Comments on the paper “The Fiscal and Monetary History of Brazil” by M. Garcia and others

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Main messages of the paper

- The paper traces the main causes of Brazil’s persistently high rates of inflation from the mid-1900s until the adoption of the Plano Real, in particular:
  - A weak institutional framework for monetary policy, resulting in sustained monetary accommodation and low real interest rates
  - High fiscal deficits; and
  - Significant resort to indexation

- It then discusses how the Plano Real tried to address these weaknesses, breaking the inflation inertia and ushering in a prolonged period of relatively low inflation

- I broadly agree with much of the analysis, therefore will concentrate my comments on a few points, in which I have some differences with it, in particular on the role of fiscal policy since the Plano Real
I my view, the Plano Real did indeed represent a major turning point in the conduct of macroeconomic policies in Brazil, but its implementation fell short of optimal in a number of respects.

The years between its adoption and the end of the century (1995-98) witnessed:
- A significant real appreciation of the exchange rate and related weakening of the external accounts.
- A progressive easing of monetary policy; and most importantly,
- Inadequate fiscal adjustment.

The public finances deteriorated significantly during that period, as the real growth of spending, no longer eroded by high inflation, significantly outpaced that of revenues.

The primary balance of the consolidated public sector moved into deficit. The overall deficit narrowed initially, reflecting a sharp decline in nominal interest rates, but worsened subsequently, and the public debt rose by nearly 10 percentage points of GDP.
The adjustment program of 1998-99

The substantial weakening of Brazil’s external accounts, in an international context marked by the Asian and Russian crises, ultimately forced the adoption in early 1999 of a strong adjustment program, supported by large external IMF and bilateral official financing.

The program included:

- the floating of the Real
- a substantial tightening of monetary policy and the adoption of inflation targeting; and
- a range of revenue-raising and public expenditure-containment measures

As a result, the primary balance moved into a significant surplus (around 3 percent of GDP), the nominal deficit was substantially reduced, and the growth of the public debt decelerated

Further, the institutional fiscal architecture was strengthened by the adoption in 2000 of the Fiscal Responsibility Law
Poor quality and sustainability of the fiscal adjustment

- While the fiscal adjustment was substantial and ushered in a prolonged period of significant primary surpluses, it remained inadequate in terms of quality and sustainability.

- It relied mainly on increases in revenue, partly reflecting the adoption of distortive taxes, like a financial transactions tax, and partly cyclical factors, related to the commodity price boom of the first half of the 2000s.

- Spending continued to rise, reflecting increases in public employment and wages, and especially the growth of entitlement programs, as a result of the failure to adopt needed pension reforms, and of continued rigidities in other current expenditures, such as education and health.
A prolonged further fiscal deterioration from 2008 onwards

- The fiscal position started to deteriorate steadily in the aftermath of the global financial crisis, reflecting first strong stimulus measures and then a continued expansionary stance, even as the economy quickly recovered from the crisis.

- Between 2008 and 2016, the public sector's primary balance went from a surplus of 3.3 percent of GDP to a deficit of 2.5 percent of GDP, and the public debt rose to 75 percent of GDP, well above the average for emerging market countries.

- Furthermore, the deterioration during that period was partly masked by accounting stratagems and one-off operations of various sorts, including the use for quasi-fiscal purposes of financial and non-financial SOEs not included in the fiscal statistics.
The costs of inadequate fiscal adjustment

- It necessitated the maintenance of high real interest rates and repeated tightening of credit conditions, with adverse impact on domestic demand

- It contributed to bouts of exchange rate overvaluation, adversely affecting export performance

- It weakened domestic and external confidence, contributing to a poor performance of private investments.

- Tax-induced distortions also affected investments and growth adversely

- The failure to curb the growth of current spending led to a compression of public investments and a further deterioration of already inadequate infrastructures, with adverse effects on productivity, and on access to and the quality of public services
Prospects for a quality fiscal adjustment remain dim

- The roots of Brazil’s fiscal malaise are deep and extensive, and reflect distributive conflicts that the current political context appears unable to resolve.

- Unfortunately, it is far from clear whether the next election will generate sufficient political consensus to put in place the policies and reforms needed to ensure a quality and sustained fiscal adjustment.

- In the absence of such adjustment, monetary policy will need to be tightened again, preventing a sustainable recovery of growth, and further deteriorating the public debt dynamics.

- Ultimately, it may prove impossible to avoid returning to the inflation tax and to financial repression as tools of fiscal adjustment.
Thank you!