

The Emperor has no clothes

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Just as in the tale "The Emperor's New Clothes" by the Danish writer Hans Christian Andersen, we were all recently startled by the fact that nothing we thought enforceable in terms of fiscal adjustment would be possible...actually, we are now being sold the idea that it was all an absolute mirage. Countercyclical policies and creeping Keynesianism, fostered by populism, have gone too far. It is time to pay the bill, we know that, but no one expected conjunctural aspects, account errors or, once more, succumbing to political necessities, could reverse with such voracity the next three years of tax saving expectations. There is no savings, rather, a likely dissaving, which will simply disrobe and expose us to all kinds of attacks and weakening.

But what is this sudden understanding and acceptance by the economic team of the impossibility of achievement of surplus target originally set? It is well known among economists and scholars that we need structural reform, that we have been building a time-bomb for some time by creating commitments and obligations which are not compatible with our revenues and income growth. And that structural reform eliminates short-term patch-up attempts, extraordinary revenues and requires technical and political commitment to adopt further long-term impact measures. Thus, the drastic reduction of the surplus sounds very strange compared to the known reality, for the team in charge of this monumental transition is technically capable, and comprises of trained professionals who have been "tested" in this field. And there is more, some restructuring measures were sent and approved by the House of Representatives and others are underway, although our Congressmen can go beyond *the limit of their responsibilities* - ignoring the Government's proposals.

There is no doubt that the persistent increase in public spending beyond the dynamic equilibrium with revenue embeds a serious risk to stability. However, no less important for maintaining stability and a predictable environment is trust and transparency of the acts and economic policy firmness of purpose. In this regard, the unpredictability of the numbers and projections, coupled with the lack of factual persuasion and dissimulation, is the crisis trigger and break with the *status quo*.

Thus, it is difficult to accept that the technicians who are there have made an error of such a magnitude. It also requires colossal effort to admit that Minister Levy has simulated or done some "arbitrage" based on groundless projections - the assumption is absolutely unlikely. In this line of reasoning, political interference may have been the cause of this disrobing, due to the lack of conviction on the new model, the crude levels of economic activity and unemployment and the resulting decline in popularity of the Commander in Chief. The situation may have simply become unsustainable under all points of view - in this case, we would be on the verge of a break of Minister Levy and staff's current mindset.

The feasibility of this analysis is corroborated by the fiscal realism, whose monitoring happens on a daily basis for the short, medium and long term. These simulations also include transitional alternatives (extraordinary revenues) and the so-called *second best* plans. The fiscal impulse is a beautiful indicator to measure different impacts in different scenarios, thus comprising a fundamental resource to define the policy to be pursued. There are several methods available for its calculation, taking into account a host of variables such as government revenues and expenditures, actual and potential GDP and elasticity of expenditures and revenues relative to GDP - in addition to these, the analysis also consider the effects of foreign exchange and interest rates, among others.

This is the context in which the paths and alternatives to be pursued should be mapped. It is absolutely reasonable, therefore, to assess *ex-ante* the likely fiscal result trajectories. The amplitude and the possibility of simulations can be huge, in light of the defined assumptions, but the probabilities are not. Consequently, the claim contradicts Minister Levy's technical posture, who days before the surplus reduction announcement said it was too early to talk about changing the fiscal target. In other words, there was a less radical way than the one chosen in the alternatives map.

Finally, the implications of the actual reduction of the fiscal target have impacts not only due to the small number in itself, with ensuing transformations and indicator results, but also spread and contaminate exponentially. Increased productivity and economic efficiency (key variables for resumption of sustained growth) need a new environment, where governance, technical prowess and transparency and absolute cessation of use of creative accounting mechanism and less republican measures flourish. In this respect, communication with the market is very important, as it establishes a causal link to the decision-making and "convinces" society and opinion makers of the adequacy of the measures. This relationship does not exist at this time, and Minister Levy's and his team's irreproachable image are subject to their next steps and determinations as major Brazilian economic policy conductors.

While the market adjusts and tries to "understand" Minister Levy's position and the real consequences of this fiscal adjustment, the price paid is a huge market volatility. Externalities such as the slowdown of the Chinese economy and the normalization of interest rates by the Fed added to our weakness may be the final ingredient to an unprecedented crisis. We are once again on a knife's edge, probably burying the minimal chances that we had of keeping our Investment Grade. We need to define now how we will navigate through this storm.

Not to mention the political crisis. God help us.