Thinking Brazil

Woodrow Wilson International Center for Scholars

THINKING BRAZIL NO. 24

AN ELECTRONIC NEWSLETTER OF THE **BRAZIL INSTITUTE**

NOVEMBER 2006

Economic Policy and Prospects for Reform: Lula's Second Administration

President Luiz Inácio Lula da Silva's reelection occurred in a much more favorable economic environment compared to the sense of crisis that prevailed when he was first elected four years ago. Brazil's economy has come a long way since its near collapse in 2002 due to capital flight and investors' fear of Lula's leftist background. Keeping with his promise to adhere to orthodox economic policies, Brazil's leader has since steered the country toward stable (albeit moderate) growth through prudent fiscal policy, a cautious monetary stance, and external adjustment. Having also benefited from an exceptionally positive global economic environment, South America's largest economy can now boast of a high primary fiscal surplus; low and stable levels of inflation, with a year-end forecast of 3.5 percent; and a declining interest rate. High commodity prices and exchange rate appreciation have allowed for the restructuring of public debt, while a surplus of international reserves allowed Brazil to pay off its debts to the IMF earlier this year.

While the economy has become less vulnerable to external shocks, distortions and inefficiencies remain as impediments to faster growth. The business environment has improved only marginally. Fiscal vulnerabilities persist, as gross public debt-to-GDP ratios remain high. An unnecessarily complex and burdensome tax code begs for reform. In addition, severe infrastructure deficiencies serve as reminders of the pressing need for increased public and private investment. On November 1, the Brazil Institute of the Woodrow Wilson Center sought to address strengths and weaknesses of Brazil's economy and to discuss the prospects for reform necessary to increase competitiveness, achieve an investment grade rating, and propel Brazil to higher levels of economic growth during Lula's second administration.

> Brazil's economy is in better shape than in any other moment in the last 30 years thanks to the sustained implementation of sound policies that will likely be maintained throughout Lula's second administration.

Otaviano Canuto, Executive Director for Brazil at the World Bank, argued that Brazil's economy is characterized not only by

significantly improved fundamentals, but also by the overriding challenge of the need to stimulate economic growth. Brazil's economy is in better shape than in any other moment in the last 30 years thanks to the sustained implementation of sound policies that will likely be maintained throughout Lula's second administration. The country's primary fiscal surplus has increased to 4.25 percent of GDP and the net public sector debt to GDP ratio has decreased sharply since 2003. Prices have stabilized, while inflation has successfully been kept at bay. Surging exports over the past four years have created a positive trade balance and a current account surplus, significantly reducing Brazil's external vulnerability and boosting its international reserves, explained Canuto. Additionally, the profile of these exports is well-balanced and therefore relatively free from harm by an unlikely decline in commodity prices: in 2005, intermediary goods account for 13.5 percent of exports and manufactured goods for over 55 percent. The Brazilian *real* has appreciated, and while retaining a floating exchange rate regime, Lula's government has nonetheless been able to strengthen the public sector balance sheet by eliminating its exposure to foreign exchange rates.

Furthermore, Brazilians themselves are better off. In part because of beneficial tax reforms, job creation has surged in the past two years. Stabilization is well regarded because more Brazilians are being employed in the formal sector, and because of a rise in purchasing power of minimum wage, argued Canuto. Poverty rates have declined, the average number of schooling years continues to rise, and the country's GINI coefficient is witnessing a steady decline—though not a probable consequence of growth but of income transfer programs such as Bolsa-Família.

It is unclear, however, if this rosy picture is sustainable, given Brazil's slow growth rate. On average, since 1980 Brazil has been growing significantly slower than other emerging economies. GDP growth has remained low in the past couple years in part because of enduring vulnerabilities in the public sector balance sheet and distortionary taxes.

Brazil's slow growth rate over the last few years appears to be a necessary outcome of the present monetary policy—not of unintentional bottlenecks or other constraints as in previous periods—and is thus in principle easier to reverse. Interest rates have remained high for different reasons. Until 1999, they were held high because of the country's exchange-rate based stabilization program. After that, high rates were retained to disinflate the economy by

Brazil's slow growth rate over the last few years appears to be a necessary outcome of the present monetary policy—not of unintentional bottlenecks or other constraints as in previous periods—and is thus in principle easier to reverse.

compressing aggregate demand to levels below aggregate supply. According to Canuto, Brazil is finally approaching a moment when the interest rate can drop and thus free up the possibility for higher growth rates, so long as inflation remains low. For this reason he is optimistic about continued growth, predicting a continuation of Lula's successful policies and macroeconomic achievements. If Brazil wants to pursue rates of growth significantly higher than 3 or 4 percent, however, major structural reforms are needed alongside a dramatic rethinking of public spending, in particular social security expenditures.

The main question confronting Brazil's economy, according to Goldman Sachs Latin America Chief Economist *Paulo Leme*, is whether or not it can follow its emerging market peers in terms of high levels of sustained economic growth. For Brazil to grow at a faster rate than the average 2.7 percent it has grown under Lula's first term, the President must use his reelection mandate and gubernatorial support to engage the PMDB in order to lead the country through much-needed but politically difficult fiscal reforms and improve macroeconomic policies. Furthermore, Brazil's

Brazil will grow at faster rates if it cuts spending, improves public spending efficiencies, practices more discipline in the pace of growth of its minimum wage, and lowers interest rates.

savings and investment ratios should increase on the order of fifty percent—at present, the country is exporting capital in the form of US treasury purchases and direct investment abroad. On the fiscal side, Leme argued that current expenditures are increasing too quickly. Spending on social security and cash transfer programs is compressing private consumption by necessitating high tax rates and lowering the possibility for further investment. Other expenditures to be reassessed include large amounts of education and health spending, which, while crucial to economic growth, are spent inefficiently and are yielding relatively low levels of human capital in return.

OTAVIANO CANUTO & PAULO LEME

Brazil will grow at faster rates if it cuts spending, improves public spending efficiencies, practices more discipline in the pace of growth of its minimum wage, and lowers interest rates. Most crucially, the country must undergo nothing short of a fiscal revolution in the form of reducing and simplifying its burdensome tax system. Other needed changes include labor reform, altering trade policy priorities to focus more on South-North relations, and judicial reform to develop mortgage markets. In short, Lula's second term must be driven by more ambitious reforms. Brazil's economy is dynamic and healthy, and the country is heading in the right direction—what is at stake is the pace of the agenda. The tradeoff between reform and the status quo is not one of economic crisis, but the level of economic growth. Brazil cannot continue on its current path of modest reform if it wants to take advantage of its growth potential and grow at a rate of 5 percent or more. Under the current scenario of timid reforms and mediocre growth, the prospect of Brazil reaching investment grade in the next four years is highly unlikely. ■

Woodrow Wilson International Center for Scholars

One Woodrow Wilson Plaza
1300 Pennsylvania Avenue, NW
Washington, DC 20004-3027
www.wilsoncenter.org

Brazil Institute

Thinking Brazil is an electronic publication of the Brazil Institute. This project was created out of the conviction that Brazil and the U.S.-Brazilian relationship deserve greater attention within the Washington policy community. Brazil's population, size, and economy, as well as its unique position as a regional leader and global player, justify this attention. In keeping with the Center's mission to bridge the worlds of scholarship and policymaking, the Brazil Institute sponsors activities on a broad range of key policy issues designed to create a Brazil "presence" in Washington.

For more information please refer to www.wilsoncenter.org/brazil or email brazil@wilsoncenter.org.

ABOUT THE WOODROW WILSON CENTER

The Center is the living memorial of the United States of America to the nation's twenty-eighth president, Woodrow Wilson. Congress established the Woodrow Wilson Center in 1968 as an international institute for advanced study, "symbolizing and strengthening the fruitful relationship between the world of learning and the world of public affairs." The Center opened in 1970 under its own board of trustees.

In all its activities the Woodrow Wilson Center is a nonprofit, nonpartisan organization, supported financially by annual appropriations from the Congress, and by the contributions of foundations, corporations, and individuals. Conclusions or opinions expressed in Center publications and programs are those of the authors and speakers and do not necessarily reflect the views of the Center staff, fellows, trustees, advisory groups, or any individuals or organizations that provide financial support to the Center.