



Brazil's Economic Malaise Rekindled as Olympic Flame Goes Out

Monica de Bolle outlines the tough economic challenges facing Brazilian acting President Michel Temer now that the Olympic games are finished and Dilma Rousseff's long-anticipated impeachment is official.

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Pedro da Costa: Hi. I'm Pedro da Costa, Editorial Fellow here at the Peterson Institute for International Economics. I'm joined by Monica de Bolle to talk about the post-Olympic outlook for the Brazilian economy. Now, of course, the latest development is that the impeachment of ex-President Dilma Rousseff is now official. And interim President Michel Temer becomes the de facto President. What are the challenges do you think that are going to be facing him most immediately?

Monica de Bolle: Well, I think he faces some major challenges going forward. And these are likely to be—well, of course, all of them political in nature. There was this kind of interpretation going on down in Brazil especially by markets and local investors that the period in which he was a temporary president, let's say, running up to this trial process that that was really the most difficult period that that was really when he had to legitimize himself and establish himself and all of that.

But really what we saw was at those months in which he was the de facto but not the de jure President were actually kind of a honeymoon period for him. I mean markets rallied on the expectation, yes, that the final removal of Dilma Rousseff would happen. His new economic team and his economic proposals were received with a great sigh of relief. Everybody was looking towards perhaps a recovery next year. Things seem to be going quite well for him actually.

Pedro da Costa: Yeah. And then it culminates with an Olympics that went fairly well and then there's national sentiment.

Monica de Bolle: And then it culminates exactly—exactly with an Olympics that went well despite all the things that we saw, all the negative press that it got beforehand. But now I think we're moving. I think there's a disconnect here because we're moving now into a completely different phase. So we have to forget everything that happened prior to impeachment and really think about what this scenario is.

Pedro da Costa: So the fact when he becomes the de facto President the uncertainty had actually increased rather than decreased.

Monica de Bolle: In many ways I think so because now he's going to face the real pressures that exist within Brazil's political system. And it's by no means established that he has the backing and the support of his current base, his current allies. It's by no means established that it will be kind of a slam dunk to get these reforms passed through Congress. By the way, these reforms are very unpopular as we've talked here before. We're talking about social security reform and the significant reduction of pensions and other benefits, as well as the raising of the retirement age in Brazil.

We're also talking about the creation of an expenditure ceiling, which would necessarily involve big cutbacks and also benefits, but spending and health and education and things—

Pedro da Costa: And all of this is aimed to fight—if I could interrupt you. All of this is aimed at reining in the budget deficit that was seen as kind of having run out of control under the Dilma Administration.

Monica de Bolle: Exactly. All of this is aimed at really addressing the structural fiscal problems that Brazil has, which if they're not addressed will mean ongoing deficits over the next several years and, hence, an ever-increasing debt-to-GDP ratio. The debt-to-GDP ratio in Brazil currently is close to 70 percent. It doesn't sound huge, but it can blow up very fast if these measures and these reforms are not passed or if they are significantly diluted.

And here is where the new Temer Administration is going to meet its first challenge because it's going into a scenario where the political crisis hasn't really been resolved. You still have a lot of issues outstanding with respect to corruption and politicians and everything else. Temer is now the guy who's going to be facing all of these pressures directly as President. And hence, he's the one who's going to have to find a way to deal with all of these things.

And it's kind of inevitable that given the unpopularity of these reforms, given the fact that he only has two years to implement them, given the fact that the Brazilian population isn't exactly aware of how they're going to be hurt by these reforms, there's going to be a backlash. And some of this backlash might actually mean that even if some of these reforms get passed in Congress, they'll be significantly diluted. And hence, we're looking at a scenario where best case you get some reforms passed, but they're diluted and they don't do much for your medium term fiscal sustainability.

Pedro da Costa: And does that mean—do you think then that markets have gotten ahead of themselves a little bit in terms of these 70 billion over Brazil? I was actually shocked to see the statistic that the market was up like 60 percent so far this year and at the same time that we're in pretty much the worst recession in the country's modern history. So how does that disconnect get resolved? Does the economy suddenly boom or do the markets come back down to earth?

Monica de Bolle: I think you're going to have a bit of both happening. So the economy is not going to boom. But the economy is likely to improve at least. I think that's the most realistic expectation given how far it's fallen in particular. On the other hand, you will see some sort of backtracking from that overly optimistic feel. And I think that overly optimistic perception had a lot to do with the kind of structural break that this impeachment process represent, right?

Because, before, you had a government that really was going nowhere very fast. And now, you have possibly a government that at least knows what its priorities are. The question is whether or not it can go ahead and implement that agenda. But it has some specific priorities. And it's consensual that these are the things that the country needs.

So you've had a very significant structural break in going from one government to the other. And I think this explains a lot of the optimism that we've seen. The problem is that when people get too optimistic they always forget that at the end of the day and especially

in Brazil these days it's the politics that's going to determine what the economic outcome actually is because the problem is fiscal.

So it's not as if you can deal with this situation outside of the political process. You really can't. The only leg of this that can actually be done outside of the political process it's also a reform effort. It's something that the government hasn't been playing up too much but can actually bring. It can actually make the recovery a little a quicker is if the government really does come up with a good privatization plan. They've been talking about privatization. They've said that they will announce something on September 12th. So this is something—

Pedro da Costa: And what are the sectors that are most right for it?

Monica de Bolle: These would be infrastructure-related sectors ranging in a number of different areas including utilities, logistics, transportation, all sorts of things. So if they can design something that actually attracts investor interest, then you might kind of get this optimism that will recede, may not recede too much. It will recede, but it may not recede as much because you will have something positive to offer and something that can actually result in some recovery rather soon.

But it's all very shaky. Everything is on very shaky ground. And I think this is what makes people like us a little bit skeptical about this optimism being really based on solid, solid fundamentals.

Pedro da Costa: Sure. And one question about something else outside of fiscal policy which is Central Bank room for action. Now, Brazil has one of the highest both nominal and real interest rates in the world. And I know you've been a little bit critical of the Brazilian Central Bank for not moving quickly enough. And they are afraid because there's a history of high inflation and inflation hasn't come down that much. But talk about what they might be able to do to at least help the recovery along.

Monica de Bolle: Well, right, now real interest rates in Brazil so that's interest rates minus inflation expectations. So say inflation expectations 12 months forward, real interest rates by that measure have actually been rising even if nominal interest rates haven't done anything. They've been kept on hold now for several months even under the new Central Bank that's there.

Pedro da Costa: So they're allowing a passive policy tightening by not cutting.

Monica de Bolle: That's exactly what they're doing. Now, then there's a question of is that the most wise course of action at this point in time when you've already had two years of a very severe recession, when unemployment keeps climbing. We now have almost 12 million Brazilians who have lost their jobs. The unemployment rate is now at 11.6 percent. At the same time last year, it was about 3 percentage points lower. So it's a massive increase in the unemployment rate.

So you kind of ask yourself. Do you really want a passive monetary tightening at this stage? And, yes, the problem in Brazil is the whole issue is fiscal. But then, again, doesn't that say something about what the Central Bank should be doing? Shouldn't the Central Bank perhaps be having a more active role in all of this and perhaps lowering interest rates

a bit and hence allowing a little bit of room for the government? Because the government obviously has a very high interest bill to pay, allowing some room for households, which are highly indebted and are paying huge interest bills as well and companies.

I mean one of the things that we've seen in Brazil and has been very stark is that companies because they're highly indebted they have been in a sense paying down their debt obligations in lieu of paying taxes. So the fiscal issue has a lot to do with this debt issue. And unless you resolve this this kind of mess, you won't really get a lot of improvement on the fiscal side either because you won't be able to boost revenues.

Companies are not paying their taxes because they're preferring to keep current on their debt obligations. So if you lower that cost perhaps you might get some tax revenue back, which the central government desperately needs.

Monica de Bolle: Absolutely. Thank you so much, Monica. I appreciate it.

Monica de Bolle: Thank you.

