What’s Next for Brazil After Neoliberalism?

Matias Vernengo

Is Lula going to change policies significantly in Brazil from the neoliberal policies of the past? This economist has his doubts. He argues that lower interest rates and a depreciated currency are required and that new restrictions on capital movements are needed.

DURING THE PAST FOURTEEN YEARS, Brazil has experienced a process of liberalization of transactions in both the current and the capital accounts of the balance of payments. Trade flows started to be liberalized in the late 1980s, and portfolio and foreign direct investment flows were liberalized in the early 1990s. The macroeconomic results were dismal, a result that is not altogether uncommon (Taylor 2000). Growth remained

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at the low levels of the post–debt-crisis period, unemployment increased, trade deficits rose, and domestic and foreign debt piled up to dangerous levels.

The social impacts have not been much better, despite claims to the contrary by authors sympathetic to Fernando Henrique Cardoso's administration. True, poverty rates fell, infant mortality also fell, literacy rates went up, and even the wretched record of income distribution seems to have slightly improved when measured by the Gini coefficient. However, poverty, infant mortality, literacy, and other social indicators have been improving since the 1940s, and hence the current results cannot be attributed to the liberalization experiment.

Income distribution—which is responsible for the terrible Brazilian reputation in social issues—actually worsened considerably. The Gini coefficient fell from 62 in 1990 to 56 in 1998 before increasing to 58 in 1999. However, Gini coefficients in Brazil measure wage inequality, not overall income inequality. If we look at the functional distribution of income, the picture that emerges is quite different and rather bleak. The share of wages in total income was approximately 51.4 percent in 1993 and only 40.7 percent in 1999. The flip side of the reduction in the participation of wages is the increase in the net operational surplus (interest, profits, rents, etc.) from 35.4 to almost 46 percent in the same period.

Not surprisingly, despite the incredible reduction of inflation, the center-right coalition that supported the Cardoso administration suffered a landslide defeat in the last elections. The result brought to power a party from the left of the political spectrum for the first time in Brazilian history. The legacy of macroeconomic imbalances and the long history of social inequality should serve as a deterrent for excessive optimism. However, progressive forces around the globe do expect a break with the pattern of reforms pursued in the last decade. This paper discusses some of the main problems faced by the current

administration, and suggests some alternatives for the main macroeconomic constraints faced in the short run.

Before assessing the daunting tasks that President Luis Inácio (Lula) da Silva has ahead of him, let me explain why one should be concerned about the Brazilian future in the midst of all the other terrible problems faced by progressive forces around the world. There are at least three reasons to take the Brazilian problems seriously. First, if the Brazilian government fails, and defaults on its foreign obligations, the repercussions in the rest of South America will be harmful. Brazil has been instrumental in shoring up the Argentine economy—at least during part of the 1990s—in maintaining democracy in Paraguay and Venezuela, and in avoiding the spread of narco-terrorism throughout the Amazon region. The whole subcontinent is in a fragile political and economic conjuncture, and a Brazilian crisis might send it directly into even worse social chaos.

Second, a Brazilian default will add to the series of international financial crises of the 1990s—including the previous Brazilian crisis in 1999—forcing an already stressed system into one more rescue process. In the absence of a clear recovery in the United States, and with the additional uncertainties of the war on terrorism, another crisis might reinforce the tendency toward global stagnation.

Last but not least, Lula and the Partidos dos Trabalhadores (Workers' Party) are closely connected with the international movement for change and redemocratization of the globalization process. The first three meetings of the World Social Forum—the anti-Davos meeting organized by progressives around the globe—were held in Porto Alegre, the capital of Rio Grande do Sul, a city administered by the Workers' Party during the last twelve years. Lula addressed the Social Forum earlier this year, and promised to work to tackle the concerns of his audience. Failure will be a severe blow to the progressive international

movement, equivalent to the defeat of the McGovern coalition for American liberals in the 1960s.

Foreign Debt Sustainability and Macroeconomic Policy

Brazil was a late convert to the liberalization, deregulation, and privatization creed of the Washington Consensus.[1] Only after the July 1994 plan to stabilize its currency (the real), called the Real Plan, was Brazil clearly adopting the set of policies promoted by Washington, even though trade and capital account liberalization had been under way for a while. Trade liberalization by reducing tariff and nontariff barriers would lead to rising imports of intermediate and capital goods. The rise of imports of intermediates and capital goods would, in turn, lead to an increase in productivity and, as a result, a rise in exports and of the rate of growth. This export boom would make the initial trade deficits sustainable in the longer run.

Also, it was expected that the market-friendly reforms would lead to an increase in foreign direct investment (FDI), which would also translate into higher rates of growth. In particular, it was argued that FDI would generate a positive macroeconomic externality and lead to an increase in domestic investment.

By and large, the expectation was that post-reform growth would be higher and led by exports. Greater emphasis on exports together with a more efficient use of imports would produce larger trade surpluses. An important complement of the reform package would be labor market deregulation that would keep real wages and unemployment relatively low. As a result, the reforms would lead to higher growth and productivity with a relatively low level of unemployment. Finally, it was believed that higher rates of growth and productivity and a relatively stable macroeconomic environment would reduce poverty and inequality.

Looking at the whole postwar period, one must conclude that

Table 1

Inflation, Growth, and Labor Productivity

	Inflation (GDP deflator)	Real GDP growth	Real GDP per capita growth	Productivity growth
1948–1980	45.3	7.45	4.40	4.1
1981–1989	341.2	3.30	1.28	0.6
1990–1994	1,643.6	0.79	–0.77	1.0
1995–2002	8.1[a]	2.41	1.18	2.8[b]
1990–2002	653.3	1.98	0.37	1.8[b]

Source: Instituto de Pesquisa Econômica Aplicada (IPEA) Data, available at ipeadata.gov.br/ipeaweb.dll; Régis Bonelli, "Productivity Growth and Industrial Exports in Brazil," *CEPAL Review* 52 (April 1994): 71–89.
[a] Figure for the 1996 to 2002 period.
[b] Figure goes up to 1999.

the growth performance of the Brazilian economy is divided into two periods, before and after the debt crisis. The real gross domestic product (GDP) growth per capita was on average 4.4 from 1948 to 1980, and it slowed down to only 0.74 in the 1981 to 2002 phase (Table 1). Table 1 also shows the differences between the first part of the 1990s and the post-stabilization period. Inflation decreased drastically, but the rates of growth recuperated only slightly. As far as growth rates are concerned, the 1990s and not the 1980s, as one would expect, is the lost decade.

Finally Table 1 shows that labor productivity growth was higher in the 1990s, in both subperiods, in contrast to the 1980s. However, rate of growth of productivity is still considerably below the level of the import substitution period.

At a first glance, the Brazilian experience lends little support for the notion that there is a positive correlation between openness and growth. If one classifies the 1948–80 period as inward oriented, 1981–89 as the crisis or transition period, and the 1990s as outward oriented, then one must conclude that import substitution was quite successful (see Table 1).[2] In the case of Brazil, at least, it is difficult to agree with the view that the ever-grow-

ing presence of the state in the 1950–80 period eventually stifled efficiency and growth.

According to the conventional view, the protectionist policies that dominated the agenda in Latin American economies generated an anti-export bias that discouraged both the growth and the diversification of exports. Two channels were responsible for the relatively poor export performance. First, tariffs and quotas increased the cost of imported intermediate and capital goods used to produce exportable goods. Second, protectionist policies were in general complemented by overvalued *real* exchange rates that reduced the competitiveness of exports.

In the case of Brazil, it is clear that at least from the late 1960s onward, there has been a concern with maintaining a relatively competitive exchange-rate regime in order to promote exports.[3] In fact, it appears that it was during the liberalization period that the anti-export bias of the Brazilian economy actually developed. Table 2 shows the evolution of the rates of growth of export and import volumes from the 1970s onward. It is clear that in the 1990s there is an explosion in the rate of growth of volume of imports. The rate of growth of the volume of exports, on the other hand, is lower on average in the 1990s than in the 1980s. That is, in the 1980s the rate of growth of exports averaged 11.5 percent, whereas in the relatively more open 1990s, the rate of growth of exports was 5.6 percent.

The increase in import penetration, in conjunction with the sluggish rate of growth of exports, in the context of a relatively open economy, spells trouble for the sustainability of the current account. Furthermore, the exchange-rate stabilization plan, which meant appreciated and relatively fixed exchange rates, implies that during the 1990s lower rates of growth were the only instrument to maintain the current account under control. These lower rates of output growth explain the fall in the rate of growth of imports.

Table 2

Growth in Brazilian Exports and Imports (%)

	Exports	Imports
1970–1980	15.5	–2.1
1981–1989	11.5	–1.4
1990–2002	5.6	13.2

Source: Instituto de Pesquisa Econômica Aplicada (IPEA) Data, available at ipeadata.gov.br/ipeaweb.dll.

More important, the current-account deficits accumulated during the 1990s imply the need to attract capital flows to finance the deficit. In other words, the deficit led to the accumulation of foreign debt. The ratio of foreign debt to GDP started growing after the Real Plan and reached 44 percent in 2001, which corresponds to the level of the debt crisis (see Figure 1). Figure 1 shows that it is only in the 1980s—when the import substitution for the most part was complete—that the ratio of foreign debt to GDP explodes. The second explosive growth of the foreign debt occurred exactly after the liberalization process.

The Cardoso administration's main instrument to keep the current account under control was to reduce the level of economic activity and to keep interest rates at incredibly high levels to attract foreign capital flows. The exchange rate was kept overvalued as an anchor for domestic prices. During the 1990s, the combination of appreciated exchange rate and high interest rates led to an increase in unemployment from 4.3 percent in 1990 to 7.3 in 2002. In sum, the macroeconomic legacy of the external liberalization process consists of low rates of growth, high unemployment, and increasing foreign indebtedness. The Workers' Party promised a clean break from these policies, while noting that the inherited macroeconomic situation would impose severe constraints on its ability to reduce unemployment and resume growth in the short run.

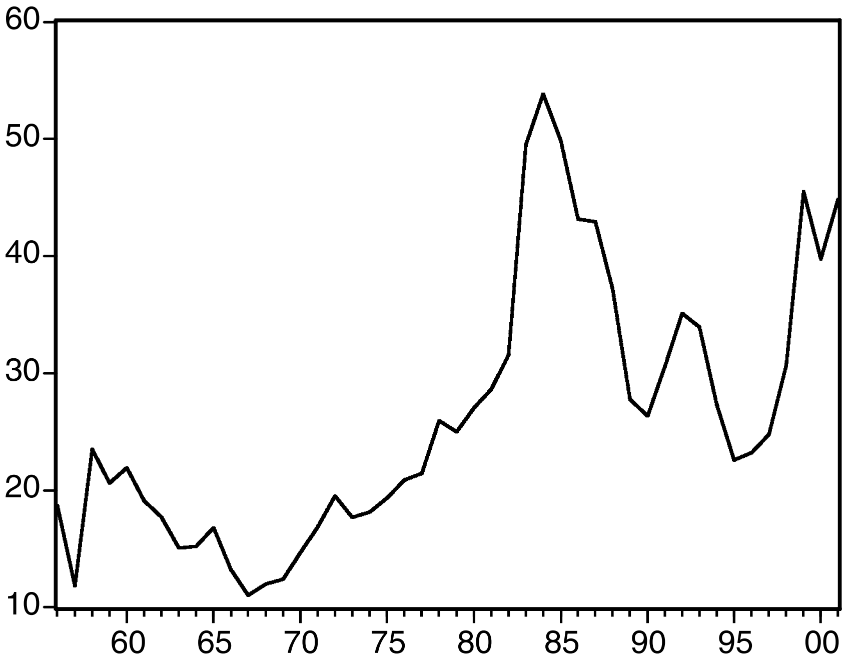

Figure 1. Ratio of Foreign Debt to GDP

Source: Instituto de Pesquisa Econômica Aplicada (IPEA) data, available at ipeadata.gov.br/ipeaweb.dll.

Beyond the Consensus or Policy Shift?

The election of Lula led many foreign investors to fear the worst. The world's most celebrated currency speculator, George Soros, in an interview in August 2002 with *Folha de S o Paulo*, one of Brazil's leading newspapers, argued bluntly that Brazil would not be allowed—presumably by financial markets—to elect Lula. Later he argued that as long as Lula led the polls, and even more should he win, the Brazilian real would be under speculative attack. That has apparently been the diagnosis accepted by Lula's administration, if one looks at the policies pursued in the first four months of the Workers' Party administration.

The administration's two most notable measures, after appointing Antonio Palocci, a politician with no economic back-

ground, and Henrique Meirelles, an ex-president of Fleet Boston, to the Ministry of Finance and the Central Bank respectively, were the increase in the base interest rate to 26.5 percent and the increase in the target primary surplus accorded with the International Monetary Fund (IMF) to 4.25 percent. These measures have led, on the positive side, to a decrease in the spread between interest in Brazilian bonds over treasury bonds—the so-called country risk—but also to a considerable appreciation of the real. The results have been highly acclaimed by the government as proof that Lula and the Workers' Party do not frighten international financial markets anymore. Also, the appreciation of the real is seen as a key variable to keep inflation under control.

The new administration has received further approval from international financial markets, after news of legislation that would increase the operational autonomy of the Central Bank, and of social security and tax reforms. Kenneth Rogoff—then the IMF chief economist—compared the new economic team to the Cardoso one, and said in economics and soccer Brazil can always line up a first-rate team.[4]

International praise would be fine, if it were not for the fact that the measures being praised—high interest rates, appreciated currency, and stringent fiscal adjustment—were the measures that caused all the trouble in the first place. It is still unclear whether Lula—as much as Carlos Menem in the early 1990s in Argentina, and so many other left-leaning politicians—should be counted as one more case of policy switch. But the signs in that direction are increasingly clear. Not surprisingly, there is increasing tension within the Workers' Party, and between some government officials.

A recent document published by the Ministry of Finance (Ministério da Fazenda 2003)—written by Secretary of Economic Policy Marcos Lisboa and based on a similar document organized by him with the participation of José Scheinkman (see Lisboa et al.

2002), former chair of the economics department at the University of Chicago along with other conservative economists—reversed the diagnosis to which most heterodox economists subscribed (e.g., Bresser Pereira and Nakano 2002), according to which the foreign restriction, not the fiscal one, was the one binding.

A quick inspection of Table 3 shows that in the first half of the 1990s, primary fiscal surpluses (revenue minus spending excluding interest payments) were obtained and coexisted with high inflation, and the primary deficit only increased after the Real Plan. In contrast, the operational deficit has been high all through the 1990s, with the exception of 1993 and 1994, but it exploded after the Mexican crisis of December 1994. In other words, the fiscal results worsened after stabilization.

Furthermore, the Mexican crisis forced interest rates up, having a direct impact on debt servicing, leading to an operational deficit of 9.4 percent of GDP in 1999. The hike in interest rates and the relatively lower rates of growth associated with the need to reduce current account deficits led to the increase in net public debt from 29.2 percent of GDP in 1994 to almost 50 percent in 1999.[5] These negative trends have since been reversed to a considerable extent. Growth resumed in the aftermath of the 1999 depreciation, and interest rates were reduced from more than 40 percent on an annual basis to 16.5 percent, before being hiked again up to 26.5 percent. Yet, despite the recent improvement, the evidence clearly shows that public deficit, especially the operational deficit, and public debt increased after the stabilization. The fiscal results indicate that the fiscal problems are the result of the stabilization process and not the cause of inflationary pressures.[6]

The fact that operational deficits soared after the Real Plan, and continued increasing even after the crisis of January 1999, leads one to suspect that it is the financial component of the deficits that is problematic. In other words, high interest rates needed

Table 3

Public Surplus, Public Debt in Brazil (% GDP)

	Primary surplus	Operational surplus	Net public debt
1991	2.8	–1.4	37.9
1992	2.3	–2.2	37.2
1993	2.7	0.3	33.0
1994	5.3	1.4	29.2
1995	0.4	–4.9	30.5
1996	–0.1	–3.8	33.3
1997	–1.0	–4.3	34.5
1998	0.01	–7.5	42.4
1999	3.2	–9.4	49.5
2000	3.5	–1.2	49.5
2001	3.7	–1.4	52.0
2002	3.9	0.01	57.3

Source: Boletim Banco Central (www.bcb.gov.br); Instituto de Pesquisa Econômica Aplicada (IPEA) data, available at ipeadata.gov.br/ipeaweb.dll.

to attract capital flow led to higher expenses with debt servicing and to higher operational deficits.

The evolution of fiscal policy shows that the conventional view—that sound fiscal policies and the increased openness promoted by the reforms are the backbone of macroeconomic stability—does not seem to have empirical foundation in the case of Brazil (Câmara Neto and Vernengo 2002). Not only was spending on nonfinancial items kept under control and tax revenues increased to the lower range of the Organization for Economic Cooperation and Development (OECD) countries—that is, around 35 percent of GDP—but also a major civil service reform was put into practice. The only real threat to fiscal stability then comes from a monetary policy that keeps interest rates consistently high.[7]

In this light, the recent agreement with the IMF to increase the primary surplus to 4.25 percent of GDP can only produce more cuts in social programs and a lower level of activity, with no

relevant macroeconomic impact. Furthermore, fiscal austerity can have only a negligible role in reducing inflation, since for a long while the economy has been below the level of potential growth. In fact, the main instrument used by the last and the current administrations for controlling prices has been a high rate of interest, to attract capital flows and maintain an appreciated exchange rate. Figure 2 shows the evolution since the Real Plan of nominal interest rates, exchange rates, and country risk as measured by the spread of Brazilian C-bonds—the main Brazilian foreign debt bond—over U.S. Treasury bonds (data in graph are monthly).

The increase in the nominal exchange rate means that the currency depreciated in nominal terms. However, in real terms, up to 1999 the exchange rate was appreciating. When the real finally depreciated, it was the consequence of a new balance-of-payment crisis, not of a Central Bank's policy. Interest rates in nominal terms fell considerably, but in real terms they increased and remained high during the whole period. If one looks at the evolution of those variables since Lula's election, one notices that the exchange rate started to appreciate in nominal terms—from almost R$4 per dollar to around R$3—and that the nominal interest rate increased. The administration seems happy, since these measures have led to a decrease in country risk from 2,000 basis points to around 800—that is, rates on Brazilian bonds are now 8 percent above U.S. bonds rather than 20 percent.

The increase in interest rates and the appreciation of the real to a great extent reproduce the policy mix pursued during the Cardoso administration. The results, as we saw, were the accumulation of twin debts, foreign and domestic. The appreciated exchange rate led to trade deficits that accumulated into foreign debt, and the high interest rates led to operational deficits, canceling all the efforts made with the maintenance of primary surpluses and leading to the accumulation of domestic debt. Unless the policy

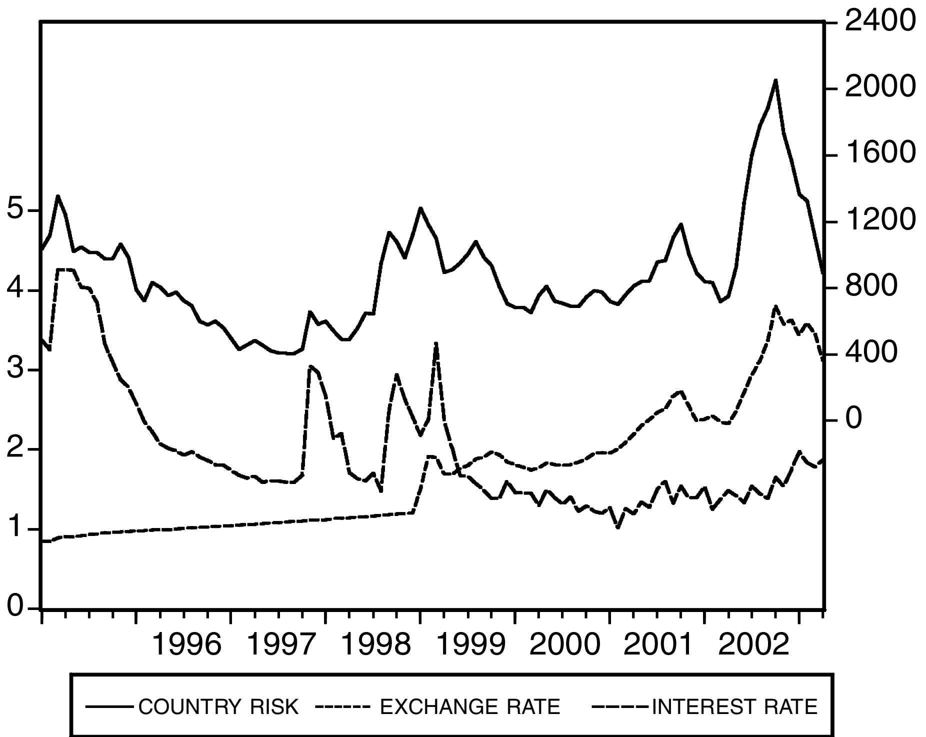

Figure 2. Nominal Interest Rates, Exchange Rates, and Country Risk as Measured by Brazilian C-bonds

Source: IPEA data.

mix is reversed—from high interest rates and low exchange rates to low interest rates and high exchange rates—another external crisis is inescapable. An alterative to the current policy package is possible, but it would certainly require a bolder break with the liberal agenda of the previous administration.

Which Way Now?

International financial markets have felt reassured by the current macroeconomic policy in Brazil. Do such reassurances mean that Brazil will have no change in the macroeconomic policy, or are they just strategic, aiming at calming down international markets? The Workers' Party reply at this point is that the latter

is correct, and once credit is recovered, they will start to reduce the interest rate. If this is the case, then the maintenance of a more depreciated exchange rate and a lower rate of interest would require some important modifications in the current course of action.

In particular, if the twin debts are to be maintained under control, as argued above, interest rates should be reduced and the exchange rate should be kept stable at a more depreciated rate. During the Cardoso administration and the initial months of the current administration, interest rates were kept high, primarily to attract foreign resources and secondarily to keep inflation under control. It is well known that in a world of liberalized capital movements, interest rates are the essential tool to attract volatile capital flows. The negative consequences of these policies have become more and more evident.

In fact, *The Economist*—a bastion of defenders of free trade in goods, services, and capital flows for decades—has finally admitted that, with regard to liberalization of capital flows, "the anti-globalists are on to something," and that, in this light, "for some countries, imposing certain kinds of control on capital will be wiser than making no preparations at all" (Crook 2003). Brazil appears to be one of those countries.[8]

Important sources of volatile portfolio flows into Brazil—and out, in moments of crisis—are the so-called CC5 accounts. These are deposit accounts of foreigners in reais in Brazilian banks, and also the main mechanism for injecting foreign funds into domestic stock markets. They are also, not surprisingly, the instruments used for the movement of illegal funds. During the Asian financial crisis, the CC5 bank accounts are estimated to have facilitated capital outflows of US$50 billion by international and domestic investors in a period of two years before the 1999 exchange crisis. Elimination of such accounts is compatible with the maintenance of a relatively open environment for foreign direct investment.

It must also be noted that Brazilian residents can freely buy and sell foreign currency, but the foreign exchange market is restricted to transactions that require prior approval by the Brazilian monetary authorities. Hence the imposition of a transfer tax or similar variation of the so-called Tobin tax in Brazil with respect to the transfer of any debt-instrument inflow or outflow would not impose additional bureaucratic controls. It must also be noted that Brazil already taxes domestic financial transactions, and this would represent an extension of the same tax to foreign financial transactions.

Tighter control on the foreign exchange market would allow the Central Bank to reduce interest rates, with a positive effect on the fiscal accounts by reducing debt-servicing costs. This would free resources for social spending, such as the Zero Hunger Program. Also, the reduction in inflows and outflows would facilitate the task of maintaining a stable and relatively depreciated foreign exchange. The depreciated foreign exchange is essential for generating the export surpluses needed to reduce the burden of foreign debt servicing, and hence to eliminate the dangers of a default.

The Central Bank, however, has clearly been preoccupied with a depreciated exchange rate, since the rising cost of imported goods is the main explanation for the Central Bank's inability to hit the inflation target. One must note that constant depreciation would have a continuous effect on prices, but a depreciated and stable exchange rate would have a once-and-for-all effect on prices. Furthermore, even if depreciation has an inflationary effect, a simple alternative that does not require scrapping the current inflation target system would be to target a price index that excludes the effects of final and intermediary imported goods.

A combination of capital controls with a flexible and controlled exchange rate and inflation targeting on core prices would reduce the need for increasing fiscal surpluses and would allow

higher rates of growth without debt accumulation. These measures alone are not a panacea, and by themselves will not lead to the resumption of growth and development. That would depend on the future negotiations on the Free Trade Area of the Americas, the proper development of industrial policy, and a better international environment, including a recovery in the United States. With the exception of an American recovery, everything else is in Lula's hands. Lula's post-election maxim—that hope defeated fear—still applies, but nonetheless there are some very good reasons to be fearful.

Notes

1. Conventional wisdom asserts that globalization is the outcome of technological developments in the information technology and telecommunications industry that made the increasing integration of markets inevitable. In contradistinction, we believe that, far from inevitable, globalization should be seen as the outcome of policies designed to liberalize the trade and capital accounts of the balance of payments.

2. Dani Rodrik (1999, 71) argues along similar lines. For him, "contrary to received wisdom, ISI-driven growth did not produce tremendous inefficiencies on an economy wide scale. The inescapable conclusion is that most countries in Latin America and the Middle East had productivity growth records prior to 1973 that look quite favorable in comparison with those in East Asia." This result stands by itself, and does not depend on Rodrik's view on the importance of the domestic institutions of conflict management.

3. From 1967 onward, Brazil promoted a reduction in tariffs and a crawling peg system that kept the exchange rate relatively depreciated. This liberalizing experience was partially successful in increasing the levels of manufacturing exports.

4. One should note that the group of economists usually associated with the Workers' Party has been allocated to the Planning Ministry and the Development Bank (BNDES), while conservative economists from the Getulio Vargas Foundation and the Catholic University in Rio, both groups with ties to the Cardoso administration, were allocated to the Finance Ministry and the Central Bank. There is a long tradition in Brazil—going back to the nineteenth century when an austere finance minister tended to be balanced with a more accommodative president of the Banco do Brasil—of balancing conservative or monetarist economists with structuralist or Keynesian ones on the economic team.

5. The fact that liabilities from state enterprises are included, but not the assets, muddles the actual meaning of the net public debt. However, the sharp increase during the 1990s is indicative of a growing problem. I would like to thank Franklin Serrano for pointing out this problem.

6. Latin American structuralists developed the notion that fiscal deficits are endogenous in a high-inflation environment. For a description of structuralist views on the role of fiscal deficits, see Câmara Neto and Vernengo (2002).

7. This has been pointed out by Galbraith (2003) and Weisbrot and Baker (2002). I would argue, however, that the sustainability of domestic debt is a secondary problem when compared to the foreign debt question. The reason is that Brazilian banks benefit greatly from carrying public debt and are willing to do so despite its increasing size. Hence, in the short run, at least, this should not be a problem for the Workers' Party administration.

8. In the same vein, the IMF has recently admitted that the evidence on the effects of capital account liberalization has been, on the whole, negative. See Prasad et al. (2003).

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