Brazil: Monetary and Fiscal Policy Suggestions

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State of the Brazilian Economy

The Central Bank of Brazil

In 1964, in an attempt to stabilize the economy, the federal government passed the Banking Law, which created the National Monetary Council and the Central Bank of Brazil (Banco Central do Brasil). The National Monetary Council issues policy decisions, and the Central Bank of Brazil enacts those changes. This framework aims to provide economic growth, low unemployment, and low inflation. Specifically, the Central Bank is an inflation-targeting regime. In the aftermath of the recession in 2015 and 2016 these objectives have proven out of reach for the Central Bank However, the failure to meet these goals is not due to policy decisions of the Monetary Council or the Central Bank. Rather, in the years after the recession intelligent policy was implemented, but remained ineffective primarily due to other structural aspects of the economy.

Brazil's inflation has reached stable levels in recent years. In 2015, inflation ballooned to 9.03 percent, and in 2016, inflation rested at 8.74 percent. However, since 2017, Brazil's inflation has consistently been below 4 percent (Plecher 2019). More recently, Brazil's inflation rate is sitting at 2.89 percent, the lowest mark in over a year. Currently, the inflation rate target is 4.25 percent for the end of 2019 and 4 percent for 2020, but Brazil has been undershooting its inflation targets consistently for the past few months (McGeever 2019). This low inflation rate offers flexibility for the central bank to lower the Selic rate even more. With an adjustable Selic rate, the Central Bank will, in theory, be able to use expansionary monetary policy to target the weak output of the Brazilian economy. However, the recovery effects are not yet felt, as high unemployment coupled with issues stemming from the current lack of pension reform is keeping economic output low.

The Central Bank also employs reserve requirements as a way to target monetary policy deficiencies (Reuters 2019). Currently, the credit market fails to provide robust economic activity. The Brazilian Central Bank, even though it is primarily an inflation-targeting regime, can target these deficiencies. In fact, the Central Bank has been lowering its reserve requirements in an attempt to free up liquidity and instigate banks to offer more credit to borrowers. In March of 2018, the Central Bank reduced reserve requirements on demand deposits by 15 percent, from 40 percent (Malinowki 2018). More recently, the Central Bank reduced reserve requirements from 33 percent to 31 percent (Reuters). While this shift was relatively small, the Central Bank expects that this reduction will eventually translate into 16.1 billion reais, the equivalent of 4.19 billion US dollars of new liquidity. The Central Bank currently estimates that continuing to reduce reserve requirements in a similar manner will lead to 100 billion reais being introduced into the economy (Reuters 2019). These changes will take time to implement, but at the current pace, creditors are likely to increase their investments, even as the interest rates lower. This change will not overhaul the broken commercial credit system, but the Central Bank remains hopeful that this will lead to increased investment within the country. Additionally, the Central Bank employs the reserve requirements to strengthen the value of the real, most recently by selling dollars from their reserves for the first time in ten years (Itaú).

The economic effects of these stable and well-advised decisions have not been felt by Brazilian consumers. Rather, tension continues to mount in the economy, as the unemployment rate has increased over four percent since the recession in 2016. The unstable economy calls into question the safety of the bank members, as an easy excuse for president Bolsonaro would be the primary enactor of monetary policy. However, Bolsonaro and many others throughout the central government have advocated for the Central Bank and have gone as far as calling for drastically increased central bank independence (Malinowki 2018). The suggested changes include higher job security for the Central Bank bankers and terms that do not coincide with the presidential terms. Another positive aspect of these changes would be greater transparency, leading to a more well-informed population. All of these policies serve to demonstrate faith in the Brazilian Central Bank, and confirm a commitment to preserve its independence during future administrations.

Labor Market Conditions

Brazilian workers are paying the price of the sluggish economy. Unemployment has almost doubled in the past seven years - from 7.6 million in 2012 to 13.4 million in 2019 (BBC news). The official unemployment survey found that 28.3 million workers (25%) were under-utlized, that is, they either were not working or were working less than they could. 12.7% of the population of Brazil over 14 years of age is unemployed, which is much higher than 6.5% in December, 2013. The unemployment rate has remained stable over the past year, as shown in the figure below (Trading Economics).

It is important to note here is that while about one-fifth of the labor force works in agriculture, it is not agriculture that has brought down the employment numbers - unemployment in agriculture has remained stable since 2014, slightly above 10 million, after the massive decline in 2011-12 (Moody's). It is clear that there is a need for stimulation in the Brazilian labor market, especially in the non-agricultural sectors.

There is some indication that Brazil is already working towards fixing its labor market issues. In September 2019, Brazil added 157,210 jobs, which was an increase from 121,390 in August (Trading Economics 2019). September was the sixth consecutive month of job creation. Further, most of these jobs were added in non-agricultural sectors, with the biggest increases in services, manufacturing, trade, and civil construction. Another positive is the recent increases in labor force participation (see chart below). With the average retirement age of 52, these low participation rates are not as surprising, but with new reforms in place, the upward trend in labor force participation is expected to continue.

Along with the increase in labor force participation, real wages have been increasing since mid-2016 (shown below). Wages increased from 2299 BRL/mo to 2317 BRL/mo from September to October alone this year. While this is not significantly higher than the record low (in the last 10 years) wage of 2178 BRL/mo in 2012, the recent upward trend is a positive. Both low-skilled and high-skilled workers saw wage increases, even though the increase was greater for high-skilled workers (Trading Economics). These increases have persisted even though labor force productivity has not seen major trend changes and has remained largely stable with decreasing volatility over time. Wages in manufacturing, though, have been on the decline, going from 2351 BRL/mo in February to 2282 BRL/mo in October this year.

Pension Reform in Brazil

An important development that has happened recently is the Pension Reform. With massive deficits caused by the pension system, along with low average retirement ages and an aging population, Brazil has attempted to reform the constitutional social security system for some time. The country spends an equivalent of 13% of its GDP on social security (8.6% on pensions alone) compared to an average of 8% for G-20 nations (Washington Post). Further, 25.5% of Brazil's population is estimated to be over 65 years of age in 2060, compared to 9.5% now, which has intensified the need for reform. After years of failed attempts, the Federal Senate finally approved the reform on October 22nd, 2019.

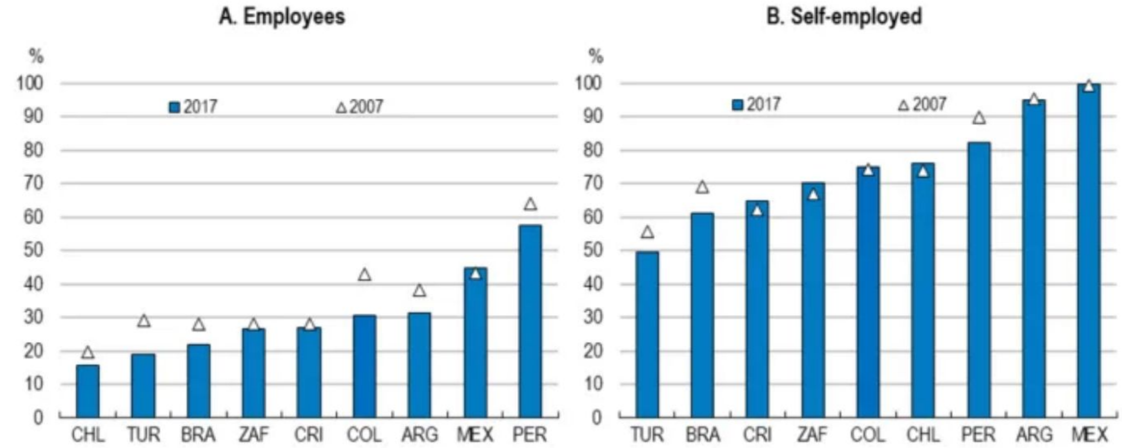
The reform places a minimum age for retirement, 65 for men and 62 for women. This is much higher than the current average of 52, which means that more of the population will stay in the workforce, and further a smaller portion will rely on pensions. The minimum contribution time for workers in urban areas is set at 20 years for men and 15 for women (Washington Post). This change, along with tax increases for banks, is estimated to save 800 million BRL over 10 years.

The Ministry of Planning estimates that without pension reform, the mandatory expenditures would have consumed the entirety of the budget by as early as 2022, effectively removing any fiscal space for policy (Instituto Millenium). Thus, the reforms not only stimulate the labor market, but also allow the possibility for fiscal policy in the future.

Comparative Labor Market Conditions

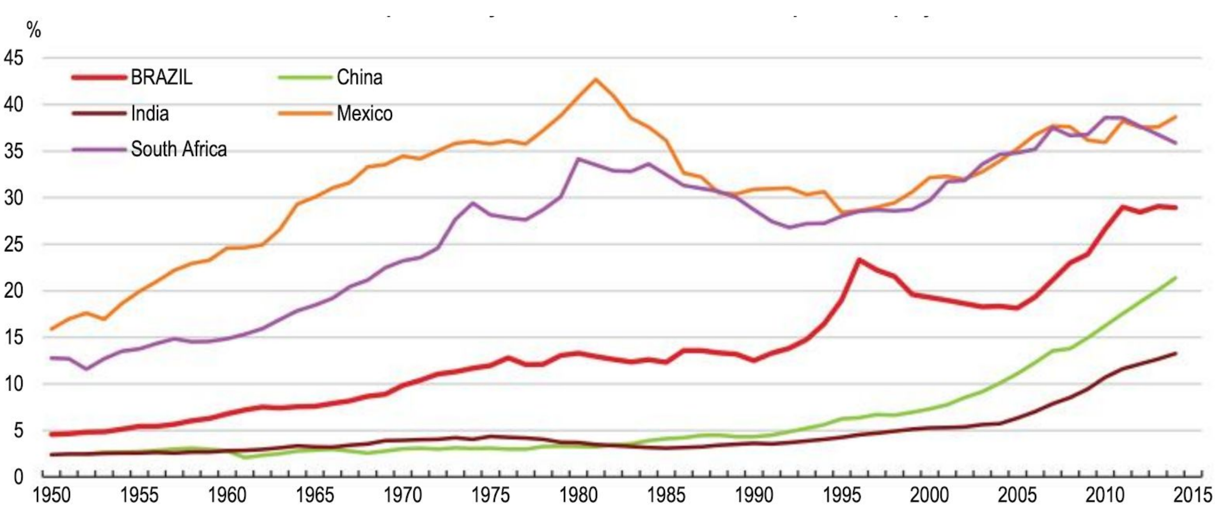
The labor market in Brazil is very informal, which has large effects on inequality. The informal workers retire at an older age than average because of the lack of social safety net. Though the proportion of informal workers is in the lower end when compared to other Latin American countries, the rate is still relatively high as shown in the diagram below (oecdecoscope). This is a result of high costs to hire formal workers, which has been exacerbated by the tedious taxation mechanism. Further, the lack of educational opportunities has meant that for many people the informal labor market is the only option. Only 49% of adults aged 25-64 have a post-secondary education, which is much lower than the OECD average of 78% (OECD Better Life Index).

Informal workers in each category as % of employment



Note: Informality is defined to include: i) employees who do not pay health contributions; and ii) self-employed who do not pay social security contributions (Brazil, Chile and Turkey), or whose business is not registered (Argentina, Colombia, Costa Rica, Mexico, Peru and South Africa). Data for Turkey refer to persons aged 15 and more. Data for Argentina refer to selected urban areas (according to the National Statistical Authority (INDEC), LFS series published after the first quarter of 2007 and until the fourth quarter of 2015 must be considered with caution).
Source: OECD calculations based on the EPH for Argentina, the PNAD for Brazil, the CASEN for Chile, the GEIH for Colombia, the ECE for Costa Rica, the ENOE for Mexico, the ENAHO for Peru, the QLFS for South Africa and the HLFS for Turkey.

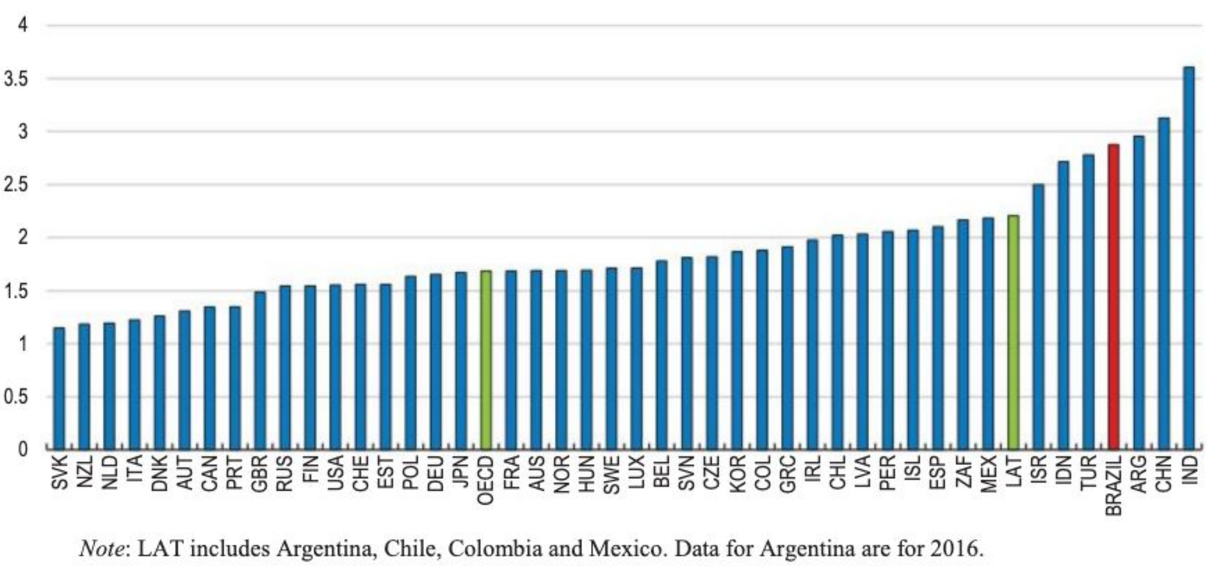
The high informal sector employment is directly related to another labor market measure that Brazil needs to improve on. While labor market productivity has had an overall upward trend, it has stagnated recently (shown below). This is also the result of lack of educational opportunities for a large portion of the economy and frictions in the labor market caused by corruption and other administrative factors.



Source: OECD Economic Outlook database, Feenstra, Robert C., Robert Inklaar and Marcel P. Timmer (2015), "The Next Generation of the Penn World Table" American Economic Review, 105(10), 3150-3182, available for download at www.ggdc.net/pwt

An important reason why Brazil is facing deficits is its bureaucratic system. The system is more restrictive compared to other Latin American countries (on average) and most OECD countries as shown in the diagram below.

Indicator scaled from 0 (least restrictive) to 6 (most restrictive), 2013



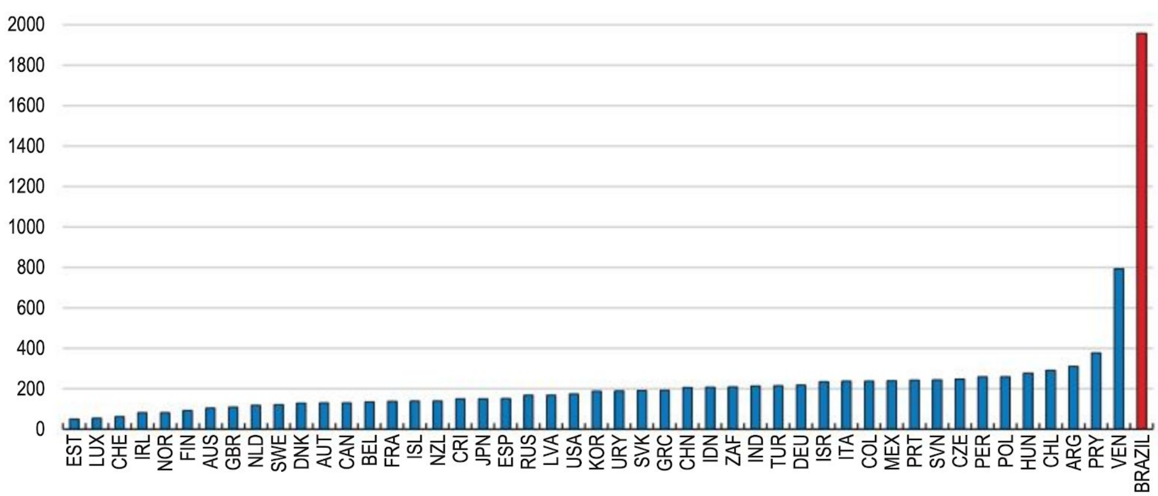
Note: LAT includes Argentina, Chile, Colombia and Mexico. Data for Argentina are for 2016.
Source: OECD Product Market Regulation Indicators, 2013, available at www.oecd.org/eco/pmr.

This is a major driver of the large informal sector and it also contributes to the investment issues that Brazil faces. The bureaucratic inefficiencies have, to a large extent, stunted infrastructural development in Brazil and it is of utmost importance that structural reforms are passed to fix these issues.

These inefficiencies are further worsened by the taxation system, which has one of the highest compliance costs. The figure below shows a comparison of average hours spent on taxes across countries and Brazil is clearly an outlier. On top of federal taxation along with its codes, each state levies its own taxes and often these have different bases, codes and rates. Any firm that desires investment in Brazil needs to comply with all of these different rules. Tax credits for input intermediary goods is only provided if it is embodied in the final good sold, and this causes a need for numerous tax accountants and hours spent on taxes (OECD). Further, these often lead to large lawsuits.

Figure 23. Hours required to prepare taxes

For a benchmark manufacturing company, 2017



Source: World Bank (2017).

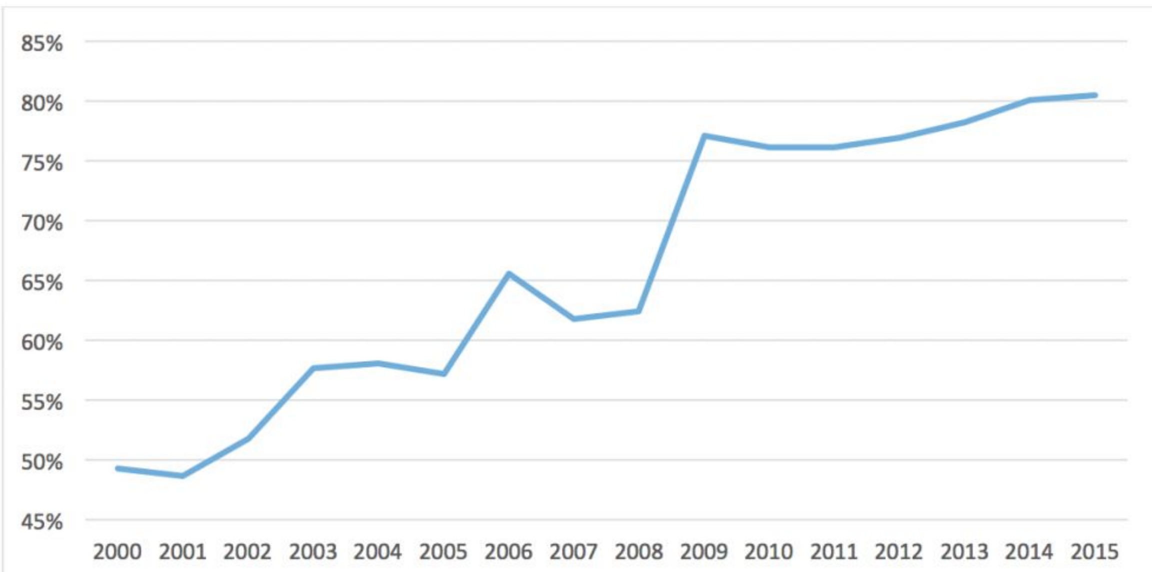
Financial Markets

On whole, Brazil's financial markets are relatively stable. The Brazilian Central Bank, National Monetary Council, and the Brazilian Securities and Exchange Commission regulate and oversee the financial markets. The B3 (Brazil Stock Exchange and Over the Counter Market), was created through the merging of three stock exchanges. The Ibovespa is the Sao Paulo stock exchange's index, which is made up of the 50 most liquid stocks traded on the exchange. The Ibovespa took a hit during Brazil's 2015 and 2016 recession, but has risen relatively steadily since, with returns above 25% over the past year (Bloomberg 2019). Despite losses in stock value the financial sector fared the recession relatively well. It is also important to note that financial instability and systemic risk were not a cause of or major contributor to the economic contraction.

The IMF's Brazil Country Report (2018, 15) finds that "banks appear to be broadly resilient to severe macro financial shocks", noting that these findings are consistent with another set of stress test results from the Brazilian Central Bank. The report also notes that since the recession, significant steps have been taken by the Brazilian Central Bank to increase macroprudential regulation and stress testing capacity. The IMF report does highlight the risk associated with the tight linkages between the government and the financial system, suggesting that fiscal instability can easily be transmitted to the financial sector due to high lending to state owned enterprises, and significant private sector holding of government bonds.

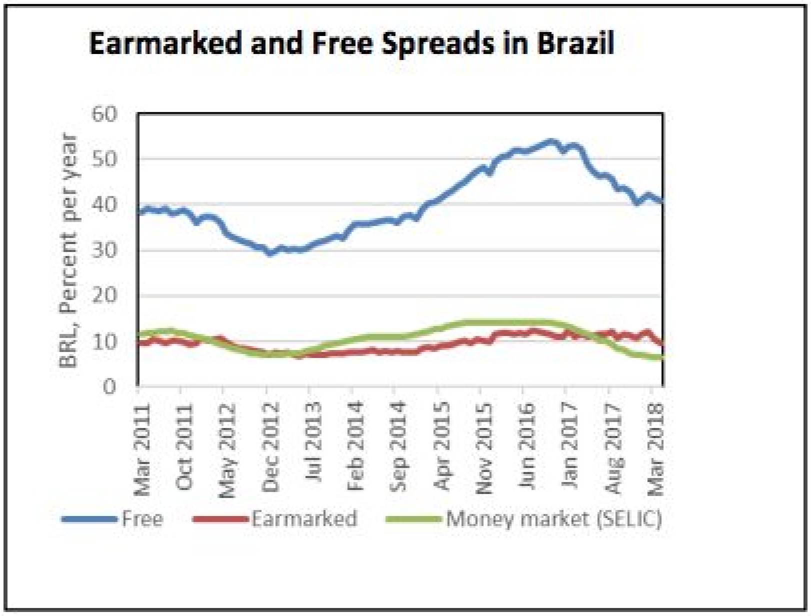
A significant distortion of the financial system arises from the outsized market share of a few large banks. In 2018, the four largest banks in Brazil controlled more than 70% of the banking system (Banks Around the World n.d.). The market share of these banks has also been rising over time (figure below) which suggests that without regulation the trend will not be reversed. This level of consolidation limits competition and causes distortions in the market. The market share of these large banks also serves to limit innovation in the financial sector because small and innovative firms are often absorbed into existing banks.

Concentration of Total Assets for Brazil's 5 Largest Banks



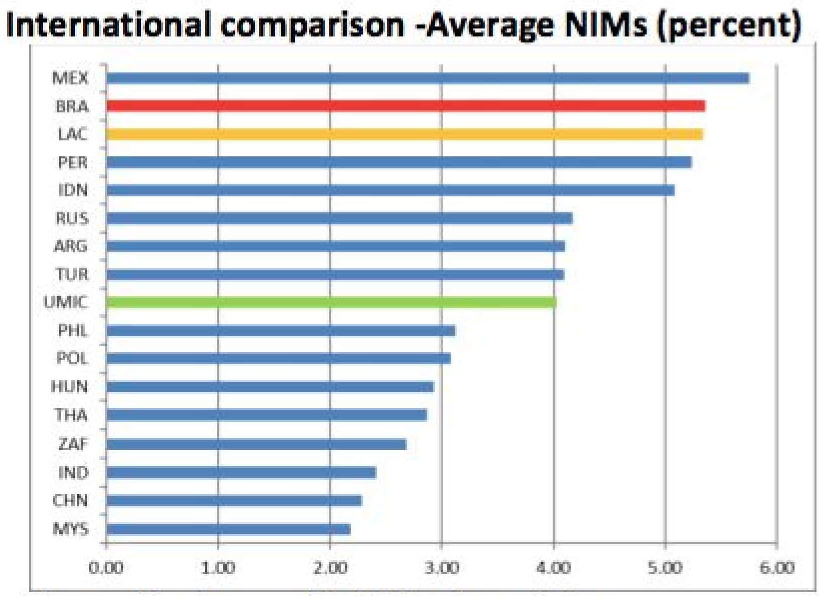
Credit Markets

Brazil suffers from a weak and distorted credit market. These distortions arise in part from the outsized market share of the largest banks as well as from significant and sustained government intervention. Approximately half of credit issued annually is "directed credit", meaning that it is required to go to certain industries at specific interest rates that are almost always below the market interest rate (The World Bank 2018). This credit and below market interest rates act as a subsidy to certain industries, with the interest rates offered sometimes falling below the rate that the government itself pays. “Earmarked” credit is constitutionally established and pulls from special funds to finance mostly long-term projects.



The figure above shows the drastic differences between the interest rates paid on earmarked credit and credit from the free market. These regulated rates have also limited the transmission of monetary policy.

The net interest margin (NIM) is the difference between the interest rate that banks generate from loaning out funds and the interest rate that they pay out to depositors. Brazil’s net interest margin is the second highest among comparable countries at 5.36%, suggesting that the costs of financial intermediation are high and that there are significant inefficiencies in the credit market.



Source: Bankscope; World Bank analysis

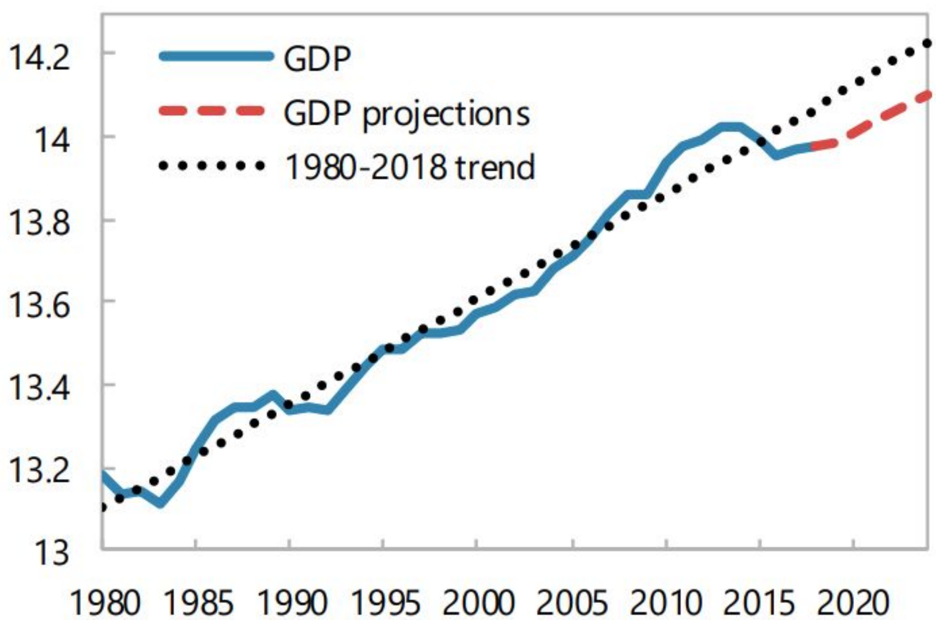
Though the high NIM's in Brazil may point to high financial intermediation costs the World Bank (2018) also finds that the profitability of Brazilian banks is 4.4% higher than other industries. This finding suggests that the lack of competition and high rates of government intervention are leading to bank profits at the costs of borrowers. Given than Brazil's economy continues to be sluggish, it is important to consider potential policies that will further boost lending and stimulate growth.

Even more striking than the spread between directed and free market credit is the difference between the Selic rate (currently 6.5%) and the interest rate on personal credit cards which is currently hovering around 300% (The Rio Times 2018). However, just days ago, on November 27th, the Brazilian Central Bank limited the annual interest rate in credit cards to 150% (Reuters 2019). This policy is aimed at supporting consumers, and is just one of a few policies over the past year that attempt to reduce the cost of credit to consumers. Given that the government does not have fiscal space to help increase economic activity, and policy actions that can help bring growth from the private sector are key.

Output Growth

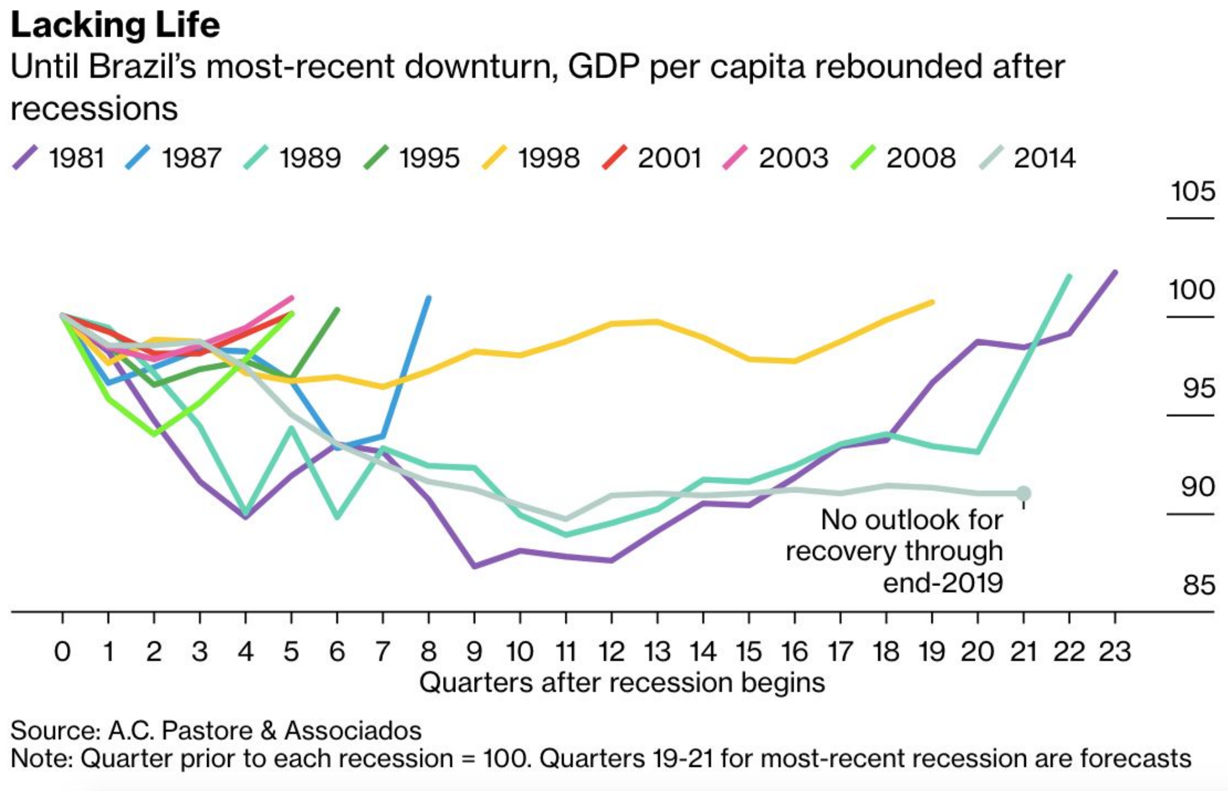
During the 2015-16 recession, real GDP fell by nearly 7%. Brazil's recovery has been extremely sluggish, with growth as low as 1.1% in 2017 and 2018. Consequently, output has remained below Brazil's historical trend (IMF 2019).

Real GDP
(Millions of 1995 reais, log scale)



Source: World Economic Outlook.

Sluggish growth is nothing new for Brazil. Since 1980, Brazil's average annual growth is 2.5%, which is well below most emerging economies. This small growth was fueled by increases in the labor force. Still, recent growth has been poorer. Compared with prior economic downturns, GDP per capita has been slow to rebound following the 2015-16 recession (Biller 2019).



Productivity remains stagnant, and investment rates are low. Brazil has a potential growth rate of 2.2%, again one of the lowest rates for an emerging market. This only stands to worsen as the workers which fueled Brazil's 2.5% growth begin to retire, which will shrink the labor force (IMF 2019). Overall, these broad trends in output, the labor force, productivity, and investment pose significant challenges to Brazil's future growth.

In the context of low growth, Brazil must also address its substantial debt. Currently, public debt makes up almost 80% of GDP, which is much larger than debt in such emerging markets as Mexico, Chile, and Indonesia. Even with pension reform, the Brazilian government does not estimate the debt ratio will fall until 2023. With low output growth and a Constitution that mandates around 90% of public spending, this debt severely limits Brazil's fiscal space (Adghirni and Fagundes 2019). Thus, Brazil faces a dangerous combination of low growth, little fiscal space, and high debt. Even worse, these trends may reinforce each other. Historically, high growth and large primary surpluses have reduced states' debt ratios (Eichengreen et al. 2019). However, Brazil has low growth, and its limited fiscal space makes large primary surpluses unlikely. Conversely, research on debt and growth has found that high levels of debt leads to a notable reduction in growth (Reinhart and Rogoff 2010). Overall, Brazil's low growth poses a significant challenge.

Investment in Future Capacity

During the decade preceding Brazil's recession, the investment rate was around 20% of GDP. Since then, the rate has declined, reaching a historic low of 15.4% in 2018. In part, this drop was caused by uncertainty surrounding public reforms and the sustainability of Brazil's debt (IMF 2019). Furthermore, Brazil's public capital lags behind other emerging markets by any measure. In 2015, their public capital stock was 39% of GDP, compared to 88% in other emerging markets. The quality of infrastructure is lower. During the previous two decades, public investment was less than 2% of GDP, and in 2015 Brazil only spent 22% of this public investment on infrastructure. In other emerging markets, public investment was around 6.2% of GDP, and 45% of this investment went to infrastructure (IMF 2019).

However, recent trends show some early signs of improvement. In the third quarter of 2019, private investment rose by 2%, which fueled GDP growth even as government expenditures and exports fell (Lima 2019). Furthermore, Brazil seems to believe that pension reform will help attract investors (Adghirni and Fagundes 2019). Investors do seem to care about pensions, as in 2018 Brazil's credit rating was lowered when it failed to pass reforms (Reuters 2018). In general, the Brazilian government is eager to shrink the public sector, and need private investors to do so (Iglesias 2019). Attracting investors will not be easy. Brazil's tax code is needlessly complicated, and Brazil will struggle to attract investors if its low growth persists (Leite 2019). Thus, low growth and decades of low investment reinforce each other. To increase growth, Brazil needs to attract investors. However, to attract investors, Brazil must increase its GDP growth. Nonetheless, given its debt ratio and low growth, Brazil's movement away from public investment is a wise decision.

Suggested Policy Reforms

Policy action taken by the Brazilian Central Bank in the aftermath of the 2015 recession has shown competence. Noticing deficiencies in the credit markets, the Central Bank reduced reserve requirements and pushed interest rates even lower, in order to promote lending on the part of banks. However, the structure of the economic systems of Brazil, like the credit markets and tax codes, have left these changes largely ineffective. The Central Bank, on the other hand, has demonstrated its value. Promotion of the bank in the form of increased Central Bank independence will likely produce more faith in the economy, and given time, the measures taken by the Central Bank will likely produce a healthier, more robust economy. If the Central Bank is given freedom to operate, it will be an effective arbiter of monetary policy as the government eventually moves onto a higher rate of growth. Cementing the independence of the Brazilian Central Bank will allow for continued policy and may help stabilize the economy other future administrations.

As the pension reform takes effect, the labor force participation rate will grow fast over the next few years. With retirement age going from an average of 52 to a mandated minimum of 65, people will stay in the labor force for much longer. This large inflow of labor opens up new possibilities of increasing government income through effective taxation. A big issue right now with Brazil is its inability to pursue fiscal policy due to a lack of fiscal space. If taxation were improved, along with measures to bring more informal workers into the formal space, the country would be able to generate a much higher revenue. With this higher revenue and the costs lowered by the pension reform, the country can use the net gain in balance to pursue fiscal policy when needed. Further, the net gains can be used to invest in infrastructure, or education, which would lead to more long term gains. An investment in education would help further increase the proportion of formal workers in the economy. One way to make the taxation system more efficient would be to standardise the state tax code, if not the rates. Further, allowing tax exemptions for intermediary products regardless of whether they are embodied in the final product would drastically decrease the amount of time spent on tax filing and would encourage more investments. This would also remove the need to hire numerous tax officers and lawyers during tax season, making the process much less tedious.

Banking reforms targeted at making the credit market more competitive will have positive impacts on consumers and the fiscal wellbeing of the government in the short run, and will likely boost growth and improve the transmission of monetary policy in the long run. Biljanovska and

Shandi (2018) find that relative to other Latin American countries Brazilians are relatively open to banking sector reform, suggesting that these policies can have real economic impacts without inciting political pushback. Reforms of the banking sector to limit government involvement will improve the functioning of credit markets and lead to fiscal savings. One important credit market reform is fading out and eventually ending directed investment. This policy change would drastically decrease fiscal spending while simultaneously introducing more competition both between banks and between firms. Another way to increase competition in Brazil would be to limit the market share of the largest banks. This could be approached through antitrust legislation or government support for innovative financial technology.

Finally, improving cooperation and communication between regulators of different parts of the financial sector can help guard against future instability stemming from the financial sector and the macroeconomy as a whole. The role of this agency would be to take a macroprudential lense to the Brazilian economy, and ensure that systemic risks do not arise. In normal times this agency should have the role of information sharing and general oversight, while in times of crisis this high level coordination can provide a forum for collaborative solutions and out of the box policy.

Conclusion

The Brazilian economy is stuck in a difficult situation. Recovery since the 2015 recession has been slow and political turnover has added to economic uncertainty. Both the monetary and fiscal policy responses taken by Brazil align with macroeconomic theory and the experiences of similar countries; however, transmission of these policies has been limited and recovery has been slow. Underlying structural challenges in legislation, regulation, and the banking sector have stymied policy impacts and limited growth. Continuation of strong and targeted monetary and fiscal policies along with reforms that address these underlying issues in institutions, the pension system, and credit markets will improve outcomes. Strengthening Brazil's policy framework have the potential to boost growth a leave Brazil better equipped to deal with economic shocks in the future.

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