# Brazil : Coping With a Double Whammy

## Ifri-OCP Policy Center Roundtables – SESSION II

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### Key messages

● A fiscal adjustment program is being implemented in tandem with a double realignment of relative prices: regulated vis-à-vis free prices and domestic vis-à-vis international prices (real exchange rate).

● A corruption scandal around procurement of the state-controlled oil company (Petrobras) has underwhelmed some major national companies, leading to a downscaling of private and public investment outlays.

● GDP is expected to contract by more than 1% in 2015 and current 12-month inflation rates – close to 9% – are forecast to slowly converge toward the target center (4.5%) along 2016-2017.

● Prospects of a future economic recovery stem from private-sector confidence boosting and a

## Introduction

Brazil's economy is currently undergoing the effects of a double whammy. On the macroeconomic policy front, fiscal adjustment is being implemented in tandem with a double realignment of relative prices: regulated vis-à-vis free prices and domestic vis-à-vis international prices (real exchange rate). On the microeconomic side, a corruption scandal around procurement of the state-controlled oil company (Petrobras) has underwhelmed some major national companies, leading to a downscaling of private and public investment outlays. GDP is expected to contract by more than 1% in 2015 and current 12-month inflation rates – close to 9% – are forecast to slowly converge toward the target center (4.5%) along 2016-17. Prospects of a future economic recovery stem from a three-pronged growth agenda outlined by the government.

## Macroeconomic policy is under repair

Brazil's current macroeconomic policy may be seen as a pursuit to restore preconditions for economic growth by unwinding the second post-2008 round of counter-cyclical policies adopted in 2012-14. Brazil's GDP performance turned lackluster after rebounding in 2010 and the government attempted to re-spark growth by implementing expansionary fiscal policy – including quasi-fiscal measures of boosting credit via state-controlled banks by way of Treasury contributions. At the same time, regulated prices – energy, oil derivatives, and public transportation – were readjusted behind inflation as an attempt to halt the latter and thereby lead the Central Bank to keep low real interest rates. Nevertheless, neither inflation rates nor private-sector investments responded favorably, and fiscal deterioration was the major outcome.

2015 started with the announcement of a multi-year fiscal adjustment program, aiming at moving the public-sector primary balance as a share of GDP from -0.6% last year to 1.2% in 2015 and 2% in 2016. Domestic regulated prices have also undergone a substantial upward realignment relative to free prices.

Additionally, a second price-correction process – between domestic and international

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three-pronged growth agenda outlined by the government.

prices of goods and services – started to take place as the local currency devalued in real terms. Brazil's central bank has announced the gradual phasing out of its massive foreign-exchange swap program in place since the "taper tantrum". While such a program succeeded as a stabilizing device since the mid-2013 turbulence, its maintenance has also had the indirect effect of mitigating pressures toward exchange rate devaluation by keeping foreign-exchange hedging at cheap prices.

Inflation rates went up to levels close to 9% p.a., reflecting shocks derived from that double price correction, but the propagation of these shocks is expected to have abated as a result of interest rate hikes by the Brazilian central bank. On the fiscal front, despite concerns with shrinking tax revenues as a consequence of an economic slowdown deeper than initially forecast, fiscal measures so far announced by the government have been reckoned as substantive enough to move primary balances to positive ranges.

## Institutions up, microeconomics in disarray: two sides of a corruption scandal

The year has also been marked by the unfolding of the investigation of a suspected scheme of rigging – including collusion among suppliers and over-pricing – in Petrobras' operations with private-sector firms. Such scandal brought immediate negative financial and operational impacts on the set of large corporates involved. This has had implications far beyond the oil production chain, which itself was expected to comprise at least 10% of all investments in the Brazilian economy in the near future.

Given the systemic relevance of the scandal-ridden corporates to the Brazilian economy – including their large participation in public concessions and other contracts with the public sector – both public- and private-sector investment outlays have come close to a halt. While on the one hand a benign functioning of key national institutions has been a remarkable feature of the process – boding well in terms of higher private-sector competition and improved cost-effectiveness in the future of the Brazilian economy – on the other short-term recessionary effects have been at play. Uncertainty about process outcomes and resulting market structures has also led to a wait-and-see attitude by other investors. This has been deemed as a major factor behind the ongoing above-expected GDP deceleration.

## A three-pronged growth agenda is getting shape

As the main components of the macroeconomic adjustment have been put in place, the government has increasingly announced paths along which it expects to foster productivity increases and growth recovery in the Brazilian economy. First, a fine-tuning of the framework for public-private partnerships in infrastructure is expected to lift the private-sector financial and operational engagement. Much beyond demand-pull effects of such investments, they would give a positive contribution to total factor productivity by mitigating infrastructure binding constraints.

Second, improving the business environment – i.e. transaction costs in the country – is expected from, among others, a possible simplification/harmonization of existing value-added taxes, a component of Brazil's doing-business environment often singled out as a major source of waste of resources. By the same token, a recently announced "national plan for exports" has included measures of "trade facilitation".

Third, as recently mentioned by Joaquim Levy, Brazil's finance minister, the cost-effectiveness of government spending – as gauged by targets and results – is to undergo a thorough process of evaluation.

## Bottom line

Higher inflation and a shrinking GDP in 2015 can be seen as temporary features of an ongoing Brazilian macro- and micro-economic adjustment. Recovery may be expected from 2016 onwards as private-sector confidence is boosted and the growth agenda becomes full-fledged. The effects of real exchange rate devaluation on exports shall help.