BRAZIL: Risks and Opportunities of the International Crisis

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Anti-cyclic fiscal policy should be conducted via targets for the structural primary surplus.

Brazil has improved its relative position in the global economic ranking amidst the international financial crisis, initiated in 2007, in the USA, and that goes on until today, with its epicenter now in Europe. The unusual 7.5% yearly growth rate in 2010, boosted by electorally motivated policies, also contributed to boost Brazilian reputation as a high growth country. But it provided grounds to the illusion that, despite the global crisis, the country would be able to grow quicker and in a more sustained fashion.

The strong economic growth deceleration Brazil has been facing in the last few months, which, in some measure, also strikes other emerging countries, has demonstrated that the global crisis' effects are much more serious than the government has assumed. Predicting how the crisis will unfold is not an easy task. But this only makes it even more important that economic policies try to minimize the risks to which the Brazilian economy is exposed to, as well as to maximize the opportunities created by the crisis. Unfortunately, most of the economic measures recently implemented do not seem to have been conceived with such goals in mind.

The government has emphasized the opportunity created by the crisis to lower interest rates, both the basic rate, Selic, as well as the banking spread. To obtain "civilized" interest rates is, undoubtedly, a great step, since it stimulates economic growth, improves income distribution and enables the creation and growth of small companies, among other benefits. The risk is that the reduced real interest rate, today between 2% and 3%, although very desirable, is not able to keep inflation on target.

The reduction of the Selic rate, from 12.5% to 8%, in the last 11 months, benefited from the deflationary environment generated by the global economy. There are two main threats to Brazil's Central Bank's capacity to pursue the reduction of the Selic, or even to maintain its current level, without putting the inflation target at risk. The first threat comes from negative supply shocks. The current rise in food prices, caused by the drought in the USA, is an example of such risk. Much more serious inflationary effects would be created by a possible military conflict in Iran, which would generate a huge rise in oil prices. Even if, in these scenarios, the rise in inflation is not coming from the demand side, monetary policy should prevent the supply shocks' second round inflationary effects.

The second threat would occur, paradoxically, with the gradual return of the global economy to normality. With the economic growth being restored to the developed countries, a true test to the reduction of the neutral interest rate will take place. Today, in spite of the favorable rooting, including mine, we cannot be sure if the

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feasibility of the reduction of the interest rate is merely circumstantial, due to the deflationary environment stemming from the crisis, or structural, solidly based on a fall of the real neutral interest rate.

But the major mistake in the government's economic policy consists in the misconceived and inefficient use of the fiscal policy. There are two main issues. The first, structural, is in the government's proven inability to take public investments forward. Year after year, despite renewed priorities, public investments shrink, whereas current expenses overflow. There does not seem to be a short term solution for the problem, aggravated by the government's ideological prejudice towards less statist solutions and by the protection of unjustified privileges of its support groups, both corporate and union-based.

The second issue is that the government insists in not taking advantage of a great opportunity created by the crisis. Today, Brazil enjoys a good reputation in global financial markets, which makes the country much less vulnerable to the sudden stops that may be generated by capital flights. This provides the opportunity to make use of anti-cyclical fiscal policy to combat the economic downturn. However, the correct way to do so would be by means of the introduction of a target for the structural surplus, adjusted by the economic cycle: in bad years, as the current one, the surplus target is reduced; in good ones, the target is raised. Many countries, such as Chile, adopt such measure, with great success. The introduction of a target for structural surplus would allow fiscal expansion measures not to create fears that the solvency of the public sector could be compromised. It would avoid, additionally, the rise of recurring expenses, under the excuse of fighting the crisis. Only temporary spending, especially investments, would be accepted.

Given that the Finance Minister himself has made statements in the past in favor of such measure, it is hard to explain why it is not yet considered. Alongside the forgotten reforms (in pensions, taxes and labor) and economic modernization measures, it has been one more missed opportunity that compromises the growth of the Brazilian economy.