Great Expectations

Brazil's economic success has raised the bar for that country, at home and abroad

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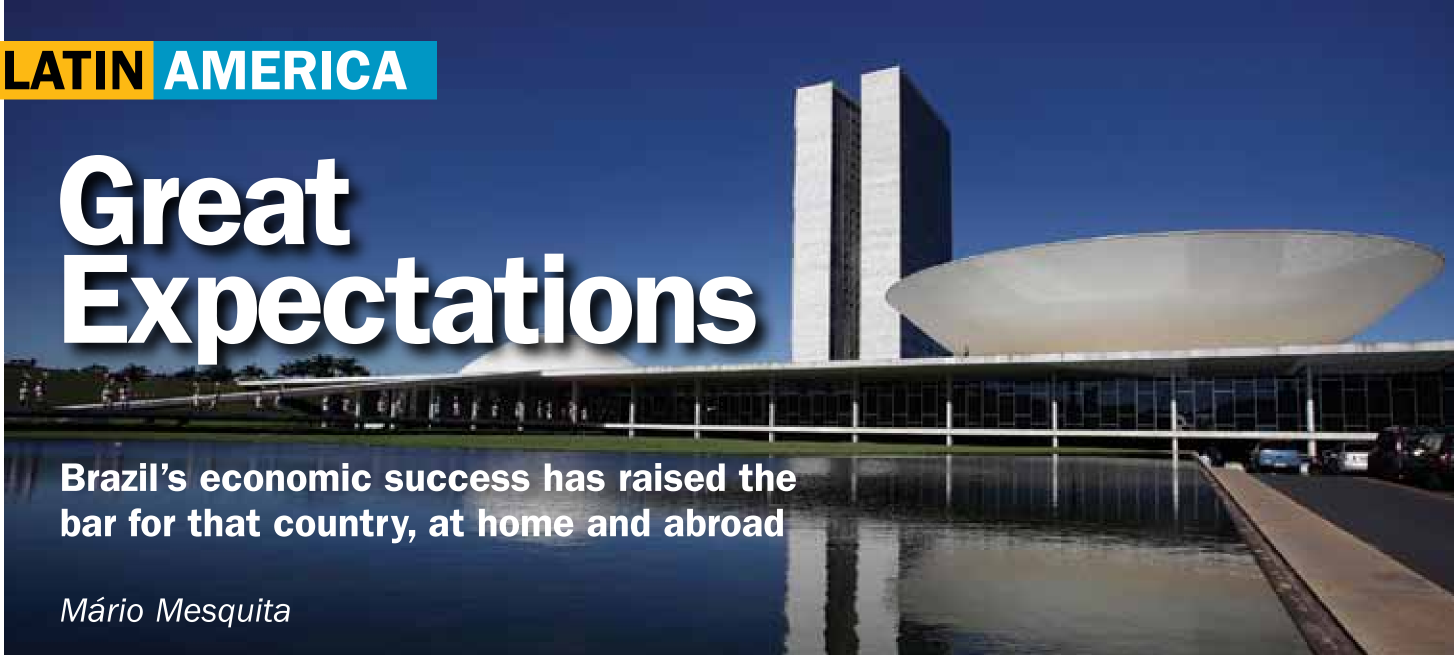

Brazilian National Congress in Brasilia, Brazil.

BRAZIL has been in the spotlight recently, with the rags-to-riches fame of its popular former president, Luiz Inácio Lula da Silva; its lead role as one of the emerging market darlings of the postcrisis economy; and winning bids to host the 2014 soccer World Cup and the 2016 Olympics in Rio de Janeiro.

Lula inherited solid macroeconomic policies from his predecessor Fernando Henrique Cardoso and managed to strengthen Brazil's economy despite a crisis of confidence in 2002 and the 2008 global crisis.

Brazil—one of the world's top ten economies, and the largest in Latin America—now governed by President Dilma Rousseff, has gained confidence and international influence, which could expand if it builds on recent success. But it must now act to increase economic growth and deliver on its potential. Better performance means increased expectations for the country from its citizens—including its newly expanded middle class—and outside observers.

Three pillars of stability

Success means focusing on the pillars of Brazil's macroeconomic policy: inflation targeting, a floating exchange rate, and maintenance of a primary fiscal surplus—that is, taking in more revenue than it spends, before interest payments.

Decades of runaway inflation were finally tamed by the implementation by then–finance minister Cardoso's currency reforms in 1994, followed by the introduction of inflation targeting (see "Ending Instability," in this issue of *F&D*) in 1999. Since 2005, consumer inflation has been within 2 percentage points of the government-set target of 4.5 percent. Brazil was one of the few emerging economies to maintain inflation roughly in line with its targets throughout the 2008–09 commodity price boom and bust. But it failed to take the opportunity offered by the generally disinflationary global environment in 2009 to lower its inflation target, and thus entrench lower inflation expectations.

Monetary policy has been successful, but fiscal performance has been mixed. Despite primary surpluses and a stable ratio of net government debt to gross domestic product (GDP) at a little over 40 percent, gross debt exceeds 65 percent of GDP. Expansion of spending has not been held in check: central government primary spending, before interest payments and revenues, rose by 23 percent of GDP between 2002 and 2010. Nor has the country lowered the overall tax burden, including on states and municipalities, which at 34.5 percent of GDP is very high by emerging market standards and deters private sector investment.

Moreover, government spending accelerated in 2009—an appropriately anticyclical response to the global crisis—but it continued to rise in 2010, when the Brazilian economy was already recovering, which contributed to economic overheating—as shown by higher inflation and a wider current account deficit.

Brazil's trade environment has benefited from rising demand for commodities from Asia—China is now Brazil's largest trading partner—which led Brazilian export prices to record highs. And the government has taken steps to turn this external boom's temporary positive shocks into lasting improvements.

One of the main achievements of the Lula administration was its prudent reaction to the opportunities of a positive economic environment. In January 2004 the central bank established a program—still in place—to increase external reserves from $48 billion to $300 billion. This was combined with the gradual retirement of domestic foreign exchange–linked debt. Such a policy entails costs—namely, the difference between interest on government debt and the financial returns on the reserves. But it also yields important and widespread benefits.

First, by increasing reserves and becoming a net creditor economy, Brazil was finally able to reach investment-grade status, which should help lower the costs of funding for both the public and private sector. Reserves exceeded external debt by $33 billion at the end of 2010. While the public sector bears the financial costs of carrying the reserves, the benefits will accrue to the whole economy.

Brazil has sizable net external liabilities, including portfolio and foreign direct investment inflows. Still, compared with early in the century, these liabilities are now mostly in the form of equity rather than debt, which means the interest paid on them correlates better with domestic economic conditions. This speeds up current account adjustment in moments of stress, as in late 2008 and early 2009.

By amassing large reserves, the public sector bet on its ability to shield Brazil from negative global developments. So when the crisis came along at the end of 2008 and the Brazilian currency—the real—depreciated, government finances enjoyed a windfall gain in the value of its external assets in domestic currency: the net debt-to-GDP ratio fell from 44 percent to 38.5 percent between May and December of that year. That, in turn, enabled the public sector to adopt expansionary policies in support of domestic demand. This contrasted with the cutbacks the government often had to make in the past when the economy was hit by negative external shocks.

The benefits of having safeguarded monetary stability in the run-up to the crisis on the one hand and having built a comfortable reserve buffer on the other paid off clearly in the aftermath of the collapse of investment firm Lehman Brothers. Brazil's economy rebounded rapidly, which mitigated the impact of the crisis on the labor market and kept inflation under control.

Moving ahead

The performance of Brazil's economy after the crisis highlights the challenges it still faces. As soon as it overcame the effects of the global recession, by late 2009 and early 2010, the economy began experiencing typical signs of overheating—similar to those just before the crisis hit in late 2008.

This overheating occurred because Brazil still does not save enough. Gross savings averaged 17 percent of GDP during 2005–09, low compared with the 24 percent seen in Chile and Mexico. As long as Brazil saves so little, increases in investment will weigh on domestic resources, leading to inflation pressures (which the central bank must counteract); increased use of external savings, through rising imports and the current account deficit; or both.

Despite its progress over the past decade, Brazil's economy has room for improvement. In particular, it appears the Brazilian economy's speed limit—how fast it can grow without inflation and/or external deficits increasing—is still considerably lower than in some of the more dynamic emerging economies, although it seems higher than a decade ago. Raising this speed limit should be the key economic policy challenge for the new Rousseff administration. A faster-growing economy would help the government achieve its stated primary goal of ending extreme poverty in Brazil—for instance, by creating conditions for increased investment in human capital.

After an initial burst of reforms during 2003–04, the Lula government seemed to lose its appetite for tackling issues like the social security deficit, which remains relatively high; the high cost of the civil service; and red tape, dubbed the "*custo Brasil*." Fiscal and structural policy did not improve as much as they could have, given the broadly favorable external conditions.

One important step for the new administration will be reforms to increase the saving rate and impose better discipline on fiscal spending.

Private sector saving could also be encouraged by increased rewards for deferring consumption, with tax breaks for longer-dated investments and by linking interest rates on savings accounts—a popular investment vehicle—to the policy interest rate set by the central bank.

Doing so would strengthen the effectiveness of monetary policy and could help the central bank achieve its inflation target with lower interest rates. Brazil has long had quite high interest rates by international standards: they dropped into the single digits only briefly during a rare recession period in 2009. High interest rates, very favorable terms of trade, and relatively good growth prospects have attracted substantial capital inflows, which account for the relative strength of the real. But its increased value clouds the outlook for less competitive segments of the manufacturing sector.

There is little the Brazilian government can or should do about its terms of trade or relative attractiveness to foreign investors, but it can help bring domestic interest rates in line with global standards. It should start by strengthening fiscal policy, protecting fiscal responsibility, and improving transparency, while also tackling social security reform—the overall deficit remains close to 4 percent of GDP, despite still-favorable demographics, two-thirds of which stems from the public sector—as well as increasing spending flexibility, including on personnel. Ultimately Brazil should follow Chile's example of cyclically neutral fiscal targets (tighter when growth is strong, easier when it slows).

Brazil also must make changes in its monetary policy institutions. Its high inflation target sets an elevated benchmark for nominal and real interest rates and fosters indexation. Moreover, the central bank lacks legal autonomy, which means that, albeit less than in the past, short-term inflation shocks tend to have more pronounced and persistent effects than in countries where the monetary authorities' ability to defend price stability is not repeatedly in question. Brazil also must reduce the high level of subsidized credit—about a third—in areas as diverse as agriculture, housing, and manufacturing investment. Subsidized credit undermines the effectiveness of conventional monetary policy.

On the external front, robust reserves and a floating exchange rate should allow Brazil to integrate more fully into the global economy, reducing its high import tariffs and increasing openness.

The Cardoso and Lula administrations managed to steady the economy. The next step is to increase potential growth and close the gap between Brazil and faster-growing economies with similar middle-income levels. Meeting that challenge will hinge on strengthening the pillars of macroeconomic policy and designing and implementing an ambitious reform agenda—something that is always easier to do at the beginning of a presidential term.

If Brazil can do this, it will stand a better chance of achieving its economic potential as well as meeting its global aspirations. ■

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