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THE LATEST ON BRAZIL'S ECONOMIC REFORMS:
A CONVERSATION WITH ECONOMY MINISTER PAULO GUEDES

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P R O C E E D I N G S

MR. WESSEL: Good morning. I'd like to welcome everybody on behalf of the Hudgins Center on Fiscal and Monetary Policy. The minister apologizes for being late. He was trying to demonstrate that the United States has had inadequate infrastructure investment. (Laughter) And so, like many things, we'll somehow find someone else to blame. Right?

The minister's going to speak for about 10 minutes and then I'm going to ask him some questions. I'll keep the introduction short.

Paulo Guedes has been since January what they call a super minister in Brazil. One ministry wasn't enough for him, so he has Finance, Planning, and Industry. He has a University of Chicago Ph.D. in economics, spent several decades in banking, and is new government; comes to this job at a pivotal moment in Brazil's economy and is pushing a very important and sweeping pension reform.

So with that, Minister.

MINISTER GUEDES: Good morning, everybody. A few words first about what is going on down there.

I think we have the dynamics of an open society, a very vibrant democracy. After 30 years, well, first we had 20 years of military government, a politically closed system, investing a lot on infrastructure. True, the state companies: Eletrobras, Telebras, Petrobras, (inaudible), and so on. When we re-democratized, we tried to transform a (inaudible) state machine into a Russonian will of the people machine. But the economists were not and the politicians not wise enough to make the transformation. Privatizing (inaudible) companies, decentralizing resources to invest on human capital: education, health, and so on.

So the general direction was good to satisfy the requirements of an emerging democracy, but we mismanaged the transformation. It took so long, we got lost in the hyperinflation, two hyperinflations, two bursts of hyperinflation; extent of that moratorium; and finally two big recessions. But all the time institutions getting better, perfecting democratic institutions.

So we had impeachment. The legislative power declared its independence making impeachment at the right first and then at the left. When the executive power tried to buy political support in the Congress, they awakened the judiciary power that put both in jail who bought and who sold. Nobody's above the law, rule of law. Voting machine every two years; and for the first time, quite natural, we had the right first in a politically closed system, then we had Social Democrats, political alliances center left, winning all the elections. And how we discovered we have conservatives and liberals in political alliance center right.

So what was a very vibrant democracy working was interpreted abroad by the establishment that was disrupted as a threat to democracy. There was no threat whatsoever. There is no threat whatsoever. There will be no threat whatsoever to democracy. It's a very vibrant democracy.

And when even the conventional media fell in love with the establishment, it was disrupted. A man was elected spending less than a million dollars. What does it say about democracy? What does it say about new social media disrupting conventional media? Should conventional media depart from what people are feeling?

And what people were feeling was a new agenda about customs, about principles and values. A man could have bad manners and great principles and values. And a lot of people have good manners and very bad principles and values. So it was political.

So my first line is about politics is don't feel sorry for us. We have a very vibrant democracy and it is now a political alliance center left -- center right. After 30 years of left, no problem. Four years like that, maybe eight, who knows? No danger at all. Institutions are getting perfect. And we will show that very soon to everybody.

Now to the economics. There was a transition politically, but economically what happened in Brazil and then for the last four to five decades, so it's not a problem with the democracy itself, if in the military at the end of that regime they were already feeling the bites of a (inaudible) economy. So public expenditures came from 18 percent of GDP at the beginning of the military government to 26, 27 when the military left. Then it kept going higher to 32, 34, 36, 40, 42, 45 percent of GDP. This is the Brazilian history of uncontrollable public spending for almost 50 years.

So Brazil, it was a very fast-growing economy, one of the fastest growing economies in the world. For at least three-quarters of the last century, Brazil had an average yearly growth rate of beyond 7 percent. Brazil used to grow faster than China, faster than Japan, faster than Korea for a very, very long period of time in the past century. And then because of excess of public expenditures, first with the military and then at the end with the democratic governments, that increased social expenditures allegedly. It's natural requirements of an emerging democracy, but they did not dismantle the privilege and the subsidies and misallocation of funds that they received. So it was an incomplete transition.

Economically we are in a phenomenon which is an incomplete transition. But the dynamics is of a great open society, a Popperian great open society. Independent powers, free press. If the conventional press misbehaves, they lose because the social media disrupt them. And the economy trying to get in the right direction, but without controlling public spending. So our program was a very simple one.

First one, conceptually, of course, I would love to do what Ludwig Erhard did in Germany for 10 years. I would love to do what Thatcher with Reagan did. I would love to do what the Chicago Boys did in Chile. So it would be wonderful to do with the Chicago oldies. So I've got a lot of Chicago oldies, guys from the old Chicago school, just to go in that direction.

It's not reasonable the eighth largest economy in the world to be the 126th in ease of doing business, 129th in openness, degree of openness. It just doesn't make sense, so we need some Chicago Boys. Don't turn away from market people, market-drive people. We must change the economic axis from state competence, intervention, to market-driven; from a very closed economy to an open economy.

Well, but there is a global world war, not at us, not with us. We are so closed we don't even feel the noise of the global trade war. We trade with China. We trade with the U.S. Very little with both.

So our program was conceptually we call it "The Road to Prosperity," just as putting together *The Road to Serve Serfdom*, which is negative of Hayek, and *Prosperity Through Competition* of Ludwig Erhard. So put both together, just put a sign and say we are opening the economy. We are going to be a market-driven economy. We will reduce the (inaudible) of credit. Forty percent, 50 percent of Brazilian credit is misallocated because it's through either two or three great public banks or through subsidies, generalized subsidies, tax exemptions and things like that, so very high taxes.

So our program was, number one concern, what is the fastest-growing public expenditures so that we have got to 45 percent? Because, see, we had hyperinflation. It's a symptom, a manifestation of uncontrolled public spending.

At the end of the military government we had a sequence of exchange rate crises. Recycling petrodollars to accelerate public spending. So we have the petrodollars to recycle, so there should be no exchange rate crisis. You are receiving money from abroad, the petrodollar recycling at the end of the ’70s, but we spent so much that even though the phenomenon was caused by recycling of petrodollars, at the end we were with a recurrent exchange rate price. So we spent everything we received and more.

Then we went to domestic financing to subsidize agriculture in the very last public government under the military rule. And that inflation moved from 36, 37, 40 percent a year to 200 percent a year. And then the military got out by the back door and the private guys moved in and they control prices, like in Venezuela, and then seize financial resources, blockade financial savings. Crazy, stupid, silly policies. And then we go to higher inflation twice. Who is behind the scene? Public spending, uncontrollable.

Now inflation gets down, institutions being perfected, an independent Central Bank in a lame duck government, a government because there was impeachment. The vice president took power and they managed 3-1/2 percent popular support, so lame duck. No control whatsoever. Received inflation at 11 percent. In two years, inflation is 3.7 percent.

What happened? An independent Central Bank, even though it’s not in the law, but institutions getting perfect all the time. Judiciary power, independent Central Bank, legislative power that impeaches presidents at the right and at the left. So we have the dynamics of an open society. Don’t feel concerned. Don’t feel sorry or sad about where we are going. We are moving well.

The losers in the election gave a very wrong impression because they were disrupted, so they’re saying bad things. They’re impressed with bad manners and things like that, but we know what we are doing. We are very constructive and the Congress will be very constructive and we are moving forward.

So the plan is, number one, explosion of public expenditures, must control that. First item, personal. Inside that, inactives, so Social Security reform, it's the pension reform. It's a fiscal hole, it's a black hole. It's swallowing the whole economy. So it's 770 billion, it's the largest by far public spending, so we attack that with a proposal of Social Security reform. We can talk about that later.

Number two, expenditures, higher expenditures. Not only the government spends a lot, but spends unwisely. We build one Europe every year. The Marshall Plan is $100 billion. We build one Europe without getting out of Brazil. So whoever builds Europe should become Europe. But if you spend one Europe, next year one Europe, next year one Europe -- $100 billion a year just to serve public debt. What is public debt? Unwise past, an unwise past of public spending (inaudible) inflation only with the Central Bank. So a snowballing indebtedness, an internal debt, instead of having the manifestation of unwise and uncontrollable public spending under the form of a hyperinflation, we now have (inaudible) snowballing indebtedness.

And then this lack of coordination of monetary and fiscal policy leaves their (inaudible) there, which is $100 billion rebuilding one Europe without leaving Brazil. So we are still Brazil. We build on Europe; still Brazil; we rebuild on Europe. It's very poor judgment of past (inaudible) on how to fight inflation without fiscal coordination. So Social Security reform, number one.

Number two, highest expenditures, it's interest, which is usually on a year-by-year basis. You look at that thing, you say it's uncontrollable. We have an independent Central Bank, interest rates is whatever it is, but we have the stock of the debt in the past. It's given -- it's uncontrollable.

Fake news is not uncontrollable. It will change the whole trajectory. If we privatize, accelerate it, and we reduce that, we have more than a trillion in value of state companies. We have more than a trillion with 700,000 real estate units owned by the union. Even the embassy here, wonderful, was bought in the '30s. It's worth a lot of money.

When the ambassador jokingly said, well, I'm retiring, but I'm not costing anything to you guys because I am already retired. I said, well, if we sell, we can sell your house. (Laughter) I'm sleeping there. Wonderful place. (Laughter)

It's (inaudible) to keep these things. If you go to Rome, it's in Piazza Navona. If you go to Milan, it's by the side of the Duomo. It's wonderful things. We bought by giving coffee in the '30s after the war. Wonderful things. I look at those things and I think we can really reduce our debt. So number two is accelerate privatization.

Number three, expenditures, the machine itself, the wage bill. Wages going 7 percent real a year. So inflation is 10 percent. Give public employees 10 percent plus 7, so you created a caste of privileges, people who make 3 or 4 times their wages comparable in the private sector. Exactly like happens in their Social Security benefits and pensions. The average is three, four, or five times than an ordinary citizen.

So number three is -- and the good news, human capital depreciates and eventually dies. Forty percent will retire, 40 to 50 percent will retire in the next 4 to 5 years. Great news. We will not replace them. We'll digitalize, we'll simplify, and we will cut without hurting anyone. They just retired and we don't let new admissions and public, they call it, (speaks in Portuguese), admission tests. So just close the admission tests one, two, three, four years. Of course, there will be exceptions here and there. But as a general rule, fix this thing and then it will deflate naturally.

So the first one, Social Security; the second one is accelerate privatization to hit the expenditures and interest, to change the balance sheet, like a company. Just change the balance sheet. Sell some assets, reduce some debt, and change the future trajectory.

So it's all about trajectories, feeling change the path of Social Security, change the path of interest rates payments for the future, change the path of the public sector wage bill. Then reduce taxes and simplify taxes. So a corporate tax is 35 percent in Brazil, 34. Dividends don't pay tax because they've been already charged. So what about if the U.S. changes corporate tax to 20? We should change to 15. Why shouldn't someone open in Brazil if it's good to open in the U.S., paying less tax? So we should reduce even more. But then you tax the dividends on the other side.

Brazil has more than 40 different kinds of taxes in a highly centralized fashion. So what we'll do is exactly to simplify, to collapse four, five, six taxes in one single federal tax, value-added basis. A simple thing. With digital controls you have now, things that used to be complex, paper-filling and things like that, it's just digital. You credit yourself, you debit yourself when you buy something there's a lot of credits of taxes that came. When you sell it there's a lot of -- there is then a credit to you. You've just -- one can (inaudible), whatever is the value left. You compare with the value-added base tax and that's it.

So we'll be simplifying and reducing tax. Like I said, it doesn't make sense to be the eighth largest economy in the world and being 120-something ease of doing business. So our target is to come from 120 to less than 50 at the end of (inaudible). In four years we had to be one of the 50 best places to have business in the world.

We have some other, it's not just the index of ease of doing business. There are three or four orders, like competitiveness, innovation, education, so things that we know are quite decisive to be in place to receive investments.

Opening the economy. We will not open linearly because we have to simplify taxes and we had to improve investments and infrastructure to reduce the logistic cost in Brazil. I could give you many examples, but there is not time.

MR. WESSEL: Sit down so I can talk. (Laughter)

MINISTER GUEDES: Okay. So finish. (Laughter and applause)

MR. WESSEL: So if you managed to sell the Brazilian embassy in Washington because of a speech you made here, I just want to make clear we want a cut. We want a finder's fee. (Laughter)

Minister, you set forward a very powerful and ambitious agenda, but I think it goes nowhere if you can't get the pension reform through. Brazil has a very generous pension system, no minimum retirement age, people retire, men at 55, 52 for women on average. The public sector, as you said, has a more generous -- it works out more generously from them.

You say you're optimistic about getting this through. It's an ambitious political goal. You need two-thirds of the Congress because you're amending the Constitution. What happens if you don't get it through and why should I believe you're going to make it?

MINISTER GUEDES: Well, that's a great question. Well, you know, I thought I would have a lot of opposition in the Congress, but when a finance minister is applauded in the street through the social media, people began talking about Social Security reform, about how we are in a new political environment, about how there's no corruption in politics because we will not allow, it became a popular thing in Brazil. So last week, there were demonstrations, public demonstrations, all over the country. And to my surprise, a lot of people screaming my name and saying we support, oh, we support. Hold up a sign --

MR. WESSEL: They hold up signs saying, "Cut my pension?" (Laughter)

MINISTER GUEDES: No, that's the amazing thing. To have a finance minister getting popular is a very odd thing. (Laughter) And getting popular because it's supporting Social Security reform is a thing of another planet or a sign of maturity of public opinion. They understand that we could become Greece, we could become Portugal. Not only Social Security would collapse, but also public wages, wages in the public sector because they are going broke.

So the amazing thing is that the Congress, the mayors and governors with whom I talk, they are also broken. And Social Security is the main problem, so they need the reform. It's not just that they want, nobody wants a reform, but everybody understands that they need the reform.

MR. WESSEL: So you've had some stormy hearings before the Congress. Your plan is to save a trillion reais over a decade.

MINISTER GUEDES: Well, 98 percent of the meetings I had in Brasilia were very successful.

MR. WESSEL: So when do you think it'll get through?

MINISTER GUEDES: Talking to people -- it will get through before the end of the first semester. This is my personal expectation.

MR. WESSEL: So you mean by July 1st?

MINISTER GUEDES: Probably it will be about that time. Because politicians understand that there are elections next year again. We have elections every two years. So what is the wise and intelligent politician that would like to have one year before the election to be talking about this thing? There's not one, not even in the opposition. So all of them understand that this is a critical thing that has to be decided fast enough because you know what is the agenda for the next 12 months after the approval: the decentralization of financial resources, what we call the federal pact.

You have very interesting discussions here Thomas Jefferson, in the Washington government, George Washington government. Thomas Jefferson one side, Alexander Hamilton on the other. Very true that Hamilton died in a duel some years later and the fight continued, the Federalist Papers, and all that dispute. The U.S. built bottom up, 13 colonies, some of them already with their Constitution. Then the British put a tax on tobacco, we must fight those guys, let's create the federal government. So 60 to 70 percent of the money was with the base, with the population, where people live.

And then we create additional layers, like a pyramid. So you fill the president of the government where the population is. And then when you need an Internet or the South Pacific fleet to police the area where the Chinese are expanding their influence, or the Internet, then you have -- or to put a man on the moon, then you have the federal government.

MR. WESSEL: So you have --

MINISTER GUEDES: But in Brazil it's the other way around. In Brazil, 60 percent or 70 percent of the money is upstairs. So when a president likes a soccer team, a stadium pops up. When the president likes an entrepreneur, he becomes the largest entrepreneur in the world in animal protein because you just pumped 500 billion to the National State Bank, Federal State Bank, and then the National Development Bank pumps money, 10 billion, to the guy. He comes here and buys two or three of your protein factories and he's the largest in the world. So this is pretty wrong; they understand that.

So we must --

MR. WESSEL: So let me ask you --

MINISTER GUEDES: We must limit and decentralize power and financial resources.

MR. WESSEL: Okay. I have one more question about the pensions. So you've proposed you would save a trillion reais over a decade.

MINISTER GUEDES: Trillion. Trillion.

MR. WESSEL: I read in the press, I admit mainstream press, that the consensus is you'll get somewhere between 600 and 700 billion instead. Is that okay? Will that be okay with you?

MINISTER GUEDES: That is the beauty of democracy. The established media says it's just going to be just 600 to 800 billion. I would suppose first that they are right because they might be very wrong. The last time they said this man would not be elected, but I'll suppose they are right. And the thing comes 600 to 800 billion. Well, it's much more than the last government proposal, which means that financially we will survive. What is the effect on me? I do not launch the transition to the capitalization regime.

So Brazilians are saying through their Congress, a representative democracy, they will be saying we are not willing to sacrifice ourselves for our sons and future generations. We prefer to have them with us in this very same plane that is going to crash one day. That's their choice if they do that. No problem.

MR. WESSEL: You won't resign if they do that?

MINISTER GUEDES: Well, we'll continue growing .6 percent a year. We'll continue in a very mediocre growth path. But they manifested their will. I'm just making it clear, hey, guys, do you want your son to come with a parachute so that you jump and he dies in this plane? Or do you prefer to pay for a transition to a new regime that will free future generations from this trap, low growth trap, perverse financing.

The wage bill in Brazil has 100 percent tax on labor. So to create one job, you destroy one. You pay two to have one.

MR. WESSEL: Let me ask you a question about the social media. I read that BNP Paribas has counted President Bolsonaro's Tweets. He doesn't Tweet quite as often as Donald Trump, but he likes Twitter. And they said that he's Tweeted more than 500 Tweets since becoming president, 8 were jokes, 5 were about pension reform. If social media is so important and you need the political backing of the president, why isn't the president talking more on social media about pension reform?

MINISTER GUEDES: Well, the president voted against the reform many times. It's more than you say. The president voted against. And when he went to the Congress he said, listen, I regret having voted against and I'm giving support to this thing. Is it full heart, he's in love with the pension regime or -- of course not. Of course not. He's a man. He has some qualities that are decisive for leadership. He's transparent. He's a sincere man. He's resilient. He's not afraid of the challenges. He's willing to give support something that he does not -- he would not like, but he understands it's necessary.

He's doing his part. He's not a fake man. He's not a man that would get there, I'm in love with this reform. No, quite the contrary, he jokes and says, listen, for me women could retire with 20 years old. I think they deserve it. It's just a joke. But it's how he feels about the world.

He says, well, do you really need that, Paulo? We need that or we will go bust. He says, okay, I support that.

And then the social media, the social media, he knows that he -- it's not something very pleasant to him, but he's given support and they understand that. There's nothing like the truth. I don't like that. I don't understand economics. (inaudible) says it's necessary, I give support. Do you want me to come here and say I love it? No, I will not do that. And we are mature enough to understand that.

MR. WESSEL: So let me ask you a question. How would you compare Bolsonaro to Trump? (Laughter)

MINISTER GUEDES: I don't know Trump very well and I know -- I met Bolsonaro one year and four months ago for the first time. I understand he's playing his role, which is to disrupt conventional politics. Our (inaudible) economic model corrupted democracy and stagnated the economy.

MR. WESSEL: So from what you've seen of Donald Trump --

MINISTER GUEDES: He's an agent of change.

MR. WESSEL: You think that -- would you say the same thing about --

MINISTER GUEDES: The only comparison I can make, and it's a wide, big, big, big problem is the following: 3.7 billion (inaudible) jumping the global market, former victims of (inaudible) economists. Eastern Europe, India, 1.5 billion Chinese, all these guys jumping global markets, labor global markets, and said we want to get better. We believe markets are the best social inclusion program ever. We are getting out of misery because we believe in markets now.

So when the poverty is being removed from the other side of the world, we Westerners not understanding this, the fact of price equalization (inaudible) percent or so, which is the Chinese don't need to come here. They just build things there with established technologies, trade equalizes prices, and wages go up there and wages don't go up here. That's why we need zero interest and skyrocketing stock markets all the time, to generate financial bridges to wealth because they're not coming from the real sector anymore, except for Silicon Valley.

So there is a general improvement in the role of income distribution. But if you take a picture locally, interest rates go down, property of people goes up. If you have real estate, up. If you have equities, up. If you are just a labor man, no, you wage is locked.

So it's a very severe problem in the Western world. We have the discomfort of people who don't have Social Security, they don't have labor laws, they don't have tax on labor. And these people are moving and getting harder, studying more, and working harder, and we feel discomfort.

And then the population looks for whoever is taking care of them. And we know that national constituencies don't solve these problems anymore. So the British vote for Brexit, the French for Macron, the Americans for Trump, and Brazil is for Bolsonaro. We are all trying to survive.

MR. WESSEL: Okay, we have a policy --

MINISTER GUEDES: Simple as that.

MR. WESSEL: Let me interrupt you. The minister has to go in a minute, but we always have at least one question. So I want to give someone in the audience a chance to ask one quick question and we'll see if the minister can give a quick answer.

Monica, here. And please introduce yourself.

MS. DE BOLLE: Thank you, David. Monica de Bolle, I'm the director of Latin American Studies at SAIS Johns Hopkins and a senior fellow at the Peterson Institute for International Economics across the street.

My question to you, Minister, is about the tax reform. So you've spoken about the need to simplify taxes, to make the system more efficient, and to make the system less complex. My question about this is how is that doable in the context where a lot of the taxes involved are taxes that are collected by the states and the states and the finances at the subnational level are in such dire condition? Thank you.

MR. WESSEL: Thank you.

MINISTER GUEDES: That's a great question. I know, Monica, has a very well-known, great reputation in Brazil as an economist. I was a student of her father at the Vargas Foundation (speaking Portuguese).

And the thing is there is a long track record of tax reforms that fail in Congress exactly on that point because people try to put all taxes together. But there is a natural resistance of states and municipalities to converge to a general tax system because they already catch stress. They're already -- exactly because in a military government they concentrate the financial power at the top. And the (inaudible) government failed to decentralize, even created more taxes that were not distributed. We call them contributions, not distributed to mayors and states, state and municipality level.

But this is (inaudible) coming and the (inaudible) is calculated by -- not by Brazilians, by Exxon, by Shell, by Total, by great oil companies. Between 500 billion and $1 trillion in the next 20 to 30 years coming out of the ground. So we will decentralize money at the margin. We don't have to change and move around the money today.

All this money that comes, we'll do it inverse to what it is the current distribution. We'll put 70 percent to state and municipalities and only 30 percent to federal government. We want to shrink the federal government and expand the state and municipalities. The money has to go where people live.

You don't feel the police there. If a guy shoots to the top here in the U.S., in five minutes you have eight snipers and one guy saying drop your gun now slowly. In Brazil if you shoot three times, the police run because they don't have guns. So we must decentralize this money.

So the answer to Monica is we will make a tax reform, not the one like Bernard Appy that tries to grab everything and put everything together. We will just make it at the federal level. We will take -- the next three or four months we will announce already contributions, (speaking in Portuguese). We will take three or four of them and we will create the single federal tax. And then over time, we will put more federal tax there. So we will give the example to state and municipalities, but we will let them tax. Let them tax.

And then we'll approve this thing, this simplification of federal tax reforms because they have the perspective of having more money in the future. And this will also be used to get their approval of the reform. All of them are financially stressed. They will not approve because they love me. They'll approved because they need money.

MR. WESSEL: Minister, I'm going to interrupt you because your staff is having heart attacks here one at a time because you're late. (Laughter) So please, thank you very much for coming. And I hope you come back later when you've finished all these reforms.

MINISTER GUEDES: Thank you. Thank you very much.

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I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

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