

# THE CHANGING ROLE OF THE STATE:

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## BRAZIL IN GLOBAL PERSPECTIVE

COLUMBIA GLOBAL CENTERS | RIO DE JANEIRO



# THE CHANGING ROLE OF THE STATE 2021

## Brazil in Global Perspective

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# FOREWORD BY THE EDITORS

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Jan Svejnar



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Miguel Henriques de Carvalho

# THE CHANGING ROLE OF THE STATE: BRAZIL IN GLOBAL PERSPECTIVE

## FOREWORD BY THE EDITORS

THOMAS TREBAT

JAN SVEJNAR

MIGUEL HENRIQUES DE CARVALHO

We are proud to present in this small volume summaries of the rich debates that occurred virtually in early 2021 on the changing role of the state in global economic growth and development. This conference is an annual partnership between the Columbia Global Centers, based in Rio de Janeiro, and the Center on Global Economic Governance of the Columbia University School of International and Public Affairs (SIPA), based in New York City. For the fourth year in a row, we examined this global theme from the special vantage point of Brazil, one of the leading emerging economies in the world and one in which the proper role of the state is a matter of constant debate. Twenty-eight economists, political analysts, and policymakers participated in the conference, adding their insights on economic conditions and policies from around the world with Brazil as a frequent case in point.

These discussions reflected in “real time” the most important economic issues that were being discussed during one of the most threatening periods in history of the global economy. Governments around the world were being forced to respond with unorthodox economic and health measures to contain the COVID-19 pandemic while preserving a pathway to the recovery of companies and employment in battered economies. This volume captures the exhilarating spirit of those times when economic orthodoxies were thrust aside and new untested policies were put in place to deal with the desperate times. All of our discussions were on the record and videos of the entire proceedings are available on our various YouTube channels. Links to each of the sessions are included in the Annex of this publication.

We turn our attention now in this Foreword to a brief as possible summary of the panel discussions. With some significant overlap, these touched upon three main themes: (i) global economic conditions and the outlook for recovery; (ii) fiscal and monetary policy responses to the crisis; and (iii) labor market conditions and social policies. In the rest of this Foreword, we follow this overall structure to distill some of the main “takeaways” – for Brazil and for the world – arising out of our 2021 Changing Role of the State debates.

### **Panels 1-2: Global Economic Conditions in 2021 and the Outlook for Brazil and the World:**

- The COVID-19 health crisis shaped economic policies and the outlook everywhere in the world, though it has affected economies differently in accordance with their initial starting conditions and the quality of the state’s response.
- After a drop without recent precedent of 3.5% of GDP in 2020, and despite the troubled response in 2020, the U.S. economy should recover in 2021. The fiscal response of the new Biden administration is adequate to meet the circumstances and not considered likely to trigger inflation in the United States.
- The Chinese economy’s recovery from the pandemic has been remarkable, although confidence in the reliability of Chinese official statistics is guarded. The European economies were notable for their collective and coordinated response to the pandemic, a response forged by Europe itself and without close coordination with the United States.

- The outlook is much more cautious for the developing countries of the world. In addition to pre-crisis, pre-existing structural constraints on growth, these middle- and low-income countries are saddled with much slower vaccine rollout when compared to the developed countries. In this respect, the Brazil case was often cited. A great deal of concern was expressed about the outlook for the Brazilian economy because of the crisis, the state's halting response, and also underlying structural constraints on growth.

- These constraints in Brazil included a track record of low productivity, a high level of public sector indebtedness, and slow progress toward implementing needed economic reforms. Speakers called attention to deeper structural distress in Brazil, such as the persistence of greater inequality, social exclusion, and an extremely high level of informality in the workplace.

- In summary, speakers were optimistic about global economic recovery in 2021 and beyond based upon the broad economic indicators and also about the growth performance of the wealthiest economies. They cautioned repeatedly, however, that recovery was extremely asymmetric ("K-shaped") around the world, with special concern for the long-term impacts of the crisis on the emerging economies. The asymmetry also extends to conditions within every country of the world, with differential impacts on the various sectors of the economies and on the lower- and middle-income earners.

### **Panels 3-4: Assessing Monetary and Fiscal Responses to the COVID-19 Crisis**

- Fiscal policy responses around the world have been extraordinary, especially in the wealthier countries. Advanced countries adopted stimulus packages of around 15% of GDP, middle-income countries of 10%, and low-income countries of 5%. The global aggregate fiscal stimulus was about US\$ 14 trillion, an astounding figure. A consensus emerged among leading economists around the world in favor of fiscal activism as the best means to mitigate the effects of the crisis; potential problems arising from this spending would have to be addressed later

once the health crisis began to abate.

- While the policy emphasis during the COVID-19 pandemic has been on fiscal policy, monetary policy almost everywhere has played a key role in increasing liquidity and providing credit to financial and non-financial sectors in advanced and in emerging economies. While similar to actions taken by monetary authorities in the aftermath of the 2008-2009 financial crisis, contemporary monetary policy responses to COVID-19 differ significantly in terms of scale and duration.

- The balance sheets of the main central banks of the world – the Fed, the ECB, and the BOJ – have expanded by large multiples since the onset of the global health crisis. And these balance sheets are expected to continue growing as monetary policy facilitates fiscal policy responses. In practice, as it has been increasingly recognized from a theoretical point of view, monetary and fiscal policy are no longer separated.

- Panelists assessed the effectiveness of such policies as quantitative easing and also the inflation and other risks inherent in the new fiscal policies and the eventual need to unwind them. They emphasized that economists must navigate "uncharted waters", in that conventional economic theory cannot explain clearly all the risks inherent in the unprecedented rise in global liquidity. One panelist compared the challenge to economic policy today as comparable to the dilemmas faced by orthodox economists in the early 1930s.

- A consensus emerged that the inflationary risks of fiscal policies were manageable and that monetary policy around the world is likely to remain extremely accommodative. This is permitting governments around the world, including in Brazil, to raise debt levels that only a short time ago would have set off debt sustainability alarm bells.

- Panelists recognized that Brazil has a large agenda of fiscal reforms, most of them vital to longer-term growth, but few, if

any, likely to advance in the current political and social environment in Brazil. The weight of public opinion has clearly shifted toward more social spending in Brazil, not less, in the years ahead. Civil service reform and tax reform could ease this transition to a different structure of public spending, but the political will to take on these controversial measures is clearly lacking in Brazil at present.

- At the same time, the panelists recognized the limits of monetary policy and the possibility of a resurgence in inflation. They warned over and over that any increase in United States and European interest rates could have severe impacts on the world economy, particularly for Brazil and other emerging economies reliant on external finance. In Brazil, warning signs are already appearing of financial asset “bubbles”, and also of rising interest rates and a surge in inflation.

- Panelists indicated also that the emerging economies of the world are vulnerable to an “exit” policy by global central banks as the resulting higher interest rates and credit spreads could create debt sustainability problems, disrupt capital flows, and spread stress and bankruptcy in their financial systems.

- Panelists contemplated contemporary pressures, evident in many parts of the world, including the United States, for central banks to take more explicitly into account the pursuit of broader social goals, such as equality, income distribution, and the choosing of winners and losers. Most panelists warned strongly against such an expansion of the central bank roles. However, others argued that these were, indeed, extraordinary times which could justify departing from the usual “rule book” governing the permissible range of central bank actions to pursue broader social goals.

### **Panels 5-6: Reforming Labor Markets and Social Policy Post-Pandemic**

- Much of the concern created by COVID-19 has focused on enormous dislocations in the labor markets and on

the need to provide emergency support via social programs to alleviate human suffering. These two panels concerned themselves with what lessons are being learned and what reforms in labor market policies and social insurance schemes should be highest on the post-pandemic reform agenda. To adapt a policymaking phrase used in a different context, how might policymakers “build back better” to promote goals of both economic efficiency and social equity in the future?

- Panelists called attention repeatedly to the so-called “K-shaped” nature of economic recovery globally, meaning that highly-skilled workers who can adapt to the new digital economy are likely to fare far better than a much larger group of workers who will have to deal with the negative consequences of the labor market dislocations for a very long time to come.

- A number of the speakers addressed this point of the K-shaped recovery with its disproportionate effects on workers in the most badly affected sectors of the economy. These included the least skilled workers, those working in the informal sector (with many of these working in highly affected areas, such as restaurants and retail), youth, and women. To illustrate, women account for two-thirds of the overall health care workforce and are in the majority in less stable, precarious forms of employment.

- No international measure to help the developing countries is more important than that of accelerating the vaccine rollout globally. International cooperation was deemed to be critical to promote recovery from COVID-19 and to ameliorate worsening social conditions in poorer regions of the global economy. Panelists decried the shortsightedness of developed countries in their reluctance to share vaccines with the rest of the world. One speaker spoke directly in favor of breaking patent protections on the current generation of vaccines to accelerate an end to the pandemic by speeding up vaccine production.

- Looking beyond the current crisis, a consensus emerged among the panelists that the state in the future will have to

restructure its priorities to emphasize health and education. Advances in these areas will be critical to achieving greater inclusion and social mobility.

- A number of speakers addressed their remarks specifically to the Brazilian case and the challenge of underemployment and poverty. While generally supportive of the emergency measures taken by the Brazilian state in the economic area, the same could not be said for the state's performance in protecting the health of the population, on which the future of the economy entirely depends. Most who did address the Brazilian situation stated that the present government had neither the vision nor the political will to help the economy move out of the current crisis and to prepare for stronger growth in the future.

- In these circumstances, economic growth in Brazil is likely to lag and social inequality, already high, is likely to worsen, the more so as emergency fiscal measures to support the unemployed are reduced in 2021 and beyond. The labor situation in Brazil is particularly alarming in that such a large percentage of the employed workforce (40% or more) works in the informal sector and lacks protection from labor legislation.

- Rejecting the view that informality is a permanent characteristic of the labor markets in Brazil, one speaker recalled that, between 2004 and 2014, Brazil managed to record many positive outcomes in labor market outcomes, including increases in the labor formalization rate and in average and minimum wages. Moreover, these improvements were accompanied by a significant reduction in labor market poverty, wage and gender inequality, and an increase (albeit slight) in productivity in the economy. It is to be greatly regretted that these positive trends did not continue after 2015 in Brazil.

- Other speakers questioned whether labor market and social policy measures, in and of themselves, really were capable of promoting sustained economic recovery. In particular, in Latin America, labor market policies have often benefited only a small

slice of the workforce best organized to take advantage of changes in legislation. These workers have benefited, but the larger part of the work force has been left behind.

- Speakers came together to emphasize that employment policy and social policy are, in the end, one and the same thing. Without a broad policy agenda able to produce "good" jobs in the economy, the discussion of labor market reforms, social protection, and equity-inducing policies in Latin American could be an empty one or a zero-sum game. If proper attention is not paid to policies that enhance overall productivity, promote openness, and foster innovation, policies in terms of labor market and more equity-inducing social policies could be based upon many good intentions, but possibly continue to produce very bad results in Brazil and Latin America .

## **Concluding Comments by the Editors**

This brief summary of many hours of rich debate hardly does justice to the quality of the various presentations and interaction between the speakers. We urge the readers to read carefully the more detailed summaries which comprise the rest of this volume and, for the more intrepid, to watch and listen to the actual discussions that can be found on our YouTube channels. The links are to be found in the appendix to this publication.

We close by expressing our expectation that this debate on the role of the state in the aftermath of the Covid-19 crisis will continue as we struggle to understand its longer-term implications of the pandemic for human welfare. We will be organizing in 2021-22 another series of conferences that will examine precisely these issues, once again taking a global comparative perspective while also honing in on the problems of the largest emerging economies, including Brazil and China.

**Thomas Trebat**

**Jan Svejnar**

**Miguel Henriques de Carvalho**

June 24, 2021



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## PANEL I

# AN OVERVIEW OF THE WORLD ECONOMY AND BRAZIL

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Safwan Masri



Jan Svejnar



Jacob Lew



Lisa Schineller



Willem Buiter



Madelyn Antoncic



José Alexandre Scheinkman



Ana Paula Vescovi

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# AN OVERVIEW OF THE WORLD ECONOMY AND BRAZIL

JANUARY 28, 2021

The Panel I was moderated by **Safwan Masri**, Executive Vice President for Global Centers and Global Development at Columbia University, and Adjunct Professor of International and Public Affairs, with commentary by **Jan Svejnar**, James T. Shotwell Professor of Global Political Economy and Director of the Center on Global Economic Governance at Columbia University. Six speakers in all participated in this session. Together, they covered a wide range of topics, ranging from examination of the performance of the global economy to a more detailed analysis of the Brazilian case, with emphasis on the evaluation of its economic challenges and alternatives to overcome constraints on growth. The first three presenters were: **Jacob Lew**, Visiting Professor of International and Public Affairs, Columbia University, and Former U.S. Secretary of the Treasury; **Willem Buiter**, Adjunct Professor of International and Public Affairs at Columbia University and Former Chief Economist of Citigroup; and **Madelyn Antoncic**, Managing Partner of Global Corporation and CEO of the Global Algorithmic Institute. The second group of three speakers turned their attention to an analysis of the experience of the Brazilian economies. The speakers were: **José Alexandre Scheinkman**, Charles and Lynn Zhang Professor of Economics at Columbia University; **Lisa Schineller**, Managing Director of S&P Global Ratings; and **Ana Paula Vescovi**, Director of Macroeconomics at Santander Brazil and Former Secretary of the Brazilian National Treasury.

For Jacob Lew, the global economic situation is being shaped by the ongoing health crisis. The impact in specific economies depends upon their pre-crisis starting points and also upon the different ways in which countries have responded to the crisis. In this context, the United States and Brazil share the “shameful distinction” of not having an adequate political response to the COVID-19 pandemic, with both countries experiencing excessive loss of lives and severe economic disruption.

In the case of the United States, despite success in the development of vaccines, the vaccine rollout process has been uneven, according to Lew. The performance of the economy in the fourth quarter of 2020 did indicate a nascent recovery, but not enough to prevent a fall in full-year GDP of 3.5%. This was a sharp break for the United States economy after having recorded positive economic growth in each of the preceding ten years. The asymmetric impact of the pandemic on the U.S. employment structure is noteworthy, with the most negative impacts concentrated in the middle and lower strata of the labor market.

In the case of the Chinese economy, after a rough start, success in controlling the pandemic has been remarkable. The observation comes with two caveats: the lack of full confidence in China’s official economic statistics and the authoritarian means which the government employed in order to contain the health crisis.

In the case of the European economies, the surprising aspect was the collective and coordinated nature of the pandemic-response actions taken by the

## PART I: A GLOBAL PERSPECTIVE

### Opening Remarks by Jacob Lew

different governments. This was noteworthy in that these policies were not taken in coordination with the United States, perhaps the first time in the post-war that coordinated action of this nature has occurred solely between European countries.

In the case of the emerging markets, these economies were the last to be impacted by the COVID-19 virus. It is in this group of countries that the economic impacts tend to be worse due to their lower fiscal response capacity, especially when considering that, prior to the health crisis, these countries were already burdened by high levels of domestic public indebtedness.

Regarding the global prospects for 2021 and 2022, Lew stated that the performance of the economies of each country will depend on the degree of success in the introduction of vaccines and the pace of return of economic activities to normal functioning. In turn, to the extent that interest rates are already at minimum levels in the United States, the Eurozone, and Japan, economic recovery will depend on expansionary fiscal policies. In the case of the U.S., President Biden has proposed a program of public infrastructure spending of up to US\$ 1.9 trillion, which will require a bipartisan consensus with the Republican Party. Infrastructure is a priority program for the US. President Biden, will be willing to sacrifice other policy goals if necessary in order to build the political consensus needed for its implementation.

Finally, Jacob Lew referred to the new U.S. Treasury Secretary, Janet Yellen, noting that she, in addition to having more than the necessary skills for the position, has a remarkable capacity for dialogue, a talent of fundamental importance at this moment in the United States when building bridges between divergent political groups is paramount.

## Opening Remarks by Willem Buiter

Willem Buiter cited in his initial

remarks data recently released by the IMF<sup>1</sup>, highlighting the growth performance of different regions of the world and providing forecasts for economic growth. In the aftermath of the 2020 recession, it is possible to identify a significant output gap in the advanced economies, although to a lesser extent in the United States than elsewhere. However, the expected growth for 2021 will not be enough to bring all advanced economies back to their 2019 levels.

In contrast, China, which grew by about 2.3% in 2020, is expected to grow rapidly in 2021 with growth on the order of 8.1%. Brazil, which was already performing poorly in the years prior to the pandemic crisis, will experience a slow recovery: the economy is expected to fall 4.5% in 2020<sup>2</sup> and then grow 3.6% in 2021 and 2.3% in 2022. Buiter points out, however, that these growth forecasts presented by the IMF are an optimistic scenario; the scenario presupposes the success of the vaccine and its distribution in countries. This may not occur if there is a delay in the rollout process, and the risk of significant delay is greater for developing countries.

Financial market performance is noteworthy. Although the GDP of advanced economies has contracted, stock market performance was quite positive in the United States and Japan. Meanwhile, in the Eurozone, the main stock indices have not yet fully recovered from their fall in the second quarter of 2020. In the case of Brazil, the Bovespa index has rebounded to levels that are actually higher than those at the beginning of the 2020 crisis.

Finally, Buiter affirmed with regard to the measures adopted to promote the recovery of economies, President Biden's fiscal stimulus proposal is appropriate and the Federal Reserve also continues to expand its balance sheet in order to maintain the liquidity of the American economy. For

1 Available at: <https://www.imf.org/en/Publications/WEO/Issues/2021/01/26/2021-world-economic-outlook-update>

2 According to official data from Brazilian Institute of Geography and Statistics (IBGE - Instituto Brasileiro de Geografia e Estatística), Brazil's GDP dropped in 2020 4.1%.

him, this fiscal and monetary expansionism may bring inflationary concerns for the United States in the future, but this is highly unlikely to happen in the short term. And if inflation reappears at a later time, the United States should have the tools to neutralize these inflationary impulses without leading the economy into another recession.

For Buiter, Europe needs to do more both in the fiscal and monetary areas to promote the recovery of the countries in the region. In turn, emerging countries, although they also need to do more in the fiscal area, would not have the same fiscal space in which to operate; not being issuers of the international key currency, these countries cannot count on the “exorbitant privilege” that the United States economy has in being able to monetize its debt and deficits. To take the case of Brazil, the government was only able to mitigate to a limited extent the economic impact of the COVID-19 crisis despite a quite considerable fiscal stimulus in 2020.

### **Opening Remarks by Madelyn Antoncic**

Madelyn Antoncic organized her remarks around what she believes to be the key to the restoration of global economic growth, especially in developing economies: the quest to achieve the Sustainable Development Goals (SDGs) defined by the UN (United Nations)<sup>3</sup>. The UN estimates that US\$ 2.5 trillion annually will be needed to meet the SDGs targets by 2030, so that support from the private sector, which is responsible for most of the employment and GDP of developing countries, will be indispensable.

Although the SDGs have been designed for countries, according to Antoncic, some of them are also applicable to companies. These include: SDG 6 (Ensuring the availability and sustainable management of water and sanitation for all); SDG 7 (Ensuring reliable, sustainable,

modern, and affordable access to energy for all); and SDG15 (Protecting, recovering and promoting the sustainable use of terrestrial ecosystems, sustainably managing forests, combating desertification, stopping and reversing land degradation, and stopping biodiversity loss). In all three of these SDGs cases, private companies could cooperate with governments to meet these objectives, for example, by not using materials that cause deforestation.

Antoncic noted that financial markets, as mediators between companies and their funding sources, must serve those corporations aligned with compliance with the SDGs. However, there is the presence of information asymmetry and the lack of transparency on the part of companies. These market failures hinder the process of allocating funding to the most compliant companies.

For her, to circumvent this limitation, Artificial Intelligence (AI) can play a key role, by processing large volumes of information using Big Data and, thus, providing the efficient allocation of capital to where it is most needed. United Nations initiatives are already in progress in partnership with AI companies to track corporate reports and establish funding allocation criteria in line with the SDGs and in harmony with international financial and accounting standards.

### **Comments by Jan Svejnar**

In a brief concluding comments following opening remarks by the first group of panelists, Jan Svejnar highlighted that the shock caused by the COVID-19 pandemic has raised the degree of uncertainty in the areas of health, economy, public sector, etc., and that it is a great challenge to overcome. Drawing upon remarks by the three presenters, he highlighted that “resilience” has been a highly valued attribute at this time. In this regard, a first important challenge will be the performance of vaccination around the world and the

<sup>3</sup> Available at: <https://sustainabledevelopment.un.org/content/documents/21252030%20Agenda%20for%20Sustainable%20Development%20web.pdf>



possible positive impacts on the different economies, although caution is needed, as the degree of success of this rollout process is not yet known.

## **PART II. A FOCUS ON BRAZIL**

### **Opening Remarks by José Alexandre Scheinkman**

José Alexandre Scheinkman examined current Brazilian challenges from a long-term perspective, noting that the Brazilian economy has shown low productivity in the last 40 years as well as the persistence of the high inequality resulting from the provision of low-quality public services.

According to Scheinkman, low Brazilian productivity is a long-term phenomenon. In 1987, the productivity of Brazilian and South Korean workers corresponded to one-third of the productivity of North American workers; using current data, South Korean workers account for 67% of the productivity of U.S. workers whereas the comparable figure is just 23% for Brazilian workers. This low productivity in Brazil occurs in the context of a marked social inequality in the country, the roots of which are to be found in the areas of health and education.

For him, Brazil has a unique fiscal situation compared to other developing countries. On the one hand, the tax system is substantially disorganized, causing distortions detrimental to the functioning of the economy; on the other hand, despite the high level of taxes imposed on the population, a very low quality of public spending is observed. Regarding this last point, while the Brazilian government may be able to play an efficient role in income transfer programs, the same cannot be said in its direct provision of services, such as education and sanitation, in which service delivery is characterized by high levels of inefficiency.

In the case of education, Scheinkman

noted that Brazil has increased its public spending in the area in recent years, reaching 6.2% of GDP. This places the country in the top 10-11% of countries in education spending, according to World Bank data. However, Brazilian educational outcomes are well below what might be expected compared to other countries with similar levels of expenditures per student. Another indication of the inefficiency of public education spending is that those Brazilian municipalities which received additional fiscal resources through increased oil royalties did not achieve corresponding improvements in their educational indicators.

In terms of sanitation infrastructure, comparative data for four Latin American countries (Chile, Mexico, Colombia, and Brazil) show that, although Brazil collects more in per capita terms than Colombia and Mexico and only slightly less than Chile, Brazil's sewerage treatment coverage is below 50%, while Mexico is between 60% and 70%, Colombia close to 90%, and Chile almost 100%. This poor Brazilian performance in the area of sanitation clearly affects most of the poorest Brazilians.

In a further demonstration of public sector inefficiency, Scheinkman stressed that, until January 2021, the country's COVID-19 immunization policy is a complete disaster. Brazil, instead of expanding the total number of vaccines purchased and diversifying its sources of supply of vaccines and vaccine inputs, followed almost the exact opposite path. The government purchased only a small amount of supplies and concentrated orders on a few sources. The vaccine rollout in Brazil is running into serious delays and the number of deaths from the pandemic is among the highest of any country in the world.

Other instances of government mismanagement can also be cited. For example, the current government in Brazil has given only very slight attention to climate issues and deforestation, going in the opposite direction to that recommended by Madelyn Antoncic in order to meet the

SDGs.

### **Opening Remarks by Lisa Schineller**

Lisa Schineller focused her attention on the analysis of the worsening of the sovereign risk assessment of Latin American countries, especially Brazil, in a context of increasing deficits and public debt and GDP declines.

Echoing concerns of the risk rating agencies, Lisa Schineller pointed out that the volatility currently being observed in most economies is not a positive development. The economic crisis triggered by the spread of the COVID-19 pandemic has exacerbated existing problems from the point of view of the countries' ability to pay their domestic debts.

Schineller noted that the ratings classification of countries takes into account a number of other variables besides the relationship between public debt and GDP, such as the institutionality of economic policy, the external position, sustainable public policies, etc. Furthermore, this classification is not intended as guidance as to which policies countries should or should not follow, but rather attempts a more objective assessment of the ability of countries to pay their public debts.

In the context of the COVID-19 crisis in 2020, out of a total of 135 countries evaluated, there were 26 downgrades, of which fully 40% referred to Latin American countries. In 2021, the outlook is for 24 new downgrades, of which 9 might be in Latin America. Observing the cases of Mexico, Argentina, and Brazil, while the first two were downgraded, Brazil maintained its rating for BB-, according to Schineller.

For her, and focusing on Brazil, some of the current ratings factors point to a less vulnerable position for the country than in previous crises. These more favorable ratings factors include a lower external vulnerability, a history of meeting inflation

targets, and exchange rate flexibility. These policy components have acted as key buffers for the Brazilian economy as opposed to Argentina, for example, which is in a less favorable monetary, fiscal, and external position. These same policy indicators are somewhat stronger in Mexico than in Brazil.

For Schineller, the key challenge for Brazil in 2021 and beyond will be the adjustment of the public accounts, which will imply difficult economic policy dilemmas. If Brazil does not unwind the fiscal stimulus it adopted in 2020, with its important implications for health and poverty, this could affect its ratings assessment in the future. This point gains special relevance when it is considered that, after the global financial crisis of 2009, Brazil adopted a series of parafiscal measures that were kept in force for too long a period of time, thus feeding into a dynamic of successive downgrades by the ratings agencies.

### **Opening Remarks by Ana Paula Vescovi**

Ana Paula Vescovi highlighted one of the main challenges of Brazil: to simultaneously promote the fiscal consolidation of the country and an increase in productivity of the public sector. Vescovi pointed out that the Brazilian state already imposes a high tax burden, since about 40% of the economy is directly related to the public sector, better management of public resources are required. However, the fact is that the Brazilian state spends poorly and inefficiently. One implication is that Brazil cannot spend more in the future on fiscal stimulus payments, either through social policies or income transfers. This is due not only to the macroeconomic constraints present at this time, but also in view of the difficulty in making efficient use of the resources already available to the government.

Vescovi affirmed that the Brazilian government is hostage to interest groups present within the public and private sectors that capture the state budget for



private interests, undermining the efficient management of public resources. In addition, the Brazilian economy is excessively closed and subject to a low level of internal competition. Reforms have been attempted. These include the Fiscal Responsibility Law in the early 2000s, the “expenditure ceiling rule” (Constitutional Amendment 95), passed in 2016 and which stabilized primary expenditures at 19% of GDP, and the Pension Reform, passed in 2019. However, even these reforms have been insufficient to produce primary surpluses in recent years; hence, the relationship between public debt and GDP has continued to rise.

For her, this debt problem is due to structural macroeconomic issues: the persistent growth of mandatory public spending, especially with respect to the payroll of civil servants and the provision of pension payments to society. In addition, discretionary expenses, such as public investment, remain compressed, which is a sign of poor management of public resources, given the centrality of investment to the economy. Thus, further reforms intended to reduce compulsory expenditure will be required, also encompassing expenditures by subnational government entities.

Vescovi pointed out that, although Brazil’s external position is one of low external vulnerability, this situation is a temporary benefit, especially when one takes into account the recent behavior of the interest curve and the exchange rate, indicating that the Brazilian external scenario may worsen in the near future. Brazil does not have fiscal space, such as advanced economies, for new fiscal stimulus. This is particularly evident in view of the fact that the real interest rate corresponds to about two and a one-half times the potential growth rate of the country, which, added to the rigidity of the mandatory expenditures, causes public spending to increase. This is a fiscal bottleneck that must be cured, in her opinion.

In conclusion, Vescovi declared

that although Brazil may not be faced with an insolvency crisis, such as the one that occurred in the 1980s, it would be very difficult for policymakers to manage a situation of fiscal dominance without severely adverse impacts on the economy. For her, these impacts could well include a return to high levels of inflation and the weakening of the currency, both posing a major threat to the inflation-targeting regime. Furthermore, there is a substantial tax evasion that, in addition to harming government revenues, compromises the economy’s growth potential. Thus, from the point of view of revenue, the only way to promote fiscal consolidation would have to come from a tax reform that would allow a greater income elasticity of tax revenues and an improvement in the efficiency of the tax collection system.

## PANEL II

# STRUCTURAL CHALLENGES AND THE GROWTH AGENDA

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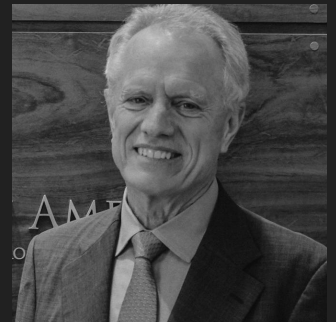
Debora Revoltella



Laura Carvalho



Edmund Amann



Thomas Trebat



Álvaro Pereira



Albert Fishlow



Otaviano Canuto



Jan Svejnar

# STRUCTURAL CHALLENGES AND THE GROWTH AGENDA

JANUARY 29, 2021

The Panel II was moderated by **Thomas Trebat**, Director of Columbia Global Centers | Rio de Janeiro, and **Jan Svejnar**, who led the discussion among panelists. The specific theme of this session was the structural challenges for growth in Brazil and in the world. Panelists and commentators were the following: **Debora Revoltella**, Chief Economist of European Investment Bank; **Laura Carvalho**, Associate Professor, Faculty of Economics and Administration at University of São Paulo; **Edmund Amann**, Professor of Economics, Leiden University; **Otaviano Canuto**, Adjunct Assistant Professor, School of International and Public Affairs, Columbia University; **Álvaro Pereira**, Director of the Country Studies Branch at the OECD Economics Department. This session featured comments by **Albert Fishlow**, Professor Emeritus, Columbia University.

## Opening Remarks by Debora Revoltella

Debora Revoltella pointed out that Europe was one of the regions most affected by the COVID-19 crisis, and was also one of the first to react to its economic impact. In general, at a significant economic cost, the countries of the region have prioritized measures of social distancing and other actions to mitigate the effects of the pandemic. In some European countries, a GDP decrease of around 15% has been observed in the first half of 2020. Europe did benefit from the experience in the 2008-2009 global financial crisis that the European economies were able to provide a timely response to the COVID-19 crisis. In the German example, later disseminated to other European countries, the government provided assistance to all affected

companies for the payment of salaries. This kept their employees in their jobs and their remunerations intact, despite reduced or partially remote working hours.

Revoltella affirmed that the European governments also authorized a delay in the payment of taxes, including payroll taxes. This was in addition to financial support through guarantees to banking institutions to permit the banks to maintain their credit operations.

The fiscal rules in force in the Eurozone were made more flexible, which allowed countries to implement an expansionary fiscal policy, an effort that was supported by the European Central Bank through policies of quantitative easing, allowing a refunding of debt at very low interest rates. This combination of measures taken at the national and European levels mitigated the impacts on people, non-financial companies, and the financial sector. Throughout the second half of 2020, there was a gradual recovery in economic activity in Europe and greater control over the spread of the virus was achieved.

Looking ahead, Revoltella sees four challenges that could stand in the way of the European recovery process in 2021.

The first is the asymmetric nature of economic recovery in terms of sectors, types of companies, and between countries and within countries; such asymmetries can accentuate existing inequalities.

The second challenge is related to the adequacy of funding sources, in view of the increase in leverage observed, due to the credit expansion measures taken as part of

the economic recovery measures.

The third challenge concerns the social dimension, and the ongoing digital and green transitions, which will require a process of retraining the workforce in order to prepare them for new jobs.

Finally, the fourth challenge is associated with fiscal policy. Over the last 40 years, every time fiscal expansionism has been practiced in European countries, this increase in expenditures was followed by fiscal consolidation. However, in the latest period of fiscal consolidation over the last ten years, public investment has remained below its long-term trend.

In summary, for Revoltella, the prospects for Europe in 2021 are quite uncertain, due to the impacts of a second wave of the virus and the uncertainty associated with the speed of the vaccine rollout.

### **Opening Remarks by Laura Carvalho**

Laura Carvalho pointed out that the negative economic effects caused by the COVID-19 crisis were greater in Latin America than in the developed countries due to the presence of deeper structural problems, such as inequality, social exclusion, the importance of services in GDP, particularly personal services and tourism, and the high informality in the labor market. On the other hand, within the region there was a significant difference in the economic policy responses to the pandemic and also with respect to the starting points of each country. These contrasts are clear, for example, in the comparison between Brazil and Argentina. In this regard, Brazil has responded particularly poorly in the health area when compared to other countries in the region, whether in the control of the virus or in the vaccination process currently underway.

However, she argued that, in terms of economic policy, Brazil did remarkably well in comparison to other countries in Latin America and compared to other countries

with comparable levels of per capita income. Brazil had a response in the fiscal area similar to the rich countries<sup>1</sup>; Brazil was ranked at sixteenth in a sample of 176 countries studied in terms of resources used to combat the effects of the COVID-19 crisis. Thus, Brazil spent 8.4% of GDP in emergency spending compared to a world average of 3.9%. This fiscal response limited the fall in Brazil GDP in 2020 to 4.1%, a much lower decline than in other Latin American countries.

For Carvalho, the main measure adopted in the tax area in Brazil was the creation of the Emergency Aid (“Auxílio Emergencial”) program, a broad income transfer program for the most vulnerable populations. The program directly reached about 70 million people in 2020, expending in total more than six times the annual spending allocated to the Bolsa Família program, historically the main conditional cash transfer program destined to very poor families in the country, covering about 14 million families in 2020. The Emergency Aid program, in addition to mitigating the fall in aggregate income caused by the pandemic, led to the reduction of poverty and inequality in the country. This was due to its positive effect on the income of people located at the base of the remuneration structure, especially in low-skill segments in the service field. This improvement in rates of poverty and inequality in Brazil during the pandemic is a paradoxical outcome.

Laura Carvalho maintained that by abruptly ending the Emergency Aid program in the beginning of 2021 the government is making a mistake. Cancelling or scaling back this program would not tend to raise poverty and inequality levels again, but would also reduce prospects for recovery in Brazil. The economic recovery in Brazil in 2021 might be slower than the global economic recovery, the opposite of what occurred in 2020.

### **Opening Remarks by Edmund Amann:**

Edmund Amann based his presentation

<sup>1</sup> Available at: <https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19>

on his newly released book entitled: *The Brazilian Economy: Confronting Structural Challenges* (2020) He identified three major Brazil is to succeed in reaching a sustained economic growth path for the long-term. These are: (i) the issues of competitiveness and productivity related to the observed decrease in total factor productivity (TFP); (ii) macroeconomic issues related to fiscal policy and the recurrent trend of public deficits; and (iii) issues related to the lack of social inclusion and environmental sustainability, which are problems by themselves, and also impact adversely the long-term growth trajectory.

Regarding the economic growth in Brazil in recent decades, the high volatility of the growth rate has been a striking feature, according to Amann. Moreover, in contrast to the period between 1950 and 1980, when the country exhibited rapid economic expansion, the growth trend has since declined, and especially in the period after 2014. The explanatory element for this behavior of the growth rate in recent years is to be found in low rates of capital formation, especially when compared to investment levels in China over the same period. Added to this is the trend of reduction of TFP from 1990 to today, especially when compared to the performance of other countries, such as China, indicating that there are also deficiencies in the human capital of the country related to the poor skills qualification of the Brazilian workforce. This is visible in the country's performance in the PISA exam, which despite the increase in expenditure in the area of education in the last 20 years, has improved only modestly, and continues to be ranked poorly compared to other countries.

On the other hand, Amann drew attention to more positive factors, such as the important progress that Brazil has made in the financial area. Some of these advances resulted from institutional improvements that allowed the interest rate to fall to record low levels while inflation remained under control. In addition, the capital markets in Brazil have

benefited from financial innovations, such as fintechs, which hold the potential to expand the sources of funding for investment.

Amann concluded by stating that the structural challenges of the Brazilian economy he analyzed are being widely recognized, although reform efforts have so far focused only on the public accounts and the financial market. The current pandemic has put enormous pressures on the Brazilian economy, already prior to the crisis had been facing severe structural restraints on growth. It is imperative to face these structural impediments if Brazil is to achieve sustainable and inclusive economic development beyond the pandemic period.

### **Opening Remarks by Otaviano Canuto**

Otaviano Canuto also proposed to focus his remarks on the structural issues underlying Brazil's long-term performance, especially its low economic growth rates. He summarized his interpretation based on a metaphor according to which Brazil suffers from a dual economic disease: "productivity anemia and public sector obesity".

"Productivity anemia" would be expressed in the mediocre performance of labor productivity in the country, which grew only 0.7% per year from the mid-1990s. This would result from the combination of the following elements: (i) low public investment and the resulting weak infrastructure in the country; between 1990 and 2016 infrastructure grew only 27%, while the GDP doubled; (ii) an uncompetitive business environment, with subsidies for specific companies and sectors that would not be competitive otherwise; (iii) complex tax rules, with different tax regimes in the individual subnational entities (states and municipalities). The growth observed in recent decades would result, above all, in the incorporation of people into the economically active population, a process related to the rapid aging of the population. The demographic transition has expanded the supply of labor in the country.



With regard to public sector obesity”, Canuto pointed out that while public investment in infrastructure has fallen in percent of GDP between 1991 and 2014, primary public spending grew, increasing its share from 22% to 36% of GDP in this period. The ratio of primary spending to GDP stabilized after 2016 with the enactment of the “expenditure ceiling rule”. This new fiscal rule could lead to a “reasonably soft adjustment” of public accounts, changing the upward trajectory of public debt in the long term. For this process to continue, however, reforms to reduce spending in three areas are needed: (i) the social security system; (ii) the remuneration of civil servants, who in several careers received more than their counterparts in the private sector; and (iii) business subsidies which amounted to 4.5% of GDP in 2017. Although a pension reform was approved in Congress in 2019, the other two areas marked for reforms have not yet been addressed.

According to Canuto, the COVID-19 crisis, and the increase in public spending associated with it, increased pressure on Brazil’s public finances as evidenced by a rise in short-term public indebtedness and an increase in interest rates. This trajectory of increased perception of risk associated with its public debt could lead the country to a “macroeconomic crossroads” where difficult choices between social spending and public debt management would have to be made. Already, it seems impossible to maintain in 2021 the Emergency Aid program on the same terms as in 2020. Canuto indicated that an alternative might be to put together social spending from the Emergency Aid program with funding from Bolsa Família and similar income support programs. To the extent that some families benefit from two or three overlapping government programs, some efficiency could be gained by combining these various sources. This could be an important step toward a minimum basic income program in Brazil, albeit the Bolsonaro government does not seem to favor this possibility.

## Opening Remarks by Álvaro Pereira

Álvaro Pereira also addressed structural issues impeding economic growth in Brazil. He said these will be even more evident as the COVID-19 pandemic crisis is gradually overcome. The outlook for near term economic growth in Brazil is guarded; the OECD forecasts in 2021 a growth rate of around 2.6% and 2.7%. Brazil has been discussing various reforms since the government of President Dilma Rousseff. As other panelists have pointed out, several important reforms have been carried out already, including the “expenditure ceiling rule” in 2016 and the Pension Reform in 2019. However, while relevant, these reforms are insufficient to address the structural constraints on growth in Brazil. A broader context is needed to understand why.

The starting point for the analysis that Pereira proposed is the fall in TFP in recent decades, a fact also observed by Edward Amann in his remarks. In the light of international comparisons, for Pereira, the Brazilian economy’s poor TFP could be the result of a series of factors of which six are suggested below and illustrated by brief examples:

(i) International trade. The Brazilian economy is extremely closed to international trade, with a low coefficient of openness and weak integration into global value chains. This situation is attributable to high trade barriers making imported inputs extremely expensive, with special emphasis on the import of capital goods.

(ii) Excessive bureaucracy. Brazil requires the largest number of hours for companies to prepare their taxes. It is difficult to open and close companies, which hinders entrepreneurship. Regulation is excessive in the labor market, etc.

(iii) Poor infrastructure. The quality of the country’s road systems, on which most transportation depends, is extremely low in international comparative terms.

(iv) Inefficient judicial system. The average time to resolve civil and commercial cases is inordinately high in Brazil.

(v) Poor quality of education. Brazil's educational performance on the PISA exams indicates serious problems of educational achievement.

(vi) High levels of informality. More than 40% of the workforce operates in low-skill occupations and lacks basic protection provided by labor legislation.

In view of these problems, Pereira urged a broad set of reforms to meet the following objectives: (i) Reduction of tariff and non-tariff barriers, starting with capital goods and intermediate consumables; (ii) Simplify the requirements for opening and closing companies; (iii) Consolidate consumption taxes into a single value added tax; (iv) Ensure the alignment of judicial decisions with decisions made in the higher courts; (v) Continue expanding access to early childhood education, prioritizing access for low-income families and single mothers; (vi) Increase resources for professional training programs, in particular for low-skilled, unemployed, and informal workers.

Successful reforms in these areas, according to OECD estimates, could raise the growth rate of the Brazilian economy by about one percentage point per year over the next fifteen years.

Finally, with respect to Brazil's fiscal finances in the long-run, Pereira pointed out that the reform program should pay close attention to "fiscal prudence", e.g., stabilizing the relationship between public debt and GDP at around 100% by 2025.

### **Comments by Albert Fishlow.**

Albert Fishlow warned that the economic crisis caused by the pandemic has accentuated the degree of economic nationalism in countries, a characteristic that

has been increasing in recent years in the world economy. This subject is relevant for Brazil, a country that has always had a low participation in international trade. Fishlow indicated that at the moment there are two conflicting policy stances, a policy conflict that has existed in Brazil for many decades in fact.

For Fishlow, the first policy approach is one of a liberal nature, represented today by Paulo Guedes, the Minister of Economy. This policy orientation advocates greater commercial openness and a lower direct participation of the state in the economy. The contrasting paradigm in Brazil, represented today by the Brazilian military, advocates greater government intervention in the economy.

According to Fishlow, this clash between economic opinions gains even greater prominence in a country, such as Brazil, with fragile political institutions and susceptible to recurrent demands for impeachment of its highest authorities, even though the grounds for impeachment may be no more than mere disagreement with the policies adopted by the government. This tendency renders unstable the institutional order of the country, a characteristic that seems to be also appearing nowadays in the U.S. political system.

Bolsonaro's term began by approving the pension reform, a topic that also focused the attention of previous presidents at the beginning of their terms of office, observed Fishlow. For him, repeated reforms of the pension system are necessary given the rapid aging of the Brazilian population. However, Bolsonaro has not made any further progress on the reform agenda, while Congress has demonstrated a degree of relative political autonomy in relation to the Executive. This stance increases and renders the country's bureaucracy even more difficult. Fishlow drew attention to the legal difficulties of promoting changes in Brazil, since new laws are often passed without their necessary implementing regulation to

ensure that the law is actually applied in practice. Brazil today has one of the most bureaucratic business environments in the world.

In addition to excessive bureaucracy and closed nature of the economy, Fishlow declared that Brazil needs to raise its investment rate from the current level of 14% of GDP, a meager level of investment which makes it impossible to sustain a trajectory of long-term growth. Reforms must be geared to do more than to simply remove the state from the economy. Another type of government intervention is needed, designed to raise the productivity level in the Brazilian economy. This is particularly the case in light of the low levels of forecast growth. In 2022-23, growth is forecast to be below 2.5% per year, clearly insufficient for the country to start dealing with all the real problems that exist.

### **Discussion Among the Panelists Led by Jan Svejnar**

Jan Svejnar highlighted the presence of asymmetries in terms of sectors, social groups, and countries in the economic recovery process. He stressed the importance in the European case of retraining the workforce for the jobs of the future, a policy stance that may also be relevant for Brazil.

Turning his attention to the Brazilian case, Svejnar underlined the oddity of its experience, originally discussed by Carvalho, in which recovery policies were able to reduce the country's poverty, albeit temporarily, in the midst of the pandemic. From a longer term point of view, Svejnar took note of the fall in TFP in Brazil, a serious impediment to future economic growth.

According to him, however, the panelists did not paint a totally negative scenario for Brazil. For example, the structural improvements in the capital markets, a point raised by Edmund Amann, are a potentially important development. Finally, Svejnar stressed the necessary reforms pointed out in

the areas of social security, the improvement of the educational system, and the efficiency of the country's bureaucracy would be very important changes for the future of the Brazilian economy.

Debora Revoltella noted the similarity between the Brazilian and European challenges. In the case of the latter, she indicated that it will be an important political challenge to identify when the right time will be to move from indiscriminate government support to companies and people to more targeted support in favor of digital transition and environmental sustainability, something that can also be done in Brazil. This could happen, for example, by means of directing the investment to areas that prioritize energy efficiency, on one side, and, on the other, to condition the receipt of government aid to programs of professional retraining.

Laura Carvalho argued in support of a long-term reform agenda for Brazil, one that is lacking at present. Tax reform is needed not only to simplify tax collection, but also to make the Brazilian tax system fairer and more progressive. Moreover, although she also recognizes the need for other reforms, such reforms to reduce expenditures should not be seen as ends, as if simply reducing the participation of public spending in GDP could lead to growth by itself.

In this respect, again, she emphasized the dysfunctionality of the "expenditure ceiling rule", which intensified the distributive conflict over the public budget, and which ended up by enabling more organized interest groups to meet their demands, as was the case of the Armed Forces. Moreover, this reform did not allow the government to achieve greater fiscal space to expand social protection that we consider to be crucial in the long run. This static rule is not clearly linked to the dynamics of the public debt and has not been applied in this way in any country in the world outside of Brazil.

Carvalho agreed with Canuto that it would be necessary to make a transfer



program smaller than the Emergency Aid, but larger than the current “Bolsa Família” program. However, she proposes that this program be financed by the taxation of higher income earners<sup>2</sup>. This would improve the distribution of income as well as increase the growth potential of the country, given the greater propensity to consume from the poorest classes, who would benefit from the transfers. Measures which take benefits away from the middle classes are ineffective from the point of view of income distribution, given the characteristics of income distribution in Brazil which is very concentrated at the top, without glaring disparities between the middle-income groups and the base of the social pyramid.

Finally, Carvalho agreed with other panelists in that Brazil is at a “crossroads”: on the one hand, the country needs to be “responsible” in fiscal terms; on the other, this should not prevent the discussion of the use of the tax policy to expand public investment in “green” infrastructure and socially inclusive expenditure, as other countries are doing.

Edmund Amann also highlighted the need to promote balance in the public accounts and also promote public spending in areas where it is essential, such as in infrastructure. The current “expenditure ceiling rule” does not necessarily lead to a more efficient use of public resources. Finally, in line with Fishlow’s analysis, Amann pointed out that the exact manner in which Brazil faces its economic problems will have a necessary political dimension, in which practical political decisions must be made to enable the reforms discussed in this panel.

Canuto returned to the theme of the quality of public spending, pointing out that the increase in public spending in Brazil

did not result in a comparable increase in the country’s infrastructure. In addition, he cited research by the World Bank and other authors that focuses on the regressive nature of the Brazil tax system which, instead of redistributing, concentrates income even more. He defended the “expenditure ceiling rule” as an imperfect means to force the country to implement more structural measures that would improve the trajectory of public spending over time. He particularly called attention to the need to reduce the excessive weight of legislatively mandated expenditures within the public sector budget.

Álvaro Pereira mentioned that, despite the structural difficulties, Brazil is in a much better situation than in the past. He attributed this to macroeconomic stability, including the introduction of a central bank with operational independence that has succeeded in controlling inflation in recent years. Many of the reforms that Brazil needs do not require money, such as those connected to greater trade openness and the reduction of bureaucracy, although these are measures do find considerable resistance from within the government apparatus. If Brazil does not advance these types of reforms, it will not ascend to the “first division” of the global economy with the ability to compete with the principal economies of the world.

Jan Svejnar concluded the session by saying that the first two panels had presented a very rich mosaic of the international context while also focusing on the performance of Brazil. From the point of view of global economic conditions, China is moving faster, followed by the United States and then Europe. The focus on Brazil outlined a roadmap of reforms that the country must implement. The reforms seem sensible and it may only be a matter of political will to implement reforms. The current crisis could wind up being a good catalyst for reform.

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2 “For more on this point, see: Toneto, Rodrigo; Ribas, Theo; Carvalho, Laura (2021) “Como a redistribuição de renda pode ajudar na recuperação da economia? Os efeitos multiplicadores da tributação dos mais ricos para transferência aos mais pobres”. (Nota de Política Econômica nº 008). MADE/USP. Available at: [https://madeusp.com.br/wp-content/uploads/2021/02/NPE008\\_site.pdf](https://madeusp.com.br/wp-content/uploads/2021/02/NPE008_site.pdf)

## PANEL III

# GLOBAL MONETARY CONDITIONS AND IMPLICATIONS FOR THE EMERGING ECONOMIES

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Patricia Mosser



Seth Carpenter



Francesco Papadia



Guillermo Calvo



Ilan Goldfajn

# GLOBAL MONETARY CONDITIONS AND IMPLICATIONS FOR THE EMERGING ECONOMIES

FEBRUARY 25, 2021

The Panel III, dedicated to monetary issues in the current context of the pandemic, was moderated by **Patricia Mosser**, Director of MPA Program in Economic Policy Management and Senior Research Scholar of International and Public Affairs, Columbia University. Panelists in this session included: Seth Carpenter, Chief U.S. Economist, UBS; **Francesco Papadia**, Senior Resident Fellow, Bruegel (Brussels); **Guillermo Calvo**, Professor of International and Public Affairs at Columbia University and Former Chief Economist at the Inter-American Development Bank; **Ilan Goldfajn**, Chairman of the Board of Credit Suisse Brazil and Former President of Central Bank of Brazil.

## Framing Remarks by Patricia Mosser

Patricia Mosser pointed out that in the current context of the COVID-19 pandemic, government policy has not been limited to fiscal policy instruments. Monetary policy tools have played a key role in increasing liquidity and in the provision of credit to the financial and non-financial sectors in advanced and emerging economies. Brazil is one such example. This massive expansion of liquidity brought new challenges to the examination of current economic policy and its ability to restore economic growth with price stability in the period that will follow the pandemic. Patricia indicated the panelists would address multiple dimensions of this global monetary experience. Seth Carpenter and Francesco Papadia focused their remarks on the experience of advanced economies. Guillermo Calvo and Ilan Goldfajn focused

on the experience of the emerging economies, the latter emphasizing, in particular, the case of Brazil.

## Opening Remarks by Seth Carpenter

Seth Carpenter emphasized the differences between the Fed's performance in the current crisis and its role in the 2008-2009 financial crisis and in the years that followed the traumatic period for the global economy.

For him, there was, first of all, a significant difference in scale when we look at the volume of quantitative easing (QE) operations since the beginning of the pandemic compared to the previous 2008-09 crisis period. Since the onset of the pandemic, the Fed has acquired a monthly average of US\$ 120 billion in assets (US\$ 80 billion of Treasury bonds and US\$ 40 billion in mortgage-backed securities). Between 2010-2013, the peak monthly purchases were US\$ 85 billion per month. (Of course, the difference might not be quite as striking if we took into account the size of the economy or the financial sector.)

According to Seth, differences are notable in the maturity of bonds being purchased by the Fed. In 2012-13, the Fed launched the Maturity Extension Program, selling short-term bonds and buying long-term bonds, with the purposes of reducing longer-term yields. At present, the Fed is buying bonds of different maturities, including short-term maturities, under the guise of guaranteeing the orderly operation of the markets.

QE increased the liquidity of the financial system, since, regardless of who sold the bond to the Fed, there was a replacement in the liabilities of the securities held by banks with bank reserves, thereby increasing the balance sheet of the banks. The peak in the earlier financial crisis was US\$ 2.7 trillion in reserves in the banking system. At the present time, the comparable figure has reached US\$ 3.4 trillion, and could reach about US\$ 5.5 trillion by the end of 2021. At the end of 2020, a quarter of U.S. banking assets consisted of reserves deposited with the Fed, indicative of the country's broad liquidity in the payment system. However, additional regulations on bank reserves could pose potential problems about the future composition of the bank portfolios, with potentially adverse impacts on other financial markets, in particular lending to emerging countries.

For Seth, a key question concerns what might happen when the Fed stops these QE operations once the vaccine rollout facilitates a recovery in the U.S. economy. As employment increases, an impact on inflation is likely to occur which could be expected to lead to actions by the Fed to reduce the system's liquidity. Thus, due to the interconnection of global financial markets, a potential increase in interest rates in the United States and an increase in spreads could have severe impacts on the world economy, particularly for emerging countries. Thus, Seth concluded his opening remarks by indicating that there will be a lot of volatility in the U.S. markets over the next nine to twelve months. It will be necessary to monitor U.S. monetary policy very carefully.

### **Opening Remarks by Francesco Papadia**

According to Francesco Papadia, unlike other crises, at the present moment, monetary policy is in third position from the point of view of the policy determinants of the global economy in the next 12 months, behind the vaccine rollout and fiscal policy, in that order. This crisis presents exceptional monetary conditions, with the

expansion of the balance sheets of the Fed, ECB (European Central Bank) and the BOJ (Bank of Japan) by multiples of ten, five, and six times, respectively. These figures should continue to grow, due to the purchase by monetary authorities of government securities previously held by the private sector. Thus, it is possible to say that, in practice, monetary and fiscal policy are no longer separated. On the other hand, central banks are working to control the interest rate curve in a scenario of interest rates at historic lows. Therefore, central banks are clearly acting in the process of allocating funds, with concerns related to the green economy, income distribution, and fintechs, central banking roles that are more relevant in advanced economies than in emerging ones.

For Papadia, this broad liquidity in advanced economies favors emerging economies, helping these countries to adopt economic policies intended to mitigate the effects of the COVID-19 crisis, keeping interest rates low, and, by reducing global interest rates, allowing many of them to increase their public indebtedness. Some emerging markets had entered the crisis period with no room to increase their debt-to-GDP ratios.

Papadia argued that this expansionary monetary policy may bring risks to financial stability in the future, when there is a reversal in its performance. Macroprudential policies can be really effective in dealing with these risks. However, he does not believe that any reversal in the monetary policy stance is close to happening, either at the ECB or at the Fed. Monetary policy leaders have signaled that inflation and a possible overheating of the economy would not be something to be faced in the short term.

Papadia pointed out that broad uncertainty exists about the future of the world economy due to the asymmetry with which the different economies have responded to this crisis. He argued that some emerging economies have more or

less solid macroeconomic conditions. For him, it is important to recognize in particular China's strong economic performance. But a possible reversal of the Fed's accommodating monetary stance, leading to increasing interest rates and spreads, could create debt sustainability problems, disruption of capital flows, and bankruptcy and stress in the financial system, especially in the emerging economies. Weakening emerging market exchange rates may act as an offsetting factor promoting growth, although exchange rate depreciation would also have negative impacts in terms of inflation.

Thus, for Papadia, thinking about what would be the best exit conditions for the current situation of ample liquidity is something that requires a comprehensive reflection, both by the advanced economies and the emerging ones. At the same time, Papadia noted that the current economic conditions do open up some possibility of better outcomes. In the fiscal area, governments have the possibility of changing the composition of spending and public revenue in order to favor environmentally sustainable economic growth and to combat inequalities. And the adverse effects of the anticipated reversal in global monetary policy could be managed through better regional and global coordination, and perhaps particularly through regional arrangements due to the greater difficulties in achieving coordination on a global scale.

### **Opening Remarks by Guillermo Calvo**

Guillermo Calvo began his presentation by highlighting the unprecedented nature of the current global economic situation in terms of increasing liquidity, something that had been occurring since the Lehman Brothers collapse in 2008, but which has become much more accentuated in the current COVID-19 crisis. This surge in global liquidity can be seen when comparing the growth of M1 and nominal GDP in the United States. Both evolved in a correlated manner until 2008,

but, since that time, M1 has grown at a much faster rate than nominal GDP, and this discrepancy dramatically accelerated last year, something that points to a gap in economic theory.

For Calvo, this discrepancy calls even greater attention when we have in mind that U.S. Treasury bonds were considered assets of maximum liquidity, but they have been converted into banking system reserves in the current environment and not used in the acquisition of toxic assets. Moreover, as Seth Carpenter in his earlier remarks on this panel suggested, that some additional regulations could be interfering with the liquidity of the monetary base. According to Calvo, this state of affairs points to an unprecedented situation that lacks a consensus framework of reference, a situation in which very different opinions can, at the same time, seem quite reasonable.

Although there has been no increase in inflation in general terms so far, Calvo affirmed it is possible to observe an inflationary process in the financial asset markets, with an increase in stock exchange indexes in the midst of the pandemic, including in emerging markets, such as Brazil. For him, this is another novelty, as in other financial crises what was observed in emerging economies was an increase in spreads, an acceleration of inflation, and a drop in output, which we are not observing at the present time. This time around, the fiscal deficit of emerging countries in 2020 reached levels close to the deficits recorded in advanced countries, around 9% of GDP. This increase in deficit spending is something that could lead to problems for emerging countries in 2021 due to their lower indebtedness capacity.

Calvo noted that the current U.S. monetary policy has transparency issues with risks of inflation and financial instability in the country. For him, It is not clear what will be done with monetary policy in the event that these risks are confirmed. In addition, even a small increase in interest



rates could reduce the present discounted value of financial assets, which could have devastating effects on the emerging markets. Moreover, although inflation is low, this should not be taken as a measure of credibility of monetary policy. This could trace back to monetary dynamics during the pandemic, a time when people's demand to hold monetary balances increases due to precautionary reasons.

In conclusion, Calvo called attention to the specific nature of the current economic crisis and its future risks. According to him, we do not have much experience in dealing with these developments, except if we think back to the 1930s. At that time, the economic crisis was partially resolved only as a result of World War II. It is to be hoped that we will be able to do better this time.

### **Opening Remarks by Ilan Goldfajn**

Ilan Goldfajn focused on the experience of Brazilian monetary policy during the current crisis. The economist noted that, similar to the United States and the European Union, Brazil and other emerging economies combined very low real interest rates with expansionary fiscal policies. This economic policy mix, although not reflected in a general increase in inflation, has resulted in the valuation of financial assets, particularly stocks, and it is unclear to what extent this process could translate into bubbles in the future. However, as long as the present global expansionary monetary conditions prevail, asset prices well may continue on this upward trajectory.

For Goldfajn, while those responsible for economic policy are not signaling when there will be a reversal in the monetary expansion now observed, the relevant market agents have already started to show signs of concern with the exit from this situation, which could have negative consequences for emerging economies, as has already occurred on other occasions. For example, in 2018, the increase,

even if slight, in the global interest rate triggered crises in Argentina and Turkey, with depreciation of the exchange rate, an increase in interest rates, and a tightening of financial conditions.

At the present time, Brazil is not ready for this change, according to Goldfajn. For him, the country finds itself in a position of political uncertainty and fiscal fragility is mounting, as evidenced by the increase in the ratio between gross debt and GDP to 89% at the end of 2020. It is already possible to observe signs of an increase in inflation and a tendency for basic interest rates to rise. The rise in interest rates also reflects an additional premium due to the fiscal position. This more fragile fiscal situation has also had repercussions on the Brazilian exchange rate, which devalued more in 2020 than those of other countries. This could be a sign that the market anticipates that this process of monetary policy reversal is closer to happening than the Fed and ECB are saying.

The depreciation of the Brazilian exchange rate is a consequence, in part, of a structural change in interest rates to lower levels. According to Goldfajn, this shift has brought Brazil closer to a normal situation than in previous periods in which the combination of high interest rates and an appreciated exchange rate made the country expensive in foreign currency terms. However, for him, the exchange rate volatility observed over the last six months is most probably related to the perception of Brazil's fiscal fragility. Evidence to support this point is that the early 2020 appreciation of global commodity prices did not lead to any increased valuation of the Real; in fact, the opposite occurred.

In sum, projected inflation for the next 12 months in Brazil has been rising, reaching the upper limit of the Central Bank's target range. Thus, for Goldfajn, linking back to the global environment of broad liquidity and exit concerns, in the Brazilian case, the current and expected

increase in the rate of inflation and interest rates would be evidence that the global liquidity exit scenario seems to be much closer than we might have thought.

### **Discussion Among the Panelists Led by Patricia Mosser**

Patricia Mosser asked the speakers what is expected to happen in case markets are right, and that the reversal in economic policy and in global liquidity conditions happens in a future closer than that now being signaled by economic policy makers.

Seth Carpenter pointed out that QE policies already show signs of tapering off. On the other hand, in terms of inflation, the 2021 fiscal stimulus package announced by the Biden Administration will act more to stimulate the economy probably starting in Fall of 2021, and is not likely to cause overheating. This is because the state and municipal entities used part of the resources they received to pay down debts; the same dynamic played out with respect to transfers received by families. Thus, the net effect of fiscal stimulus in the United States on aggregate demand will be less than many imagine. Expected GDP growth for this year, although vigorous, will not be enough to close the product gap until early in 2022. For Seth, inflationary pressures would be more likely to occur from that point in time forward, which would lead to interest rate increases in the US. in 2022.

Ilan Goldfajn supported this view, adding that central banks will fight against market expectations of rising rates as long as they can, that is, as long as the output gap is positive and there are no signs of stagflation. However, for him, the Brazilian case is instructive. With inflation already rising, the Central Bank's reaction will be to raise interest rates. According to Goldfajn, the point to emphasize is that global central banks will react only as signs of actual inflation are observed, and will not react simply to rises in asset prices or signs of market bubbles.

Guillermo Calvo anticipates the Fed will accompany the large fiscal effort in the United States; otherwise, market interest rates would rise. However, in light of the greater interactions between the Fed and the Treasury, he noted a possible interest rate increase will impact prices of the Treasury bonds with potentially negative repercussions on the stock market. This could lead to widespread distress in the financial system, which would require the Fed to return to operating in the market. So the current situation does raise concerns.

Francesco Papadia argued that the current interest rate would not be above that corresponding to the "natural rate", in Wicksellian terms, i.e., the interest rate compatible with growth in potential GDP. This increase might occur first in the United States where the impact of fiscal stimulus has been greater than in Europe. If this increase does occur, it could have very strong impacts on the emerging economies because of their high debt levels and more fragile fiscal positions compared to the advanced economies.

Patricia then asked about the possible impacts of the high levels of leverage in the non-financial corporate sector. Corporate debt levels have increased in almost all countries of the world in the context of the current crisis with potential implications for financial stability in both emerging and advanced economies. She pointed out this scenario could have negative impacts on small companies.

Ilan Goldfajn shared this concern, but said it is unclear what can be done about it at this time. It will likely be a topic that will be quite relevant in the future. Francesco Papadia indicated the need to rethink the set of macroprudential measures currently adopted, because although there are intrinsic limits in their scope, macroprudential policies could be used in a more beneficial way to reduce risks associated with corporate

leverage. Seth Carpenter also agreed that financial stability is the key issue, the behavior of which could impact the real side of the economy. However, he noted that the focus of financial stability is on the financial sector. While the concern about the leverage of the non-financial sector is clear, what can be done about the concern that would protect financial stability is not evident.

Patricia Mosser noted that financial crises exhibit both financial and real sector impacts with relevant consequences for economic performance. This is what occurred in the 2008-09 financial crisis with its fallout on the real estate market and on families. At least in the United States, the existence of a housing bubble can translate into a crisis in the labor market and that it can take a very long time to recover because everyone needs to deleverage at the same time as the financial sector. This may be a concern in the future, when the economy moves closer to its normal operation.

Patricia Mosser then asked the speakers for their views on the new roles that seem to have been assigned to central banks as a result of their greater interaction with fiscal policy. These new roles would involve central banks more in the process of actually allocating credit resources, particularly in the case of advanced economies. Central banks are also being asked to participate in other discussions, such as those surrounding climate change.

Francesco Papadia said he was uncomfortable with this closer interaction between monetary and fiscal policy. The tradition has been that fiscal and monetary policies are formulated separately, so that the central bank should not be involved in the process of allocating resources nor should it have concerns about income distribution. At the same time, he noted a reversal of this approximation between the two policies could be difficult, especially when this process has been ongoing for at least the last twelve years since the great financial crisis, in 2008-2009.

Ilan Goldfajn noted that central banks have been facing the same problems about redefining their roles as have other economic agents. Companies have begun to pursue not only maximum value for the shareholder, but also objectives relating to social and environmental governance. This new context requires rethinking the role of central banks in order to preserve their original functions while also seeking to meet realistically what society is asking of them, and not try a simple return to the past.

Guillermo Calvo emphasized that the situation of the pandemic is atypical, and has made the interpretation of the respective roles and instruments of monetary and fiscal policies confusing. However, it is necessary to preserve the temporal consistency of policies. Thus, for him, if fiscal policy remains expansionary, this may require monetary policy responses, due to the potentially negative effects of an expansionary fiscal policy on the market value of government securities.

Seth Carpenter also expressed discomfort with the current stance of monetary policy in the United States. He stated that he is attached to the “mythology of American democracy”, contrasting that with the deliberately non-democratic character of the Fed. For him, the Fed needs to remain politically isolated in order to fulfill the roles and responsibilities for which it was clearly designed. On the basis of this understanding, the pursuit of broader social goals such as equality, income distribution, and the choosing of winners and losers should be addressed in those areas of government in which the authorities were elected to make such decisions. According to Seth, this would give such decision making the appearance, at least, of fulfilling a democratic responsibility. On the other hand, when this line becomes undefined, which is occurring frequently, elected members of government end up not having the courage to make difficult decisions, transferring part of the burden of these decisions to the central bank. Such positioning weakens institutions in the sense



that decisions are not democratically taken. This could lead to poor results.

Guillermo Calvo, whilst is fully in agreement with this point, stressed, at the same time, these are extraordinary circumstances. Thus, according to him, due to the entirely unprecedented nature of the pandemic shock, central banks would not be breaking a rule, since there would simply be no rule that could have contemplated such an extreme situation.

Ilan Goldfajn added that, although agreeing with Seth's view on the limits of central banks, this view may not apply in our current reality and, perhaps, not for the next 10 to 20 years. The matter is up for discussion and will require a serious reflection on what is up to the central bank to accomplish and what is not.

Finally, Franceso Papadia recalled that the central banks of advanced economies are actually doing now what the central banks of emerging economies have always done. He expressed hope that this anomalous situation would not last for the next 10 to 20 years and would be very happy to see this time period shortened.

## PANEL IV

# GLOBAL FISCAL CHALLENGES IN THE POST-PANDEMIC PERIOD

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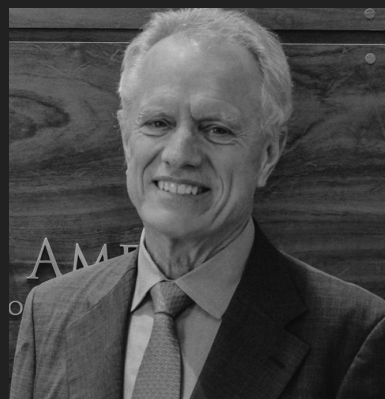
Jan Svejnar



Danny Leipziger



Ana Carla Abrão



Thomas Trebat

# GLOBAL FISCAL CHALLENGES IN THE POST-PANDEMIC PERIOD

FEBRUARY 26, 2021

The Panel IV, moderated by **Jan Svejnar**, Brazil's recent fiscal performance was discussed in greater detail, including the risks inherent in an increase in its public sector indebtedness in the context of the current COVID-19 pandemic. Members of the panel included: **Danny Leipziger**, Professor of International Business & International Affairs, George Washington University; **Ana Carla Abrão**, Partner of Oliver Wyman Co. (São Paulo); and **Thomas Trebat**.

## Opening Remarks by Danny Leipziger

Danny Leipziger covered three topics: (i) an overview of the global fiscal situation; (ii) the current Brazilian fiscal framework; and (iii) the fiscal perspectives for the post-pandemic period.

The economic crisis caused by the COVID-19 pandemic led to a fall in GDP in most countries as a result of the retraction in aggregate demand due to declines in exports, family consumption, and private investment. Each of these GDP components was severely impacted by the pandemic. In response to this drop in aggregate demand, many countries executed an expansionary fiscal policy, though to varying degrees consistent with their resources.

Broadly speaking, according to Leipziger, advanced countries adopted stimulus packages of around 15% of GDP, middle-income countries at 10%, and low-income countries at 5%. The aggregate was about US\$ 14 trillion in stimulus spending around the world during 2020. Given the seriousness of the current situation, even

economists linked to institutions such as the IMF and the World Bank recommended fiscal activism as a means to mitigate the effects of the crisis, pointing out that the potential problems arising from excessive indebtedness would have to be addressed later. Even so, fiscal expansion has been unable to prevent the drop in the level of economic activity in most countries; according to IMF projections, only in 2023 is GDP expected to recover to the pre-crisis 2019 levels in most economies of the world.

Leipziger stressed that this substantial increase in public spending occurred along with a drastic reduction in tax collection, a phenomenon common to recessive periods, which resulted in an extraordinary expansion of deficits and the increase in public debt in almost all countries. In general, countries were already excessively indebted in the pre-crisis period, although the low global interest rates made the cost of carrying that debt less onerous than at other times of higher interest rates. Attention needs to be paid to the quality of spending, especially in emerging countries, where excessive indebtedness may become a problem in the near future. Advanced economies, in particular the United States as the issuer of the international key currency, have a greater debt capacity than economies with lower degrees of development.

Turning to the Brazilian case, recent fiscal reforms, such as the approval of the “expenditure ceiling rule” (Constitutional Amendment 95/2016), point to a greater control of public expenditure in the future. However, the rigidity still present in public expenditure—about 90% of public expenditure

is constitutionally mandated – might reduce the radius of maneuver to reduce public expenditures even more. In this sense, an alternative to reduce public expenditure in Brazil would be the reduction of subsidies to the private sector. Brazil has started to reduce these subsidies. For example, Leipziger recalled that the subsidies implicit in National Bank for Economic and Social Development (BNDES - Banco Nacional de Desenvolvimento Econômico e Social) lending to private firms in Brazil have been reduced since passage of a reform in 2018. However, many other subsidies to business remain in place and need to be re-examined, according to Leipziger.

For him, the fiscal situation in Brazil is not all grim. Brazilian public debt is essentially domestic debt. While this is positive, the large amount of public sector debt can cause distortions in the domestic capital market by directing resources to public securities and compressing the availability of financing to the private sector.

Beyond this, Leipziger emphasized it is necessary to look at the denominator of the public debt/GDP ratio, the main indicator used to assess country indebtedness conditions. In this context, it is of concern that Brazil has not had sustained economic growth for almost a decade. Measures must be considered to accelerate growth. According to him, these include the expansion of expenditure in infrastructure (the sector of the economy in which public spending is generally complementary to private investment) and measures that increase competition in the economy and improve the business environment by reducing bureaucracy. Regarding the prospects for fiscal stability, the current international scenario is one of abundant international liquidity, so that countries, particularly the emerging economies, should seek to attract foreign investments in productive sectors.

Finally, for Leipziger, debate will continue on how much public debt is

safe to assume by the global economies. He pointed out that economists, such as Olivier Blanchard, argue that countries should be less concerned with the size of the public debt if interest rates remain low. As long as the GDP growth rate is higher than the interest rate on the debt, there would be no upward trajectory of the debt-to-GDP ratio. To Leipziger, this debate on public spending to promote economic recovery has particular relevance in the United States where debate rages over the size of the US\$ 1.9 trillion infrastructure spending package proposed by the U.S. President Joe Biden. Economists, such as Larry Summers and Blanchard, consider this level of spending as excessive while others, including Joseph Stiglitz and Paul Krugman, consider it appropriate. In either case, in the United States and elsewhere, the key issue is to evaluate what will be the allocation of this spending, particularly what will be the expected returns on these expenses.

### **Opening Remarks by Ana Carla Abrão**

Ana Carla Abrão concentrated her remarks on the Brazilian fiscal experience, highlighting that the public debt/GDP ratio is currently at 89% in Brazil, a very high level and one that is likely to increase in the next few years. On the basis of a study by the Independent Fiscal Institute (IFI), Brazil will only manage to stabilize this ratio in the year 2030 at a level slightly higher than 100%. A major reform push will be needed to promote economic growth and for the country to return to a more benign fiscal trajectory at some point in the future.

For Ana Carla, some reform legislation is pending in Congress to address the fiscal imbalance, including three constitutional amendments which require a qualified majority (three-fifths of the Congress). These pieces of legislation deal with imparting greater flexibility in government expenditures, tax reform, and public service reform, referred to in Brazil as administrative reform.

Ana Carla recalled that the “emergency amendment” (Proposal for Constitutional Amendment 186/2019), originally introduced in Congress in November 2019, is essential to ensure greater flexibility in the structure of public expenditure<sup>1</sup>. It provides for the possibility of future reductions in government spending through the freezing of the payroll of civil servants, reductions in government hiring, and re-evaluation of tax incentive measures in effect in order to increase tax collection. For her, this last measure could be particularly important with respect to subnational entities in Brazil (states and municipalities) which are in an even more fragile fiscal situation than the federal government. However, the pandemic and its aftermath have radically changed the terms of the discussion. Social spending in Brazil has increased very rapidly since 2020 and has been largely financed through the issuance of public debt.

According to Ana Carla, various measures now in front of the Congress deal with the question of tax reform. Surely Brazil has one of the most complex tax systems in the world, so the objective is to simplify the system around a centrally-collected value added tax. It is possible that some form of tax reform will be approved later in 2021. In addition, problems such as the regressiveness of the tax burden need also be addressed.

For Ana Carla, the most important structural reform for Brazil is the administrative reform which the Government sent to Congress in 2020. This reform can reduce bureaucracy and thereby remove impediments to growth and promote lesser inequality in the country. (Brazil is one of the most unequal countries in the world). This is true for three main reasons.

First, public service reform may have a positive impact on the quality of public services for the population. According to her, the current structure for careers in the public service in Brazil is rigid, outdated, and extremely expensive. The operational redesign of the public sector, as proposed in the administrative reform, should include a number of key measures. These include: the redefinition and flexibilization of the hiring processes of civil servants while maintaining its neutral and fair character; the implementation of individual and collective performance evaluation models; drawing an explicit relationship between the remuneration of civil servants and their respective performance evaluations, including the possibility of dismissing poorly-performing employees; and investment in workforce retraining and new skill acquisition.

Second, in her opinion, administrative reform should be able to increase the productivity of the Brazilian public sector, given that the country’s productivity has been stagnant for 25 years, and that the public sector accounts for more than one-half of the economy.

Third, this reform should be able to make it possible to reduce public expenditure on civil servants’ salaries, which currently accounts for 13% of Brazilian GDP and is growing. Ana Carla noted that this level of expenditures in percentage of GDP is far above comparable indicators for countries with similar levels of economic development and even with respect to other, more developed economies. As this is a very complex and fragmented reform, approval of administrative reform may take some time. For her, it is good news that public debate has already begun. A principal concern going forward will be the likelihood of very strong resistance from public service unions.

In conclusion, Ana Carla declared that Brazil’s tax problem preceded the pandemic and was aggravated by it, due

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1 The “emergency amendment” (Proposal for Constitutional Amendment 186/2019), was promulgated by the National Congress on March 12, 2021, becoming Constitutional Amendment 109/2021.



to the additional expenses related to the mitigation of the effects of the pandemic on the economy. The structural reforms that are needed to address this problem are known. At the same time, the government currently in power in Brazil has not shown enough political will to take on the structural agenda. This means that Brazil may have to wait for Congress to take the lead or, failing that, for a new government to take office in 2022 which would put a higher priority on reforms implementation.

### Opening Remarks by Thomas Trebat

Trebat began his remarks by highlighting the atypical character of the current fiscal moment which is posing a challenge to pre-established ideas about the role of government spending and the limits of public expenditure capacity. Literally around the world, public expenditures have risen to previously unheard of levels, bringing in their wake increases in public indebtedness. At the same time, he noted, the occurrence of inflationary outbreaks has not been observed. Research done some years ago by Carmen Reinhart and Kenneth Rogoff rather notoriously noted that a debt to GDP ratio of 100% was almost always associated with great difficulty in refinancing public debt and a downward spiral for the economy<sup>2</sup>. For Trebat, this has not proven to be the case, or, at least, not yet as by some measures that debt/GDP ratio is already close to 100% in many countries.

Trebat affirmed that Brazil has been able to manage the increase in debt in part due to the reduction in domestic interest rates. In real terms, interest rates on Brazilian public debt have declined from 6% in 2017 to just 1% in 2020. This decline in the interest rate burden of the debt helped clear the way for a significant fiscal expansion. He pointed out that the global public sector deficit reached 14.5% of GDP in 2020, a

level comparable to those of advanced economies with presumably much higher levels of fiscal capacity. Brazil's public expenditure increase to combat the effects of the pandemic was 8.4% of GDP, about twice the global average, and the country had a smaller-than-expected drop in GDP in 2020: a 4.1% decline, in line with the drop in which was about 3.5%.

Thus, for Trebat, analysis of Brazil's fiscal situation should not be held hostage to the idea that a public debt/GDP of 100% is a hard limit beyond which debt service problems become virtually inevitable. At the same time, the macroeconomic conditions that allowed this greater flexibility in 2020-21 can change rapidly so that managing the fiscal scenario requires great care, especially in view of Brazil's greater fiscal vulnerability compared to the advanced economies and even in relation to China.

Trebat added a noteworthy feature of Brazil's fiscal performance has been the implementation of a large program of income support known as "Emergency Aid". According to him, in 2020, the cost of the program was close to 3.1% of GDP and it ultimately reached about 70 million people (approximately one-third of the total population of the country). The relative success of the program made it feasible to reduce poverty and inequality in the country in the midst of the pandemic in 2020, a rather remarkable outcome. While the government has sought to cut back on the Emergency Aid program in the beginning, it makes a great deal of sense to continue it as long as the health crisis persists in Brazil.

Turning to the possible impact on Brazil of the global economic scenarios, what will be the difficulties that Brazil will face related to "exit circumstances"? According to Trebat, these circumstances are associated with possible future reversals of the current situation of broad global liquidity, characterized by very low interest rates and expansionary fiscal policies practiced

2 In this respect see: Reinhart, Carmen. M. and Kenneth. S. Rogoff (2010). "Growth in a Time of Debt". *American Economic Review*, 100 (2): 573-578. Available at: <https://www.aeaweb.org/articles?id=10.1257/aer.100.2.573>

by advanced economies, particularly the United States. Although it is not possible to predict exactly when this will happen, this change in the international economy could catch Brazil at a difficult time both politically and economically.

In conclusion, Trebat declared that the unprecedented context of the pandemic opens new perspectives for thinking about the orientation of fiscal policy. Brazil's so-called "fiscal challenge" should be examined in the light of a fiscal policy that is guided by the right balance between equity – to promote equality and poverty reduction – and efficiency – to promote the growth of a prosperous and productive private sector. For him, in recent decades Brazil has alternated between economic policy stances that emphasized efficiency and others in which it prioritized equality, perhaps the exception being the beginning of the 2000s when favorable external conditions briefly allowed policy to focus on equity and efficiency objectives more or less simultaneously. Trebat asked: "What might this teach us about the future?" For him, an example could be the implementation of a program similar to the current Emergency Aid, while also promoting reforms such as those suggested by Ana Carla Abrão, especially broad tax and administrative reforms. He indicated, for those who might argue that the simultaneous pursuit of equity and efficiency is impossible or utopian, the experience of the Nordic countries seems to prove a relevant reference scenario for Brazil<sup>3</sup>. He noted that the five Nordic economies are practically world leaders both in terms of economic growth promotion (efficiency) and also in terms of robust systems of social protections (equity).

### **Discussion Among the Panelists Led by Jan Svejnar**

Jan Svejnar argued that a variety of possibilities have been observed internationally

3 Thomas Trebat has recently examined this topic in the following academic paper: Trebat, T. J. (2021). "Growth, Equity, and the Labor Market: Nordic Lessons for Brazil". *Revista Tempo do Mundo*, (25), 357-387. Available at: <https://doi.org/10.38116/rtm25art13>

in coping with the pandemic, with different degrees of success, particularly in terms of fiscal policy. Some countries placed a greater emphasis on supporting companies through ensuring liquidity and providing support to maintain their employees. These measures avoided a generalized process of bankruptcies and dismissals. In other countries, Brazil among them, the policy emphasis was placed on direct income transfer programs to the population. Thus, in 2021, when several countries are facing a second or third wave of the virus, there is already an accumulated policy experience in how to deal with the crisis that can be shared between countries.

Svejnar also pointed out that low interest rate levels are a particular phenomenon of this current crisis, which has given a greater degree of freedom to the exercise of expansionary fiscal policies, even by countries with lower economic power and with serious fiscal problems, such as Italy. The possibility of an increase in Fed interest rates in the United States is expected to have severely asymmetric effects on the other economies in the world, mainly affecting emerging countries.

In response, Danny Leipziger also expressed concern about the possible impacts of U.S. interest rate behavior on the emerging countries, especially those considered excessively indebted. A rise in interest rates could require international coordination to deal with the financing issue. He noted that the last time a breakdown in global financing flows occurred was during the late 1980s and early 1990s, prior to the Brady Plan. Any initiative today to provide relief to indebted countries may need to count on China, in addition to the United States.

Leipziger agreed with Ana Carla about the need for public sector reform and a reduction in the size of the state, highlighting that it is necessary to reevaluate those areas in which the Brazilian state actually needs to produce directly for the population. For him, there is a need to reduce the size of the Brazilian

state. He picked up on Trebat's proposal as to the need to seek a new fiscal framework to balance equity and efficiency, but noted that the reforms currently being proposed could adversely affect the lower and middle classes. Politically, this could be complicated, according to Leipziger. For him, in this context, the pace of reforms could continue to slow, without definitively addressing the country's fiscal problems. Thus, although there is clarity as to the diagnosis of Brazil's main problems, political restrictions could make the country's future problematic.

Ana Carla picked up on this theme of the political economy of reform in Brazil. She observed that Brazil has not been able to benefit from the current scenario of global liquidity. It is possible to observe a significant outflow of foreign investment from the country contributing to a currency devaluation of about 30%. She expressed concern about the rise of inflationary pressures in Brazil, so that the gains against inflation achieved throughout 2018 and 2019 could dissipate, leading to an increase in interest rates. And although Brazil was quick to execute the Emergency Aid program in 2020, the program was marked by some misallocation of funds.

Thus, it is difficult to see, in Abrão's assessment, any improvement in the framework of economic policy currently in force in Brazil. In her opinion, the reforms, such as privatization being proposed by the economic team led by Minister Paulo Guedes, could improve the situation. However, the economic team lacks the necessary political support from the President and his inner group of supporters. In her view of the upcoming presidential elections in 2022, it is of critical importance to avoid turning away from the types of economic reforms that the country really needs and veering toward populism instead. Such an outcome would be harmful for democracy in Brazil.

Thomas Trebat argued that even if the market reforms discussed by Ana Carla might be useful, they will also take a great deal of time to implement and, thus, not have

a significant positive effect on the economy in the short-term.

In turn, according to Leipziger, the size of the Brazilian capital market and the fact that most of the public debt is held domestically and not abroad is one important mitigating factor. For him, a large internal market for domestic securities is a relatively new phenomenon in Brazil. Moreover, the country currently has high and stable levels of international reserves, and this is another contrast with earlier periods of debt-induced crisis in Brazil.

The autonomy of the Central Bank of Brazil has recently been reaffirmed, and this is another positive sign. He also noted that the recent devaluation of the exchange rate, through increasing exports, could also stimulate the economy, although this phenomenon also brings unwanted inflationary impacts. The point is that the country should be able to find room in 2021 to continue the expansion of emergency income transfer programs, even as it seeks to pursue the types of market reforms that would be beneficial in the long-run. In fact, for Leipziger a careful expansion of social programs in these crisis conditions might increase popular support of reforms aimed at economic growth and efficiency.

Ana Carla took a different point of view on the outlook for the Brazilian economy. She argued that while Brazil is a large market, the fact is that the country is getting steadily poorer. Regarding the possible beneficial effects of the currency devaluation on the Brazilian economy, she noted that the only relevant effect expected would be an increase in inflation. This is because the country does not have the conditions to take advantage of the potentially positive effects on exports, due to the lack of a trade reform. Brazil is still a very closed economy. Finally, and while supporting the maintenance of the Emergency Aid program and the strengthening of the social safety network, she indicated that it is necessary for Brazil to signal that it is facing up to the current fiscal imbalances, which have been



aggravated by the pandemic. For her, if the country does not face these imbalances, it will pay the costs in the future in the short-term (i.e., during the next several years) and also in future generations.

About how much public debt is too much, Svejnar argued that this time the accumulation of debt in Brazil is internal debt, denominated in the currency issued by the government itself. Thus, he asked, is it not possible that Brazil would be protected in a similar manner as Japan, a country that has a public debt/GDP ratio above 200%?

On this topic, Leipziger questioned whether the Japanese example really does provide a good framework since the byproduct of excessive Japanese indebtedness could be to repeat Japan's experience of twenty years of recession and poor economic prospects for the future. However, he did acknowledge that the fact that the debt is domestic is better than if it were mainly external, as is the current case in Argentina.

Trebat also added a note of caution about the debt. He recalled that the excessive accumulation of domestic public debt can also generate negative impacts, such as the shortening of the maturity of the debt, increasing the risk of debt rollover, crowding out longer-term investments, and contributing to generalized uncertainty in the economy and volatile financial conditions. In addition, he declared that the exchange rate could weaken due to uncertainty about interest rates and inflation, while financial stability itself could become a concern. Regarding the latter case, it is worth remembering that the inflation of assets that occurred in Brazil in recent months can quickly become a deflation, causing stress in the private financial markets. Thus, as emphasized by the other panelists, for him it is necessary to recognize fiscal restraints and to manage the public sector debt to promote fiscal stability in the long term.

# REFORMING LABOR MARKET AND SOCIAL POLICY POST-PANDEMIC (PART I)

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Thomas Trebat



Jan Svejnar



Armínio Fraga



Cecilia Machado



Joseph Stiglitz

# REFORMING LABOR MARKETS AND SOCIAL POLICY POST-PANDEMIC

APRIL 26, 2021

The Panel V was the first dedicated to the theme of reform in the labor market and in the area of social policy in the post-pandemic period, with special reference to Brazil. **Thomas Trebat** was the moderator of this panel, which had the participation of the following: **Jan Svejnar**; **Armínio Fraga**, CEO and Founding Partner of Gávea Investimentos and Former President of Central Bank of Brazil; and **Cecilia Machado**, Assistant Professor at Fundação Getúlio Vargas-Rio de Janeiro (FGV-RJ) and Research Fellow at Institute of the Study of Labor (IZA). This session also featured the special participation of **Joseph Stiglitz**, University Professor at Columbia University and winner of the 2001 Nobel Prize in Economics.

## Framing Remarks by Thomas Trebat

Thomas Trebat drew attention, at the opening of this panel, that old problems connected to unemployment and inappropriate social protection were exaggerated in the wake of the devastation created by the COVID-19 pandemic. Both problems are currently at the center of the public debate all over the world. In a general manner around the world, an expansion of the state's sphere of action in the economy occurred, both to mitigate the effects of the health crisis itself caused by the pandemic and then to adopt broad measures for the economic recovery of countries.

In carrying out these actions, he remembered that numerous governments have sought to alter basic characteristics of the economic system, with the aim to change the social, technological, and environmental

forms of organization in force in each country. Notable among these international efforts has been the United States with its theme, adopted by the Biden administration and echoed elsewhere in the world, to “build back better.” This has come to mean taking on old problems that have intensified in the context of the current pandemic, such as youth unemployment, discrimination against women in the workplace, informality, and the need for workers to acquire new skills. In Brazil's situation, as in most Latin American countries, Trebat emphasized that the difficulties related to the labor market and the insufficiency of social policies are even stronger due to the economic stagnation that has marked the country in recent years, leading to the prospect of another “lost decade” in terms of economic growth, reminiscent of the infamous lost decade in the 1980s.

## Opening Remarks by Jan Svejnar

Jan Svejnar underlined that the current economic crisis, brought about by the severe external shock that was the COVID-19 pandemic, impacted aggregate demand and output throughout the world economy. From the recovery point of view, instead of a faster V-shaped recovery or a slower U-shaped recovery, what has been observed inside most countries is the so-called K-shaped recovery. On the one hand, the “digital economy,” in which activities can be carried out remotely from people's homes and which employs many of the most highly skilled and highest paid workers, is in full recovery. On the other hand, a very large group of people is still suffering very negatively from the impacts of the crisis, particularly workers in the services sector in

which activities are performed on a face-to-face basis and which concentrates workers with lower qualifications and incomes. In general, income concentration and poverty, problems that had already been worsening in the years before the pandemic, have worsened with the current crisis, both within and among countries.

Svejnar briefly reviewed how the recovery experience has varied among countries and regions. Thus, in the United States, where there is not much protection in the labor market, there was a rapid rise in unemployment with the start of the pandemic last year, and, afterwards, a fall in unemployment, although an important part of this fall was due to a reduction in the labor participation rate.

For Svejnar, in the member countries of the European Union (EU), in turn, the scenario is different, to the extent that they rely upon extensive labor legislation. This has led many EU countries to adopt a series of compensation schemes that resulted in partial layoffs for workers without interruption of the link between worker and company. This measure was partly funded by the state, maintaining the liquidity of the companies, and thus leading to a smaller increase in unemployment, although in practice the working day was reduced. In terms of the labor markets, the United States and the EU absorbed the effects of the shock caused by the crisis in somewhat different ways, although both experiences rested upon the adoption of expansionary fiscal policy and accommodative monetary policy to cushion the negative effects caused by the pandemic.

Regarding economic recovery, Svejnar pointed out that the performance of countries has also varied. China, where the crisis hit earlier and not as deeply, is recovering quickly in the international context. The United States is recovering relatively well, particularly due to the widespread vaccination program being carried while in Europe the recovery has been slower.

## Opening Remarks by Armínio Fraga

Armínio Fraga examined the role of the state in the Brazilian economy. Although state action in the economy has been significant for a very long time, in Brazil the form of state intervention suffers from many problems, and yet the country does not seem to learn lessons from past mistakes.

Thus, within the context of a deliberate strategy of industrialization and urbanization from 1930 to 1980, Fraga argued that there was extensive state intervention in the country's productive sector, especially in economic infrastructure. As well, successive governments moved to the adoption of protectionist measures to substitute imports. For him, these policies were not very successful, while at the same time little emphasis was given to education and reductions of social inequality. The failure of the economic model was made particularly evident by Brazil's hyperinflation in the 1980s.

According to Fraga, in the last 40 years since the collapse of the import substitution strategy, the performance of the Brazilian economy has been mediocre. Although Brazil has reduced social inequality to some degree, it remains one of the most unequal countries in the world.

The 1988 Constitution, for Fraga, despite having created the Unified Health System (SUS - Sistema Único de Saúde), a public, free, and universal system inspired by the British healthcare system, has not led to the evolution of a more efficient economic strategy. During Fernando Henrique Cardoso's presidency (1995-2002), several privatizations were carried out and a regulatory system for public monopolies was created, with the state turning its attention more to the health and education areas. In addition, he affirmed that in the later period of the Cardoso administration, the Bolsa Família (a conditional cash transfer program for very poor families) was implemented. However, alongside the

successful Bolsa Família, but on a much larger scale, a policy of indiscriminate subsidies to businesses was also practiced. Depending on how these subsidies are measured, such subsidies to business reached up to 7% of GDP (currently the figure is around 4.5% of GDP), without any visible social impact whatsoever.

Another negative characteristic of Brazilian state intervention, in the opinion of Fraga, is the absence, with rare exceptions, of an adequate system for monitoring and evaluating the policies adopted by the state. A typical example, in his view, is the role performed by the National Bank for Economic and Social Development (BNDES - Banco Nacional de Desenvolvimento Econômico e Social) which has been a kind of “black box” for state intervention. Another example is the lack of a performance evaluation system for the large number of public employees throughout the country. This generalized lack of evaluation of public policies ends up by not providing the feedback learning about policy implementation that is so crucial for long-term economic development.

Focusing on the current possibilities for government action, for Fraga there is a problem with how to finance social policies in Brazil as the elevated tax burden of 35% of GDP does not leave much space to increase the public debt. Additionally, Brazil is beset by a rigid public budget; 80% of public spending is absorbed by the government payroll and social security outlays. In many middle-income countries, the weight of these expenditures is around 60% or less.

Fraga then turned his attention to three other policy areas deserving of special attention from the Brazilian state at this time.

The first would be environmental policy, in topics related to climate change and the preservation of the Amazon rainforest. In these critical areas, Brazil has

been doing poorly as evident, for example, in the reversal in the deforestation reduction trend with negative impacts for Brazil and the world. The second area would be the impact of new technologies on the labor market, something that has received attention all over the world. In Brazil, the issue assumes specific contours due to the widespread informality in the labor market. The third area is that of social inequality. Brazil would need to go beyond the Bolsa Família program in order to promote greater social mobility.

Stepping back, an overall assessment of the current macroeconomic environment in Brazil would go as follows. According to Fraga, a first group of people exist who see in the current context a clear tradeoff between dealing with the economy and dealing with the pandemic; a second group argues that economic recovery is impossible unless you deal with the pandemic.

It is the first group that is in political command of Brazil at the moment. So extremely basic actions were shunted aside, such as social distancing measures, the use of masks, accelerating vaccination as much as possible, well-planned lockdowns, and so on.

On the macro side, the usual tools were used, such as interest rate reduction, which reached the historic low of 2%, and an unprecedented fiscal expansion. However, for Fraga, there is a prospect of a reversal in monetary policy, with an expected rise in interest rates, while fiscal expansion is not something the government cannot finance for much longer, since the country does not have the same debt capacity as the advanced economies.

There are serious macro issues related to productivity and social matters, according to Fraga. The way in which Brazil has been dealing with them does not foster a favorable business environment for the expansion of investment. At the same time, public investment in the social area is at



the lowest level in history having declined from 5% of GDP to just 1% of GDP. This is a clear indication, in his view, that Brazil also faces problems related to its definition of priorities.

In conclusion, Fraga argued that while there is a reform effort underway in the Brazilian economy, it is insufficient to alter significantly the general framework of the Brazilian economy. Thus, although it is within the reach of the state to promote the necessary changes, it is not clear that these changes will occur under the current government and under the current circumstances. This observation is bolstered by the very poor government performance in the health areas and in the protection of the Amazon.

### **Opening Remarks by Cecilia Machado**

In her presentation, Cecilia Machado examined in depth the impact of the crisis caused by the COVID-19 pandemic on the labor market, with special emphasis on the Brazilian case. Two points help us to understand what is going on currently in the Brazilian labor market as well as elsewhere: (i) the social distancing measurements, that especially impacted the services sector, mainly less qualified workers in services; and (ii) the adoption of new technologies and the home office, with potential to increase the labor productivity in the segment of highly qualified workers. Both of these developments will tend to increase social inequality in Brazil.

Despite difficulties in the compilation of labor market statistics during the pandemic period, with many surveys conducted by telephone, Machado affirmed that a comprehensive picture emerges of the impact of the COVID-19 crisis on the Brazilian labor market. According to her, about 70% of employed persons in Brazil work in the services sector in which there was a drastic reduction in employment right at the beginning of the crisis in 2020. Although employment recovery is underway, it is not expected to be complete before the end of 2021.

Regarding the characteristics that distinguish the Brazilian experience in relation to developed countries, the most relevant would be the presence of widespread informality in Brazil, comprising something like 40% of the employed labor force. She remembered that, historically, informal workers in Brazil earn close to the average wage, but their incomes are very volatile. Lacking protection from labor legislation, the informal sector was the most negatively impacted by the COVID-19 crisis.

Machado affirmed that informal workers are composed mostly of women and black people, amplifying inequities already present in the Brazilian labor market, particularly those associated with gender and race. Many women left the labor market, especially during the height of the health crisis, while job creation in the beginning stages of the recovery has occurred mostly for men.

Concerning remote work in Brazil, according to Machado, fewer than 10% of employed people have been working from home. While, potentially, this percentage of telecommuting could reach around 22%-25% of the workforce, this would still be far lower than in developed countries, such as the United States and the United Kingdom, where the percentage of the workforce able to work remotely is 40% to 50%. This is an indication of the asymmetric impacts with which the pandemic crisis has affected the country, and suggests that the home office will play only a limited role in the recovery of employment in the period after the pandemic.

In addition, Machado declared that the impact of the pandemic has also been unequal in the education sector, with face-to-face school activities suspended for most of the pandemic, and great disparities in the ability of students to participate in remote education. For her, the crisis impacted Brazil at a time when the government has had a very tight budget constraint, reducing the range of maneuvers that could be taken by the Brazilian state in the face of the crisis,



particularly in the health area. At present, there is a marked delay in the vaccine rollout program which affects the entire population. This makes it difficult to return to normality in the labor market and, the longer the delay, the harder it will be for people to recover the jobs they had before the pandemic.

In the case of informal workers, Machado noted that these workers do not have access to unemployment insurance and the Bolsa Família program for social protection is not associated with the formalization of work. Therefore, for her, it would be essential to rethink the tax system in the country in order to increase the degree of formalization, as well as to think of active labor market policies to give greater dynamism to the labor market.

### **Comments by Joseph Stiglitz**

Joseph Stiglitz responded to the opening remarks by the panelists with some observations about the recent macroeconomic performance of the United States. Stiglitz does not believe in an eventual resurgence of inflation in the country, in this respect taking a different position from public remarks by the former U.S. Treasury Secretary, Larry Summers. In the near future, inflation is not the concern.

According to Stiglitz, what we are seeing right now in the U.S. economy are the expected impacts of the withdrawal of the massive government aid provided to deal with the economic consequences of the pandemic. This fiscal injection was on the order of 24% of GDP. While quite large, these extraordinary fiscal measures should remain in effect for as long as the unemployment rate remains high.

For him, one of the economic consequences of the pandemic in the United States has been an increase in the savings rate in the upper income strata of the population. However, for the poorest 50% of the U.S. population, the savings rate is zero or even negative, a bifurcation in monetary

income balances which is reflected in the K-shaped pattern of economic recovery presently being observed.

On the other hand, although this pandemic is a somewhat novel situation and, therefore, shrouded in uncertainty, those individuals with positive savings balances are not expected to spend their net balances on consumption as the economy recovers. Instead, they can be expected to spread their spending over time. In the meantime, asset price inflation, including in the U.S. stock market even if not in the consumer goods market, is likely to be observed.

These elements do not point, for Stiglitz, therefore, to an overheating of aggregate demand in the United States which could result in a rise in inflation, a trend that is also reinforced by the fact that several countries in the world have not yet managed to contain the virus. Even in the case in which inflation increases, there would be tools at hand, such as raising interest rates, which are at very low levels and probably below recommended levels. However, any rise in interest rates in the United States could have deleterious effects on Brazil and other emerging markets.

Another aspect of the measures taken in the context of the current economic recovery discussed by Stiglitz is the raising of taxes for the upper income strata. Legislation to this effect will likely be approved in the U.S. Congress, including raising the minimum corporate tax rate and the global corporate minimum tax. For him, this eventual increase in government revenue should be used to increase wages in social assistance, education, and health, which are basically public sectors. Indirectly or directly, the government sets the wage pattern in the economy and this has contributed to the reduction of inequality.

### **Discussion Among the Panelists Led by Thomas Trebat**

Jan Svejnar argued out that the

race to digitize work is great among advanced economies, and that this is a priority, as is the universalization of digital education. On the other hand, he pointed out that the huge fiscal expansion practiced in the context of the current pandemic has taken public debt to levels hitherto unprecedented for peacetime, which brings up new questions of how to deal with this scenario.

In his comment, Armínio Fraga emphasized that Brazil has not been taking advantage of the improvement in international commodity prices and high international liquidity due to low interest rates. In case of a reversal of this very favorable international scenario, Brazil will face difficulties. Nevertheless, the fact that the Brazilian economy is still relatively closed may be somewhat positive in a scenario of international deterioration.

Armínio Fraga also pointed out that the low aggregate value of Brazilian exports reflects the country's economic structure, and that this structure requires changes. For example, in the area of education, although access to school has increased in Brazil, the level of education attained and the rates of school dropout indicators are not at desirable levels.

Fraga added two other issues: the need for a tax reform, which simplifies the complex and bureaucratic Brazilian tax system, while making it less regressive; and the need for a reform of public administration. Salaries and job stability in the Brazilian public sector stand in sharp contrast with the employment situation in which the majority of the Brazilian population finds itself. At the same time, he noted that the services that the public service offers to the Brazilian population are far below what could be expected.

Cecilia Machado, in turn, also highlighted the centrality of improving public services, such as health and education in order to promote greater inclusion and social mobility in Brazil with positive impacts on income distribution.

Regarding the need to emphasize education, Jan Svejnar recalled that about three-fourths of the capital stock of the United States consists, according to estimates, of the country's human capital. Brazil has its many challenges in education, but the country has already demonstrated that it is capable of great achievements in this regard, as shown by the successful case of Embraer.

About accelerating vaccinations in the emerging world, Thomas Trebat stressed the view of the widespread recognition that the advance of vaccination is a necessary condition for effective economic recovery. Thus, he asked the panelists to reflect upon the role of the United States in this area and what more could be done to share vaccines with countries where the pandemic is now in an advanced stage and vaccinations are woefully inadequate?

In response, Joseph Stiglitz discussed the breaking of patents related to vaccines, a measure he considered to be something simple, though very contentious. The economist recalled that about 100 country members of the WTO supported the waiver of intellectual property rights related to COVID-19 vaccines. Stiglitz himself helped to organize a letter that was signed by more than 90 Nobel laureates and 75 Heads of state to the same effect, i.e., in favor of breaking patents. However, the Government of the United States has acted, at least through the end of April 2021, to block this measure from going forward, supporting the position of the pharmaceutical companies. For Stiglitz, this is a very foolish position for any government to hold, especially the United States, because the longer this disease continues to spread, the greater the opportunity for it to mutate, making it more resistant and, thus, prolonging the pandemic. This is a clear case of supporting the pursuit of profit over the pursuit of life itself. It is also a narrow-minded position when one stops to consider that the pharmaceutical companies have benefited from all the basic scientific research done with government funding.

Stiglitz also mentioned the problems related to “vaccine nationalism”, which has led countries such as the United States to impose controls on the export of vaccines and vaccine supplies to other countries. In the U.S. case, the government is blocking AstraZeneca vaccine (and its ingredients), a vaccine not yet approved in the U.S., from being sent to Mexico. Another problem is the accumulation of vaccines in countries at a level considered excessive, jeopardizing the access of other countries. For example, Canada has signed contracts to receive vaccines sufficient for eight or nine times the size of its actual population. For Stiglitz, these are examples where global capitalism shows its most “odious face”.

Stiglitz indicated that Russia and China are engaged in very aggressive vaccine diplomacy. Russia, for example, is helping other countries to develop their local capabilities to produce their own vaccines as well as providing the Sputnik V vaccine to neighboring countries. For Stiglitz, measures like this will have a major impact on geopolitics and geo-economics in the long term. For him, Biden’s disappointing performance in this matter of vaccine diplomacy is one of the biggest mistakes at the beginning of your term.

In his final comment, Armínio Fraga highlighted the difficulties of achieving, at this moment, a global coordination in facing the problems associated with the pandemic, while expressing hope for improvement with the arrival of Joe Biden as President of the United States who has signaled his support for greater international cooperation and coordination. In her last appearance, Cecilia Machado pointed out the difficulties that have plagued local production of vaccines in Brazil, as well as the delays in the vaccination program. For her, this issue is the biggest concern for the recovery of employment in the country. Finally, Jan Svejnar mentioned the fact that vaccination is advancing much faster in the United States than in European countries, with important impacts for the recovery

of the North American job market when compared to the European experience.

# REFORMING LABOR MARKET AND SOCIAL POLICY POST-PANDEMIC (PART II)

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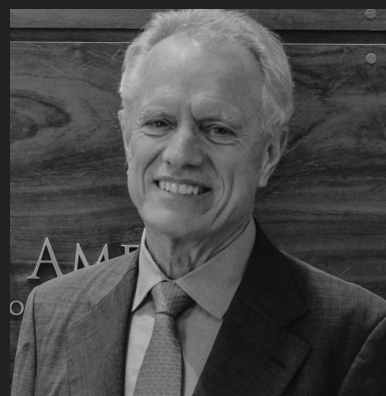
Stefano Scarpetta



Celia Kerstenetzky



Andrés Velasco



Thomas Trebat

# REFORMING LABOR MARKETS AND SOCIAL POLICY POST-PANDEMIC (PART II)

APRIL 27, 2021

The Panel VI, the second panel on reforming labor market and social policy post-pandemic period, with special emphasis on Brazil's experience, had **Thomas Trebat** as the moderator, and featured the following speakers: **Stefano Scarpetta**, Director of the Directorate of Employment, Labor and Social Affairs (ELS) at the OECD; **Celia Kerstenetzky**, Full Professor at Institute of Economics, Federal University of Rio de Janeiro (UFRJ); and **Andrés Velasco**, Dean of the School of Public Policy, The London School of Economics and Political Science.

## Opening Remarks by Stefano Scarpetta

Stefano Scarpetta highlighted the situation of the labor markets during the pandemic and future perspectives with special reference to the OECD countries. The COVID-19 pandemic was the worst health crisis in a century, requiring economic measures on an unprecedented scale to mitigate its effects. Progress against the disease in the OECD has been noteworthy. In those countries in which the vaccination process is in a more advanced stage, we have observed a steep reduction in terms of the number of cases and deaths, a positive sign that the pandemic may be receding.

According to him, the average OECD unemployment rate in the months of March and April of 2020 returned to levels reached in the aftermath of the global financial crisis of 2008-2009, with the unemployment increasing more in the United States, Canada, and Mexico than in the European countries. In Europe, however, unemployment continued to increase even following the reopening of the economy in the second half of 2020.

Stefano pointed out that the unemployment rate does not capture all the complexity of the impact of COVID-19 crisis on the labor market. The total number of hours worked may be a better indicator. This indicator registered an even greater fall than that of employment, and mainly in those countries that had adopted governmental subsidies for the payment of wages in order to maintain employment, albeit with the reduction of the working day. For him, this practice was adopted on an unprecedented scale in Europe and elsewhere around the world, affecting around 60 million workers in all; in France, for example, more than one-third of formal sector workers were affected.

Another particular feature of this crisis in the view of Stefano was the fall in the labor participation rate, resulting, in part, from the implementation of social distancing measures which made the process of searching for jobs more difficult.

From a sector point of view, Stefano affirmed that the most impacted branches of activity were located in the labor-intensive services sectors, with hotel and restaurant activities standing out. This marked a difference in relation to employment patterns in the 2008-2009 global financial crisis, when construction and industry were the most affected sectors.

Stefano added that the COVID-19 crisis had a very uneven impact on labor markets around the world, disproportionately affecting four groups of workers, with overlap among them. The first group is composed of the least skilled workers. Many of them were not in essential services, could not



work remotely, nor did they have the basic infrastructure to be able to work from home. Still on remote work, Stefano pointed out that, before the COVID-19 crisis, on average in the OECD only 5% of the employed population worked remotely, but, during the peak of the pandemic, in 2020 this figure jumped to 39%.

The second group of adversely affected workers includes the informal sector, the self-employed, and those working on temporary and part-time contracts. Workers in these categories accounted for 40% of total employment in the most affected sectors.

The third group is composed of the youth, who had also been disproportionately impacted in the 2008-2009 crisis. Temporary contracts and internships are very common work arrangements for people in this age group.

The fourth group is made up of women, who account for two-thirds of the overall healthcare workforce and are also in the majority in less stable and more precarious forms of employment. In addition, women are burdened with unpaid work related to domestic activities, which have grown dramatically in this crisis, such as childcare (especially for children who have not been in school for a long time) and care for the elderly.

With regard to the recovery of the economy and employment, as the vaccination process progresses, the economy is expected to reopen. For Stefano, with the gradual withdrawal of job retention schemes and other employment subsidies adopted during the peak of the pandemic, it is necessary to take measures that stimulate businesses to reopen. It will be important, for example, to avoid bankruptcies. For him, caution will be necessary in the process of withdrawing those support measures aimed at the most severely affected groups of workers, such as the youth.

A set of guidelines should lead a new pattern of state intervention in the economy, for Stefano. Measures adopted for the recovery of the economy are an opportunity to invest in new digital and green infrastructure, but also in social protection programs, closing gaps in this area that existed prior to the pandemic. In this last case, some measures that were taken on a temporary basis during the peak of the pandemic, such as cash transfers to specific groups, could be converted into more lasting actions, expanding the social safety net with special attention paid to young people.

Stefano Scarpetta emphasized the need for workforce training and retraining programs, particularly given that many of the jobs that were lost will not be recovered and new jobs being created will require different types of skill levels. So supporting “up-skilling”, particularly of less skilled workers, is very important, as is supporting business innovation.

### **Opening Remarks by Celia Kerstenetzky**

Celia Kerstenetzky organized her presentation around the question of informality, the main structural problem of the labor market in Brazil, and what could be done about it. Looking back to the period between 2004 and 2014, the period during which the Workers’ Party held the presidency of the Republic of Brazil, there was a simultaneous increase in both the labor formalization rate and in average and minimum wages. Moreover, for Celia these advances were accompanied by a significant reduction in labor market poverty, wage and gender inequality, and a slight increase in productivity. In her opinion, these results are due, at least partially, to policies adopted in the period, such as tax simplification, credit incentives, increased compliance inspection by the labor courts, greater educational opportunities, increased social spending, stricter regulation of outsourcing, and new laws such as those regulating domestic employment practices. Furthermore, it may be noted that the increase in formalization



occurred at the same time as observed increases in the level of employment and in the real minimum wage. For her, these observations seem to contradict a longstanding assumption that these three indicators could not behave simultaneously in this way.

For Celia, this favorable period of labor market indicators did not last beyond 2014 in Brazil. From 2015 to the present, a strong deterioration of the labor market has been recorded, resulting mainly from two structural initiatives which drastically altered the Federal Constitution and weakened labor protections. These were, first, the reform of the main Brazilian labor code (known by its Portuguese acronym as CLT – *Consolidação das Leis Trabalhistas*). This occurred in 2017 during the interim government of President Michel Temer. The reform aimed to make the labor market more flexible and decreased the bargaining power of workers. This was followed by a decision in 2019 to end the mandatory tax used to fund unions and complementary measures to encourage firm-level bargaining rather than collective bargaining. According to Celia, this reform was taken in the name of inducing a greater degree of formalization in the labor market, although this did not occur.

The second structural reform was the so-called “expenditure ceiling rule” promulgated via Constitutional Amendment 95, in 2016, which came into effect from 2017. This measure introduced one of the strictest fiscal rules in the world, a freeze in real terms on the most of real primary federal government expenditures for the ensuing twenty years, which would lead over time to a decline in social spending per capita, this in a country where the underfunding of the social area is widely recognized.

For Celia, both initiatives have not only led to an increase in the problems that the Brazilian labor market already faced and added new ones.

It is not only a matter of rolling back the clock to labor market institutions that were in force prior to 2015 and subsequently dismantled. Even in this earlier period, informality in the Brazilian labor market was around 36% of the employed labor force. It is necessary to go further in terms of reforming the labor market.

In this regard, the Nordic model of labor market policies could be taken as a reference for this discussion, since the Nordic model robustly combines high income levels with high levels of universal social spending and a progressive tax burden. Added to this is the adoption of active labor market policy measures, such as qualification, training, and retraining of the labor force. Reference is to the Danish and, more broadly, Nordic model of “flexicurity,” which combines the existence of a flexible labor market with low hiring and firing costs and comprehensive social protection. It would be important to supplement the regulatory practices in the labor market that existed prior to 2014 with the adoption of active labor market policies.

Another central element for promoting the increase of formalized employment, which also finds resonance in the Nordic experience, is the high weight of the social public service sector in total employment, that is, in occupations such as those in education and healthcare. These jobs are high quality jobs in Brazil in that they are formal and well-paid. The proposed expansion of the social public service sector is multifunctional, as it can meet painfully unsatisfied social needs, generate many quality jobs, and also contribute to improving the productivity of the labor force through greater investment in health and education.

Finally, for Celia, the expansion of public employment, besides being formal and better paid, also has a positive impact on the employment of women, non-whites, and young people. Such jobs involve higher degrees of unionization and a lower incidence of long working hours. According to her, the adoption of this job strategy would

represent an increase in the participation of public employment in the social service area from 25% to 45% of total employment in Brazil. To put this in a different light, and despite the common belief of an overloaded government payroll, Celia argues that Brazil has a relatively low share of the labor force employed in the public sector: 12% compared to 21.3% for the average of the OECD countries.

### **Opening Remarks by Andrés Velasco**

At first, Andrés Velasco drew attention to the very negative impact that the COVID-19 crisis has had on the economy of Latin American countries. Internally, this crisis resulted in a substantial reduction in supply capacity, due especially to the reduction in labor supply, and in aggregate demand. Externally, the pandemic led to a brief, but profound, episode of capital flight, especially between the months of March and May 2020, to which was added a six-month period of rapidly worsening terms of trade, and a simultaneous drop in foreign exchange inflows originating from workers' remittances from abroad. These worker remittance flows are very important for several Latin American countries, though not necessarily for Brazil and Chile.

In terms of the labor market, the impact of the crisis has been uneven, harming less the higher skilled and higher paid workers, who have largely migrated to remote work, and more the working poor, youth, women, people on temporary contracts, freelancers, and self-employed workers. Andrés recalled that the labor market in Latin America, in normal times, already functions terribly with low occupation rates, especially among women and young people. In times of crisis, as in the present circumstances, this picture becomes even worse.

For him, in Latin America, nobody really wants to discuss the labor market, because these tend to be debates tinged with ideology and, therefore, not very productive. For persons on the left, only

collective bargaining is discussed. While understandable, collective bargaining practices benefit primarily formal and unionized workers in which most positions are usually held by middle-aged and middle-class men. However, the majority of the labor force, composed mostly of women, young people and the poor, is not formalized or unionized. For the persons on the right of the political spectrum, all labor-related discussion is about the liberalization of the labor market and mainly concerned with reducing labor costs, to the exclusion of broader concerns about labor market performance. Hopefully, in Andrés' opinion, the current pandemic will make us rethink these two extreme positions, which are too rigid and ideological.

Regarding the Nordic model, Andrés noted that the "flexicurity" model is something quite specific. It refers to a policy of income protection and not of employment, also includes a considerable amount of discipline, so that the benefits received are linked to the worker's engagement in retraining programs. Workers have access to unemployment insurance benefits in Denmark, for example, but receipt of these benefits is strictly conditional upon participating in retraining programs to prepare for a return to employment.

However, this Nordic-inspired alternative, one emphasizing both worker rights and worker obligations, probably would not be on the agenda for discussion in Latin America today. For Andrés, instead, the discussion would probably turn to policies such as universal basic incomes (UBI). UBI would not be an adequate solution in Latin America since the level of public debt of the countries in the region is already too high. Brazil, for example, is expected to emerge from the COVID-19 crisis with a public debt level to GDP ratio of 100%. Although interest rates are lower than ever in Brazil, long-term interest rates have already started to rise, an indication of the economy's fiscal fragility, in his opinion.

More important is Latin America's struggle to form cohesive societies. It is hard to imagine a situation in which integrated, cohesive societies in Latin America are possible without good jobs and good wages, not only for middle-aged white men, but also for women, for young people, and for less skilled workers.

According to Andrés, as for reforms, employment subsidy measures may be important. These might include a negative income tax, income support policies for the poorest, and measures to encourage formalization, especially for the youngest workers and the least skilled. Minimum wage legislation also has a relevant role, especially if it is linked with employment subsidies. However, in his opinion, minimum wage increases unaccompanied by other measures, especially in periods of low economic growth, can lead to job destruction, therefore increasing inequality.

Regarding active labor market policies, such as those linked to workforce retraining, a great deal of money has been spent on such policies in Latin America, without, however, generating satisfactory results. Thus, for Andrés, although active policies for the labor market are necessary, the measures tried so far are in need of improvement.

Andrés concluded by stating that, while labor market reforms are important, economic growth-oriented policies are needed. He recalled that the period of best performance of the labor market in Brazil in the early 2000s also coincided with the period of greatest economic growth in the country, and that the worsening of labor market indicators was associated with the depression that followed shortly thereafter. Thus, it is central to adopt policies aimed at promoting economic growth, which should include, in addition to the known policies, smart industrial policies, and different from those adopted during the time of the Dilma government in Brazil.

## **Discussion Among the Panelists Led by Thomas Trebat**

During the debate, Stefano Scarpetta argued that one of the great lessons of the pandemic was the adoption by some countries, especially in Europe, of employment retention schemes through state subsidies. The use of these policies was a good response to the “sudden shock” of the pandemic. Stefano also stated that these measures, although successful, should be well targeted and temporary, and might not work if adopted in the middle of the crisis.

Stefano agree with Andrés Velasco about the low efficiency, in general, of active labor market policies in light of recent empirical studies. Stefano argued, however, that some of these policies work very well, not only in terms of increasing employment in the short term, but also in creating more stable jobs and less precarious forms of employment.

Finally, Stefano argued that, for Latin America and other countries, UBI policies would not be recommended. Appropriately focused cash transfer policies (negative income taxes, for example), which reach the people who need the most support, would seem to be the preferable policy approach.

Celia Kerstenetzky stressed that the public social service sector in the Nordic countries has played a very important role in creating higher-quality jobs. If initiatives such as UBI fail to gain traction in Brazil and Latin America, as other speakers on the panel suggest, Celia argued that then policies to create jobs to provide social services might become a means to meet social demands for employment and income.

For her, the expansion of social services in the country is essential for at least the following reasons: (i) expansion is necessary to meet severe shortfalls with regard to the provision of social services,

such as in health and education (including lifetime learning and retraining); (ii) these types of service provision also raise the productivity of the domestic labor force; (iii) expanding these sectors also creates good and formal jobs, with lower wage inequalities; and (iv) these jobs are favorable to women, youth, and underrepresented groups. Increased employment via expansion of social services would address job losses related to technological change, while contributing to environmental preservation, as these are people-intensive and low-carbon sectors.

In turn, Andrés Velasco argued that it is necessary to understand that employment policy and social policy are one and the same thing. For him, without an agenda of good jobs, the discussion about social protection and equality-inducing policies in Latin America is an empty one. Therefore, Andrés argued that one of the important lines of public policy should be to link the receipt of subsidies to the creation of high-productivity jobs. He stressed the need to do more for social service professionals, particularly those in health care, who are on the front lines of the pandemic. Moreover, an expansion of public social services is inevitable because of the aging population in several Latin American countries, such as Brazil.

For him, however, the expansion of public employment in the social sector is unable to address the labor market problems of Latin American countries because they are branches of activity in which productivity grows very slowly, and it is necessary to create jobs in sectors where productivity is high and growing, so that countries such as Brazil can participate more in international trade. For Andrés, social policy is also an employment policy, and employment policy is also an innovation policy. He concluded by saying that we must keep this point in mind, because otherwise we will have many good intentions, but will continue to achieve very bad results.

# APPENDIX: VIDEOS OF EACH OF THE PANEL SESSIONS

## PANEL I – AN OVERVIEW OF THE WORLD ECONOMY AND BRAZIL

Youtube link: <https://www.youtube.com/watch?v=fybx17Rli9g&t=24s>

**Speakers:** Ana Paula Vescovi; Jacob Lew; José Alexandre Scheinkman; Lisa Schineller; Madelyn Antoncic; Willem Buiter

**Moderator:** Safwan Masri

**Comments:** Jan Svejnar

## PANEL II – STRUCTURAL CHALLENGES AND THE GROWTH AGENDA

Youtube link: <https://www.youtube.com/watch?v=2IYeBjpMkLg&t=1256s>

**Speakers:** Álvaro Pereira; Debora Revoltella; Edmund Amann; Laura Carvalho; Otaviano Canuto

**Moderators:** Thomas Trebat and Jan Svejnar

**Comments:** Albert Fishlow

## PANEL III – GLOBAL MONETARY CONDITIONS AND IMPLICATIONS FOR THE EMERGING ECONOMIES

Youtube link: <https://www.youtube.com/watch?v=lkhE1cF6wr0>

**Speakers:** Francesco Papadia; Guillermo Calvo; Ilan Goldfajn; Seth Carpenter

**Moderator:** Patricia Mosser

## PANEL IV – GLOBAL FISCAL CHALLENGES IN THE POST-PANDEMIC PERIOD

Youtube link: <https://www.youtube.com/watch?v=FpvNHnZtuls&t=649s>

**Speakers:** Ana Carla Abrão; Danny Leipziger; Thomas Trebat

**Moderator:** Jan Svejnar

## PANEL V – REFORMING LABOR MARKET AND SOCIAL POLICY POST-PANDEMIC (PART I)

Youtube link: [https://www.youtube.com/watch?v=\\_7iKNsNuYSU&t=525s](https://www.youtube.com/watch?v=_7iKNsNuYSU&t=525s)

**Speakers:** Armínio Fraga, Cecilia Machado, Jan Svejnar

**Moderator:** Thomas Trebat

**Special Guest:** Joseph Stiglitz

## PANEL VI – REFORMING LABOR MARKET AND SOCIAL POLICY POST-PANDEMIC (PART II)

Youtube link: <https://www.youtube.com/watch?v=pNITasHWm1k&t=4280s>

**Speakers:** Andrés Velasco; Celia Kerstenetzky; Stefano Scarpetta

**Moderator:** Thomas Trebat





