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Brazil Prepares for Austerity Under New Finance Minister

by Gregory Scruggs
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As the Brazilian economy slides toward recession, the country prepares for fiscal adjustments that will entail an austerity policy. Finance Minister Joaquim Levy, appointed by President Dilma Rousseff as part of a campaign promise, has announced several areas of public spending that will be targeted by cuts. Unemployment benefits, loans to state governments, and tax breaks to businesses are all on the table. However, the Bolsa Família, a conditional cash-transfer program that is the signature policy of Rousseff’s ruling Partido dos Trabalhadores (PT), will not be touched at present.

Levy’s announcements in January and early February come as unemployment is on the rise and economic growth has stalled since the recent boom in 2010-2011. Brazil is now the slowest performer out of the four major emerging markets that include Russia, India, and China (collectively, the BRIC countries). His proposed fiscal adjustments have been well-received by the international investment community as well as business leaders and economists in Brazil.

While some of the proposed austerity measures will require congressional approval, Rousseff has indicated that she has full faith in Levy and will support his market-oriented reforms despite her political leanings, which traditionally veer toward intervention in the economy. Labor groups are particularly concerned about the changes to unemployment benefits and consider the move, during a traditional labor holiday, a slap in the face that will further poison relations with the federal government, which blossomed under Rousseff’s predecessor, President Luiz Inácio Lula da Silva (2003-2011), himself a former metallurgist.

Bleak economic outlook for 2015 provides impetus for fiscal adjustment

During the 2014 presidential campaign, the country’s economy achieved top billing in debates as Brazil’s macroeconomic indicators became increasingly alarming (NotiSur, Nov. 7, 2014). January estimates suggest that this year’s inflation rate will reach 6.99%, above the government’s target rate of 4.5%. Median economic growth is forecast at a miniscule 0.13%, just five years after the Brazilian economy grew 7.5% in 2010. A fall in prices for commodities including soy, oil, and iron ore have greatly impacted the economy, which has been reliant on those exports. In turn, consumer confidence has dropped and the surging consumption of the new middle class has been sharply curtailed. The Fundação Getúlio Vargas (FGV) confidence index fell to its lowest measure since the institute began collecting data in 2005. Brazil entered a technical recession—two consecutive quarters of negative growth—last year but returned to positive growth in the final quarter of 2014. However, the specter of re-entering recession in the first half of this year remains a threat.

Guido Mantega, who served as finance minister during Rousseff’s first administration, cut interest rates and embarked on higher public spending. He became known internationally for accusing foreign central banks, such as the US Federal Reserve, of waging currency wars. Domestically, his interventionist approach did not sit well with business leaders and resulted in continued economic decline. Consequently, Rousseff pledged that Mantega, who served for ten years between her and Lula’s administrations, would not continue during her second term.
In her selection of Levy, the president strongly indicated a change in economic policy. Levy trained at the University of Chicago, whose Chicago school of economic theory emphasizes supply-side free-market policy solutions. In a document published on Feb. 11, Levy defended his policies to a skeptical public. "One of the pillars of a functioning economy is fiscal equilibrium, with disciplined public spending and a commitment to meet established goals, to ensure that public debt heads in the right direction," he wrote. Levy went on to claim that fiscal stability will grow credit, augment domestic savings, and create jobs.

**Levy’s austerity moves appeal to global investment and finance community**

In a marked contrast to Mantega’s testy relationship with fellow finance ministers and institutions like the World Bank and International Monetary Fund (IMF), Levy has already endeared himself to the global economic elite with his austerity policies. In late January, he outlined his fiscal-adjustment plan at the World Economic Forum in Davos, Switzerland. Speaking to the Financial Times, he said, "We always have to be mindful of our credit rating." Brazil’s investment-grade credit rating was at risk in 2014 but has stabilized, with Levy publicly aiming for an A rating. To get there, he has stated a goal of cutting R$60 billion (US$21.2 billion) from the federal budget to reduce the deficit to 1.2% of GDP.

The first measures went into effect shortly after the election in October with changes to the rules for federal unemployment benefits. Under the new rules, workers must be able to prove 18 consecutive months of employment within a two-year period to qualify. The Ministério do Trabalho e Emprego (MTE) predicts that 26% of current unemployment insurance recipients, or 2.2 million people, will lose their benefit. With the unemployment rate nearing 6%, such a move may prove one of the most politically challenging of his austerity package. This measure is expected to cut down on fraud and save R$16 billion (US$5.65 billion).

Temporary tax breaks established under Mantega will expire, with four tax hikes slated to bring in R$20.6 billion (US$7.9 billion). The gasoline tax will increase by R$0.22 (US$0.07) per liter, which could bring in another R$14.07 billion (US$4.97 billion) to federal coffers. Finally, foreign transactions, such as credit card purchases for goods acquired abroad, will incur a 3% tax rather than the current 1.5%.

Former Central Bank chief Arminio Fraga praised Levy’s moves, calling him an "island in a sea of mediocrity" in a January interview with Estado de São Paulo that was highly critical of Rousseff’s leadership. Now founder and chief investment officer of Gávea Investimentos, Fraga represents an opinion widely shared by the economic elite that tepidly endorsed the leftist economic policies of Lula during the country’s economic growth spurt but have soured on the PT’s fiscal approach in recent years.

**Economists generally supportive while labor protesting**

Even as economists argue that austerity policies are necessary, they are generally a bitter pill to swallow for the general public, with Europe’s recent experience leading to widespread social unrest. A similar debate has begun to play out in Brazil, although it is too early to tell if the proposed fiscal adjustment will lead to widespread protests like the ones that swept the country in June 2013.

Mauro Rochlin, an FGV economist, reflects the view that Levy’s proposals are a necessary medicine. "It’s fundamental that the government’s accounts be balanced," he said. "To the extent that fiscal policy will be contractionist, austerity-driven, this tends to contain demand, and in the context of
high inflation, it’s a positive measure. More than a measure, it’s a necessary strategy." Given the generally accepted failure of Mantega’s economic policies, the widespread view among Brazilian economists favors Levy’s tactics.

However, Levy’s approach has its discontents, albeit a minority opinion. Luiz Gonzaga Belluzzo, an economist and editorial consultant at Carta Capital, told a reporter in late December, "They [Rousseff’s administration] think we should adopt the policies implemented in Europe that didn’t work—but here, they’ll work. Are we on Mars?"

While economists debate the matter, labor groups are already feeling the pinch of changes to the unemployment benefit. Ricardo Patah, president of the União Geral dos Trabalhadores, called the provision "a punch in the back." It came on the heels of more than 1,000 layoffs at automobile manufacturers in São Bernardo do Campo, the industrial heartland of São Paulo state where Lula first gained power as a union organizer. Since Lula rose to the presidency in 2002, the federal government maintained a regular consultation with the labor group, a practice that has diminished under Rousseff. With the most recent move, that relationship has further withered.

"After winning the election, the president and her chief of staff Aloizio Mercadante received us very well and agreed to call the leadership again if anything happened. The surprise came on Dec. 29, when the chief of staff called us, not to discuss or to listen but to announce the package [of changes]. It doesn’t make any sense," Patah said.

On Feb. 10, several labor groups converged on the Senate chambers in Brasília to protest the changes to unemployment insurance. They chanted, "Oh, Dilma, pay attention, either you revoke the measures or we stop the country!" As of yet, the issue has not attracted wider public support although the return of fare increases on public buses, the issue that sparked the 2013 unrest, has yielded scattered protests in cities throughout Brazil. Public attention is currently distracted by Carnival, which concludes on Ash Wednesday, Feb. 18, but the full social and political impact of Brazil’s new austerity measures will be a hot button issue throughout 2015.

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