increases, which were traditionally the government’s prerogative,” he said. “The risk we run if gridlock continues is that it will not only block our way out of the recession but throw the economy into an actual depression.”

Castelar shared his concern, noting that “IBRE projections point to a fall in domestic demand of 8% and a reduction in worker incomes of 8% in 2015–16, with industry contracting by more than 20% in the triennium of 2014–16. This means that the share of Brazilian manufacturing in GDP will be back to 1930s levels.” Castelar believes that, given the difficulties of making the fiscal adjustment that the situation demands, Brazil risks kicking the can down the road only to find out in the future the bitter fruits of current tolerance of fiscal disorder.