

Marcos Antonio Macedo Cintra

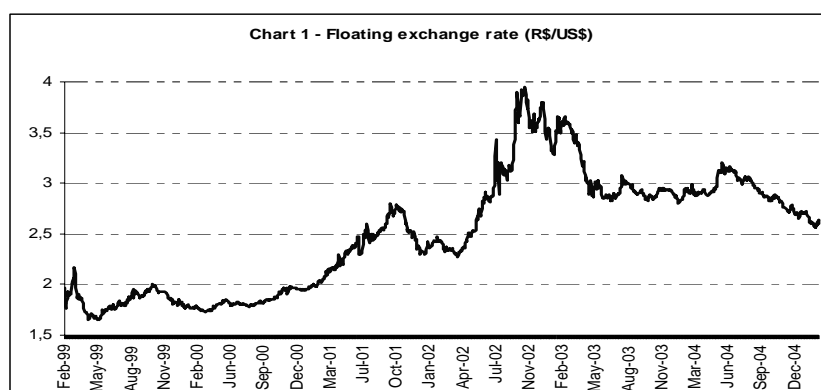
Successes and Limits of Brazilian Macroeconomic Policy in the Period 1999-2004

From January 1999 the Brazilian administration supported both by the international and the domestic financial community, together with the IMF, formulated a macroeconomic policy based on three pillars: a) a floating exchange rate and free capital mobility for the adjustment of external accounts; b) high real interest rates to ensure the achievement of inflation targets; c) increasing primary surplus to constrain public sector indebtedness. This macroeconomic model has proved to be able to bring forth economic cycles by following expansion and retraction movements in world trade and liquidity. However, it has not succeeded in putting the country back on a path to social and economic development. This path is meant as a consistent expansion of investments, especially higher and long-term ones (such as those in infrastructure or heavy industry) or riskier ones (such as those with high technological content), along with employment increase, wage increases and improved income distribution.

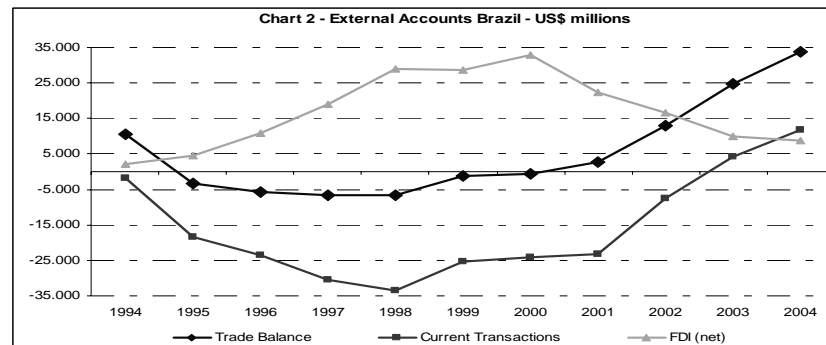
This paper supports the thesis that exchange, monetary and fiscal policies with free capital mobility are contradictory and contribute to obstructing sustained growth, the elimination of external vulnerability, the tackling of infrastructure constraints, and the expansion of social expenditure. The paper is divided into four sections. The first part deals with the external account adjustment and the possible impacts of exchange rate valuation as from mid-2004 on. The second section analyses how inappropriate the inflation target policy is under domestic pricing conditions. The third part describes the fiscal policy role, an adjustment variable of the macroeconomic model, since it bears the impacts of exchange rate and monetary policies. Final considerations outline possible alternative policies as an attempt to dismantle the vicious circle of the macroeconomic model with financial liberalization.

1. Floating Exchange Rate and External Adjustment

The three devaluation shocks of the Brazilian currency during this period (1999, 2001, and 2002) made possible a pronounced adjustment of external accounts (see Chart 1 and 2). The balance of trade skyrocketed from a US\$ 6.6 billion deficit in 1998 to a US\$ 33.7 billion surplus in 2004. This resulted in a reversion in the current account balance from a US\$ 33.4 billion deficit to an US\$ 11.7 billion surplus. In 2004 the recovery in commodity prices – which rose by 17.5% on average – and the growth of 23.4% in manufacturing exports led to a higher trade balance despite an increase in imports. Encouraged by an extremely favorable international conjuncture, including 18% growth in world trade, low inflation rates, and near-zero or negative real interest rates in major developed countries, Brazilian exports reached the level of US\$ 96.5 billion.



Source: Central Bank of Brazil, Time Series (*Séries Temporais* <<http://www.bancocentral.gov.br>>).



Source: Central Bank of Brazil, Time Series (*Séries Temporais* <<http://www.bancocentral.gov.br>>).

The dynamism of the agribusiness (soya, meat, wood and its byproducts, sugar and alcohol, paper and cellulose etc.) along with the expansion of the agricultural frontier, genetic improvements sponsored by the Brazilian Agricultural Research Corporation (Embrapa), and world economic growth was one of the factors which most contributed for the export boom. The agribusiness trade surplus totaled US\$ 34.1 billion in 2004. It corresponds to a 32.1% growth when compared to the figures from the previous year. Another relevant factor was a change in strategies adopted by foreign corporations in the country: either their direct participation in foreign trade by exporting higher technological content products and in faster growing areas, or their association to or acquisition of local companies which stimulated reaction from Brazilian corporations (Baer/Cintra 2004).

Foreign direct investment reached US\$ 32.8 billion in 2000. It played a relevant role in the consolidation of external accounts, especially at moments of high levels of risk aversion in the international financial markets (see Chart 2). First, foreign corporations attempted to explore the potential growth in the domestic market. Only a few export strategies went beyond regional integration. An example is the automotive industry, in view of the constitution of the Mercosur (Southern Cone Common Market). Faced with persistent frustration with the poor performance of the Brazilian economy and the exchange rate devaluation, foreign corporations started to adopt a more active export strategy through expansion to new markets and redistribution of production lines among transnational affiliates. In a few cases the

domestic market scale and/or specialization derived from the dynamics of the domestic market also implied export activities, including the field of higher technological content products. Thus, there was sales expansion in higher aggregate value manufactures, such as automobile parts, chassis, vehicles, tractors, planes, machinery, furniture, electro-electronic products, pumps etc.¹

In sum, exporting efforts were combined not only with the opportunity to use idle productive capacity, but also with economies of scale, productivity increase, and some sort of technological catch-up. In addition to synergic gains, access to new markets and improvements in distribution systems, exports by (foreign and domestic) corporations have resulted in higher revenue in foreign currency, representing a hedge mechanism able to guarantee parts and components imports and the payment of foreign debts, and to reduce dependence on new loans abroad, since it contributes to an improved risk rating and opens up external credit lines in more favorable conditions. Finally, exports have become strategic for foreign and domestic companies.

The total foreign debt dropped from US\$ 241.5 billion in 1999 to US\$ 220.2 billion in December 2004 (see Table 1). This movement has been led by long- and short-term private debt which fell from US\$ 140.8 billion to US\$ 105.5 billion as a result of corporate decisions to reduce liabilities in foreign currency. This posture, especially from those companies which do not manufacture tradable goods, is

1 Furtado (2004: 4) supports that: "it can be stated that the Brazilian industrial fortress rests on metal-mechanics, which ranges from natural resources (mineration) to iron and steel industry (natural resources and scale), and then mechanics (and a broad range of electrical equipment which can be classified in this type) to which different manufacturing processes are joined. Brazil built up solid positions in these sectors. [...] Brazil has demonstrated itself to be competitive in mechanical and electrical equipment segments, both at a large/small scale and manufactured to order. Many of these companies export production shares larger than those of leading companies in the agroindustrial complex. In the Brazilian metal-mechanics industry there is already an element which was previously unknown in these activities and in most industries: an export-oriented plant". Transport materials industries (US\$ 16 billion, 16.6% out of the total) and metallurgic products (US\$ 10.3 billion, 10.7% out of the total) have been leading exports, followed by the soy bean complex (US\$ 10 billion, 10.4% out of the total) and meat (US\$ 6.2 billion, 6.4% out of the total). The signing of trade agreements with Chile and Mexico also helped promote sales of trucks, buses, and agricultural machinery.

associated with the perception of higher instability in global financial markets, exchange rate volatility, and precariousness of exchange rate hedge as a result of the reduced offer of exchange rate indexed public bonds. As a counterpart, the external public debt rose from US\$ 100 billion to US\$ 114.7 billion. The reduction in debt stock favored an improvement in different external indicators of the Brazilian economy, such as interest payments/exports, debt service/exports, foreign debt/GNP, foreign debt/exports etc. (Prates 2004). However, anticipated amortizations totalling US\$ 41 billion in 2005 and US\$ 31 billion in 2006 maintain the need for high external funding. This requires the continuity of a policy for reduced dependence from extremely volatile international capital flows, since they are subject to euphoric and depressive moods.

Table 1: Total foreign debt by debtor (US\$ millions)

Description	1999	2000	2001	2002	2003	2004
Medium- and long-run debt	199.001	189.500	182.276	187.316	194.736	182.630
Non financial public sector	97.364	87.780	92.755	110.310	119.785	114.712
Financial private and public sector	101.637	99.720	89.521	77.005	74.950	67.918
Short-run debt	26.609	27.420	27.658	23.395	20.194	18.744
Non financial public sector	3.318	2.578	427	110	11	1
Financial private and public sector	23.291	24.842	27.231	23.285	20.183	18.743
Total foreign debt (A)^{2/}	225.610	216.921	209.934	210.711	214.930	201.375
Intercompanies loans (B)	15.859	19.236	16.133	16.978	20.484	18.808
Total foreign debt plus intercompanies loans (C=A+B)	241.468	236.156	226.067	227.689	235.414	220.183

Source: Central Bank of Brazil, Press release – external Sector, January 2005.

Note: 1/ Excludes principal stock relative to intercompanies loans. It considers a revision in indebtedness position as from March 2001.

The domestic interest rate increase as from September 2004, along with open capital accounts and a floating exchange rate, triggered rapid short-term capital inflows, which sought to make arbitrage among interest rates – while the US federal funds rate was 2.25% per year in December 2004, the Selic rate reached 17.75% per year – by

appreciating the Brazilian currency (see Chart 1). On the one hand, the currency overvaluation acts as an auxiliary mechanism for inflation control. Thus, it helps to achieve the 2005 inflation target. On the other hand, it jeopardizes the consistent increase in both trade and current account surpluses which helps stabilize the balance of payments and constrains foreign vulnerability. The currency overvaluation forced the Central Bank and the Treasury to buy international reserves at the spot market, as well as to intervene in the derivative market (Bolsa de Mercadorias & Futuros, BM&F). It is estimated that US\$ 7 billion were purchased on the exchange market from December 2004 to January 2005. Net international reserves (excluding IMF resources) rose to US\$ 29 billion in early February 2005. However, reserve purchasing has an impact on the public debt stock if the Central Bank decides to sterilize them, and/or on domestic liquidity (and therefore the GNP growth rate), if it decides for a non-sterilization policy. The first alternative proves to be contradictory to one of the macroeconomic policy goals, i.e. to reduce the net public debt-GNP ratio; the second alternative is contradictory to the pursuit of an inflation target. The Central Bank chose the sterilization of the domestic currency by partially reversing efforts for public debt reduction during 2004 in order to limit an excessive valuation of the Real.

Despite the successful exporting strategy, Brazilian exports are still concentrated on agricultural and industrial commodities characterized by high price and volume volatility. This fact makes exports strongly dependent on the dynamics of the international economy. Under these circumstances, a real exchange rate favoring exports and import replacement becomes crucial for a sustainable path to the Brazilian economy. The appreciation of the Real combined with excessive exchange rate volatility may jeopardize the creation of expectations favorable to productive investment, particularly the export-oriented one. Thus, the appreciation of the Real threatens the sustainability of the dynamic export sector in the forthcoming years and makes it difficult to consolidate external adjustment. The constraint of short-term inflationary pressures associated with the prolonged and expressive currency valuation does not seem to offset the risk of future external imbalance.

2. Interest Rates and Inflation Targets

In June 1999, after the currency crisis started on 13 January, an institutional framework was conceived for monetary policy: the inflation target regime. This policy aimed to replace the exchange rate as an anchor, which was effective during the first phase of the Real Plan (1994-1998) for a system which was able to affect the demand level and expectations of economic agents by means of simple and automatic interest rate management rules. The Brazilian inflation target regime was established as follows:

- the Extended Consumer Price Index (IPCA) calculated by the IBGE Foundation has been selected as the price index to determine the achievement of an inflation target, not excluding more unstable prices;
- the inflation target would bear a variable tolerance interval up- and downwards (initially 2%, then 2.5%, and again reduced to 2% in 2006);
- targets and tolerance intervals would be set by the National Monetary Council (CMN)² a year and a half in advance, for instance, the target (4.5%) and the tolerance interval (2%) for 2006 were set in July 2004;
- the chosen target should be achieved over a calendar year (twelve months);
- the Central Bank conducts an opinion survey with market analysts (*Boletim Focus* released on the Central Bank homepage every Monday) to gain expectations of so-called “rational agents”. It represents one of the major parameters for monetary policy decision-making (see Chart 3). In this regime, the chief monetary policy tool is the short-term interest rate (Selic) – because of anticipated inflation and the output gap³ – in order to make the index price converge with the target previously set (Farhi 2004: 82).

2 Members of the CMN are the Minister of Finance, the Minister of Planning and the Central Bank President.

3 A output gap is defined as the difference between the “potential output” and the economy’s actual output. The “potential output” would correspond to the achievable production level without any mismatch between supply and demand, thus not causing any price raise. The inflation target “model” of the Central Bank would be supposedly based on a production function where the “potential output” could not exceed GDP growth limit of 3.5%.

Inflation remained within the tolerance limits in 1999 and 2000 and exceeded them in the following years, especially in 2002 and 2003.⁴ The inflation acceleration was basically determined by the supply shock represented by the currency devaluation and its dissemination mechanisms. These implied higher price indexes in late 2002, during the election of President Luis Inácio Lula da Silva (see Chart 3 and 1). Indexed prices made it difficult to reduce the inflation rate. With the recovery of economic growth at international and domestic levels in 2004, agricultural and industrial commodities experienced a price increase shock and profit margins of corporations had little relative room for recovery. Nonetheless, the inflation rate remained within the tolerance limits.

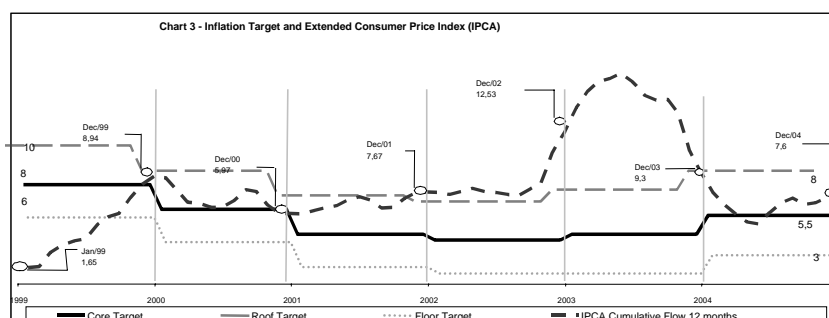
Thus, the peculiar Brazilian framework of pricing caused the exchange rate devaluation and/or other exogenous supply shocks (agricultural commodity prices, oil, iron etc.) to affect most prices of goods and services. The strict target regime became inadequate, since only non-controlled price behaviour proved to be sensitive to short-term interest rate movements. Tradable goods prices – comprising the exports – are directly impacted by exogenous shocks such as an increase in international prices of commodities and semi-manufactured goods. Some segments, especially commodities (soya or paper pulp), manage to adjust internal prices which are equivalent to the currency parity. These sectors became insensitive to the interest rate, for they can partially reduce their production share of the domestic market or even export their whole production to foreign markets.

Government-regulated prices (comprised by services in their majority) are also affected by the exchange rate, but not by the interest rate. For instance, agreements for privatization of telecommunications and electricity distribution companies define yearly tariff adjustments based on the General Price Index – Market (IGP-M). This index strongly influences wholesale prices and it is very sensitive to supply shocks.⁵ Therefore, the yearly adjustment scheme of administered

4 Core inflation targets were: 8% in 1999, 6% in 2000, 4% in 2001, 3.5% in 2002, 4% in 2003 – however, it was later adjusted to 8.5% due to its unrealistic estimate –, 5.5% in 2004, and finally 4.5% in 2005 (see Chart 3).

5 This index is calculated by the Getulio Vargas Foundation. It is calculated from the weighted average of: the Wholesale Price Index (IPA-M) corresponding to

goods based on the IGP-M accrued in past twelve months created an important vector of inflationary inertia and a pass-through of currency devaluation, and other exogenous shocks, on domestic prices. Goods of which prices are government-monitored are also insensitive to interest rates for their own adjustment mechanisms.



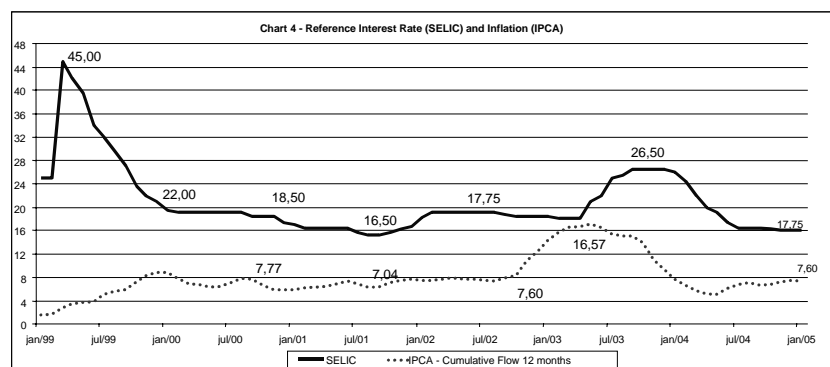
Source: Central Bank of Brazil, *Inflation Target System (Sistema de Metas para a Inflação* <<http://www.bancocentral.gov.br>>).

As to non-tradable goods prices (in the domestic market), they adjust themselves to the aggregate demand caused by the interest rates increase by means of the reduction of (wage) costs and profit margins. Nevertheless, these prices account for just one third of IPCA – adopted as the reference index to determine and to calculate the inflation target – whereas the aggregate share of tradable and administered goods reaches approx. 69%. Therefore, the monetary policy needs to be extremely restrictive to constrain the demand, so that a price reduction in the non-tradable goods sector and in a few segments of the tradable goods sector offsets the adjustments of government-regulated prices and some tradable goods insensitive to interest rate variations. During this period, the short-term real interest rate (Selic), less the accrued inflation of the previous twelve months, consistently remained at a nearly 10% level except for the year 2003 (see Chart 4).

A overly short-term horizon for the achievement of the target (twelve months) also contributed to maintaining a restrictive monetary policy. This fact had a negative impact on growth, employment, in-

60%, the Consumer Price Index (IPC-M) corresponding to 30% and the National Cost-of-Construction Index (INCC-M) corresponding to 10%.

vestment recovery, as well as on the evolution of public debt stock, despite continuous and increasing fiscal surpluses.

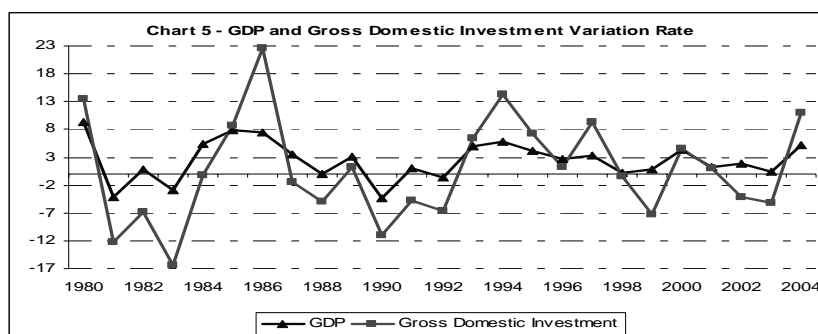


Source: Central Bank of Brazil, *Inflation Target System (Sistema de Metas para a Inflação* <<http://www.bancocentral.gov.br>>).

In addition to these limitations of the inflation targeting regime associated with a peculiar pricing mechanism, the slight signs of recovery of consumers' purchasing power fostered the consumption-credit market in 2004 and reduced the efficacy of the high interest rate policy in the short run. First, the banking system extended loan terms as a result of increased confidence in debtors' solvency (individuals or corporations). In this scenario, the gradual Selic rate increase is offset by a term extension of consumer loans which keeps instalments almost constant. Secondly, the securitization of receivables was consolidated with the economic expansion and sales growth, leading to increased corporate liquidity. Thirdly, credit expansion by means of payroll check discount made possible the entry of new consumers into the market, such as retirees and those who managed to refinance their debt (overdraft protection agreement, for instance) for this credit modality, and to later expand their consumption. Fourthly, the strategic partnership between retail corporations and the financial sector – Pão de Açúcar-Itaú, Panashop-HSBC, and Casas Bahia-Bradesco – increased the potential commitment of retailers to consumption credit and stimulated sales (Barros/Baer 2004). In spite of these innovations in the consumption credit segment the Brazilian loans volume remains extremely low, i.e. approx. 26.3% of GDP in December 2004, marked

by short maturity and extremely high interest rates. This makes the current banking system unfit for economic development funding.⁶

The inflation measured by IPCA should converge with the 5.1% adjusted target⁷ in 2005. Market analysts, however, still estimate an inflation rate of approx. 6%. Thus, the Monetary Policy Committee (Copom) of the Central Bank started to raise the short-term interest rate in September 2004 in order to slow down growth (from 5.2% in 2004 to approx. 3.5% in 2005).⁸ This perpetuates the low and discontinuous growth evidenced by the Brazilian economy since the 1980s (see Chart 5). In this scenario, the private sector continues to show low levels of investment rates (18% of GDP in 2003), especially in the



Source: IBGE Foundation <<http://www.ibge.gov.br>>.

domestic market-oriented industries, despite a relative amplification of the investment rate in 2004. Major obstacles to investments result from uncertainties regarding the economy's prospects associated with

6 The credit-GDP ratio was 37% in 1995. See Cardim de Carvalho (2005). According to the Central Bank in December 2004 average interest rates on loans were 31% per year to the corporate sector and 61.5% per year to individuals.

7 In 23 September 2004 the Monetary Policy Committee (Copom) decided to adopt a 5.1% adjusted target for 2005 since it seemed unrealistic to pursue the 4.5% target.

8 Such deceleration will not necessarily lead to a recession, although the GDP growth rate fell to 0.4% in the fourth quarter of 2004. As the current levels of international liquidity persist, along with low interest rates in major markets, and the world trade growth rate reaches approx. 21% per year, the dynamism of the Brazilian economy may proceed at approx. 3.5%, despite the macroeconomic policy and infrastructure bottlenecks. In this case, a longer cycle may prevail in the following two or three years, but with low growth rates. However, it is apparently not enough to foster the social and economic development of the country.

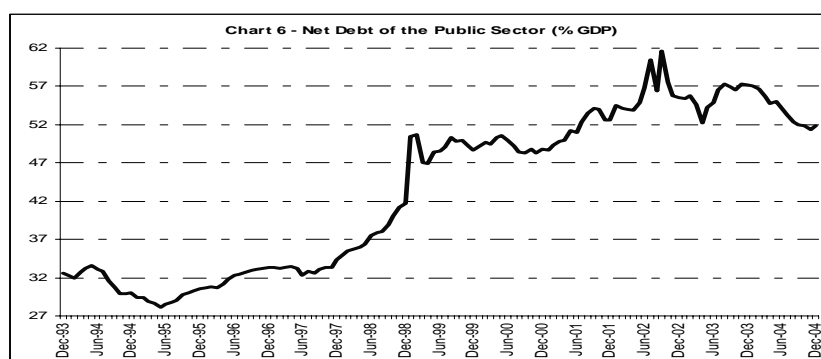
structural factors (external vulnerability, high public debt stock, high interest rates), amplified by the excessively orthodox management of the macroeconomic policy. As long as there is no evidence of sustained economic growth, chances for a new private investment cycle are apparently poor. Frustration with the domestic market expansion potential is still very strong in investors' minds. Under these circumstances, investments have been determined by very solid comparative advantages, such as in the agribusiness (soya, meat, paper and celluloses etc.); the competition dynamics which require continuous investment, for instance, in telecommunications and retailer distribution; international price behaviour (mining, iron metallurgy and petrochemicals). Furthermore, the squeezing of some production chains and the investment stagnation caused bottlenecks in the supply chain. These bottlenecks can only be solved through higher expenditures in the development of new capacities, which demand proper policies for credit provision, trade and technological innovation. The development of competitive advantages requires state policies which are able to sustain higher investment rates in relation to GDP and, simultaneously, to bypass balance-of-payment constraints through an accelerated expansion of net exports (Resende 2004). Needless to say, these policies are antagonistic to the current policies based on inflation target, currency valuation, and fiscal surpluses.

In sum, concentrated market structures capable of transferring international price changes, high indexation levels, and a consumption-oriented credit market forced significant relative price changes. These changes lead to higher inflation rates in an economy like the Brazilian one, without necessarily causing a price rise in every sector.⁹ Nevertheless, the inflation targeting system governing the monetary policy decision-making determines the maintenance of real interest rates at approx. 10% per year. This combination of inflation targeting regime and floating exchange rate subject to great fluctuations proved to be extremely perverse and led to recurrent stop and go cycles. It has also made sustainable growth difficult by discouraging investment, with negative impact on the public debt and the employment rate.

9 Cf. Fraga et al. (2003): "the volatility of all variables – inflation, exchange rate, output, and interest rate – and the inflation level are higher in emerging economies in comparison with those observed in developed economies".

3. Fiscal Surplus and Reduction of Public Indebtedness

In the beginning of the Real Plan the financial status of the Brazilian public sector was very good. The previous administration had conducted a huge budget and public indebtedness adjustment. A primary surplus of 2.6% of the GDP was observed and the public sector net debt was relatively reduced in relation to GDP in 1993 (Belluzzo/Almeida 2002). Nonetheless, during the first phase of the Real Plan (1994-1998), the federal administration unloaded the burden of the monetary policy and later that of the exchange devaluation on the public sector as a whole. The public debt stock and interest payment rose dramatically. In the period 1994-1997, the net capital inflow led to an expansion of foreign liabilities and of Central Bank reserves. The monetary sterilization policy implemented by the Central Bank led to a domestic public debt increase. During the phase of net capital outflow, the reserve dropdown was followed by an interest rate rise. This fact made debt service grow and determined a rapid increase in the net public debt-GDP ratio (see Chart 6). These factors were responsible for steadily feeding the net debt, and not excessive public expenditures. Therefore, the domestic public debt evolution bears a phenomenon of financial and monetary nature with certain serious fiscal implications.



Source: Central Bank of Brazil, Time Series – (*Séries Temporais* <<http://www.bancocentral.gov.br>>).

Finally, monetary and exchange policies in a context of finance liberalization resulted in higher fiscal and financial fragility in the public sector. Since a large amount of the debt was indexed to the short-term interest rate (Selic) and to the exchange rate, its stock was extremely volatile. The attempt to reduce the net public debt in relation to the GDP – converted into a goal together with the IMF – made fiscal policy implementation perverse. By means of high interest rates, low GDP growth rates, and a floating exchange rate, the strategy of reducing public debt started to require increasing primary surpluses¹⁰ and, therefore, a relative squeezing of social expenditures and an absolute squeezing of public infrastructure investments.

After IMF resource inflow in November 1998 the primary balance of public accounts at three federative levels of government – federal, state, and local – became one of the macroeconomic policy priorities.¹¹ In order to establish a pattern of budget balance at all levels of government – Federation, States and municipalities – different programs were implemented: the Incentive Program for the Reduction of the State Public Sector in Banking Activities (Circular N° 2.742 dd. 1997 issued by the Central Bank), Program for Support and Restructuring of State Fiscal Adjustment (Law N° 9.496 dd. 11 September 1997) followed by the Fiscal Responsibility Law (Supplementary Law N° 101 dd. 4 May 2000) and the Law on Fiscal Crimes (Law N° 10.028 dd. 19 October 2000).

The fiscal adjustment aimed at increasing revenues and decreasing expenditures to save resources for the achievement of fiscal surplus and public debt reduction targets. The domestic tax burden rose from 29.33% to 34.01% of GDP corresponding to a 4.68% increase in the period 1998-2003. Afonso/Araújo (2005: 7, 20) showed that the taxation increase “has not resulted in an equal variation in expenditures on goods and services by the public sector”. The government demand dropped from 21.93% in 1998 to 21.59% of GDP in 2003 and investment expenditures fell from 2.8% to 1.7% of GDP in this same period. Resources were partially allocated for payment of social benefits (income transfers). However, its majority was allocated for payment of

10 Fiscal surplus targets were increased from 2.8% in 1999 to 3.5% in 2001; 3.75% in 2002; 4.25% in 2003; and 4.5% in 2004.

11 Since then the Brazilian government has signed four agreements with the IMF totalling US\$ 80.1 billion and has drawn US\$ 58 billion (see Table 2).

Table 2: Agreements signed between the Brazilian government and the IMF

	1998 (a)	1999	2000	2001	2002	2003	2004	2005 (b)	2006 (b)	2007 (b)	Total
Loans US billion	19,9	-	-	18,5	26,2	15,5	-	-	-	-	80,1
Drawn Value US\$ billion	14,4	-	-	17,4	26,2	0					58,0
Drafts US\$ millions	5.212	6.783	0	8.044	18.709	19.260	0				58.000
Paid interests US\$ millions		517	389	159	550	1.189	1.244	1.196	627	279	6.150

Source: International Monetary Fund

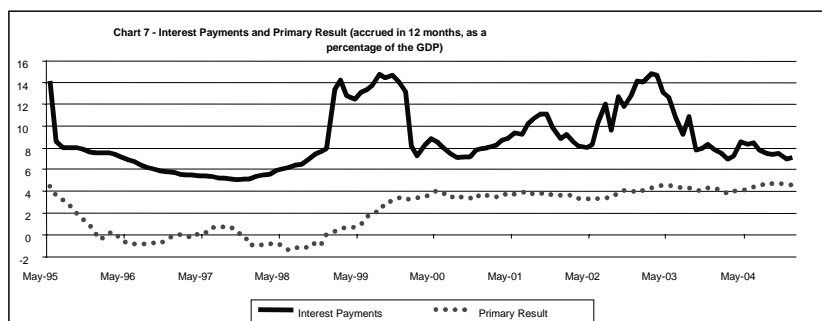
<<http://www.imf.org/external/np/tre/tad/exfin2.cfm?memberKey1=90&date1Key=2005%2D01%2D31>>.

Notes: a) Brazil received funding from other international organisms along with IMF loans totalling US\$ 41.5 billion;

b) An estimate.

the public debt service of which interest rates rose from 5.19% to 7.77% of GDP.

In fact, since 1996 the Brazilian public sector has disbursed interest payments of approx. 7% of GDP, except for 1997, when it dropped to 5% of GDP, and during crises in 1999 and early 2003 when it rose to 15% of GDP (see Chart 7). Not only exchange and monetary policies immobilized fiscal policy, but also implied a transfer of increasing interests to creditors. This fact deteriorated domestic income distribution (the richest 10% population absorb 44% of the domestic income whereas the poorest 10% absorb just 1%).



Source: Central Bank of Brazil, Time Series – (*Séries Temporais* <<http://www.bancocentral.gov.br>>).

The Federation, States, municipalities, and state-run companies achieved a primary surplus (revenues less expenditures, excluding interest payments) of 81 billion Reals during 2004. This value corresponds to 4.6% of GDP above the target set by the government (4.5%) and above that agreed with the IMF (4.25%). This primary result was enough to pay 63% of interests which reached 128.3 billion Reals that year corresponding to 7.3% of GDP (see Chart 7). Thus, the public sector nominal deficit was 47.1 billion Reals corresponding to 2.7% of GDP. The net debt stock of the public sector rose from R\$ 913.1 billion in December 2003 to R\$ 957 billion in December 2004. Nonetheless, the public debt-GDP ratio fell from 57.2% to 51.8% in this same period (see Chart 6). This 5.4 percentage point drop interrupted an uptrend observed since 1995. However, it implied neither any improvements in the funding framework of the Brazilian state, nor a route to public debt sustainability in the medium run (three to five

years), despite the generation of high and increasing primary surpluses. Crucial factors for explaining this performance were the economic growth estimated at 5.25, a lower interest rate in the period April-August 2004 (stable at 16% per year), and the currency appreciation along with fiscal restriction.¹²

Some improvements have been observed in the debt management: exchange rate-indexed bonds declined from 20.5% of total in December 2003 to 9.3% in December 2004; Selic post-fixed bonds fell from 55.5% to 54% in this same period; and pre-fixed bonds rose from 11.4% to 19%. This facilitated the monetary policy management. Nevertheless, despite efforts made by authorities, the relationship between the Central Bank and the banking system has changed little concerning public bond liquidity and turnover.¹³ These assets kept their basic feature of a quasi-currency (transactions concentrated in extremely short terms) and the average maturation of bonds issued by the Central Bank was 15.8 months and that of bonds issued by the Treasury was 11.2 months in December 2004. Therefore, a flight risk against the Real resulting from any foreign disturbance remained latent.

In addition to the restricting character of the fiscal policy, an increasing sacrifice in public investment is observed. Its lowest level since 1984 was recorded in the period 2003-2004. The Treasury – supported by “technical” arguments found in the IMF agreement – pursues an increasing fiscal surplus and restricts infrastructure expenditures. This represents a hindrance to tackling economic infrastructure bottlenecks: a precarious road network, insufficient railway capacity, port saturation, difficulties in expanding electricity generation and basic sanitation systems. However, infrastructure expansion represents one of the major requirements for ensuring sustained growth. Considering the sector nature – long maturation term and uncertain implementation costs, extensive capital requirements and amortization pe-

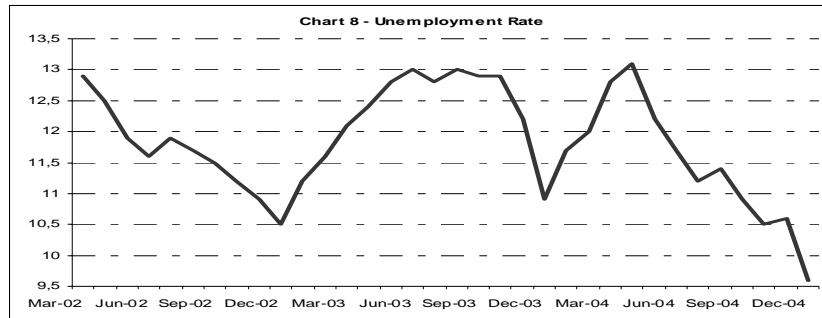
12 Prospects for 2005 do not seem very optimistic. These factors shall be less favorable except for the exchange rate. The reference interest rate has been rising since September 2004 and a GDP deceleration is estimated at approx. 3.5%. A relevant discussion on the domestic public debt renegotiation (80% of the GDP) is beyond the scope of this paper. As an example see Carvalho (2005).

13 It is still too early to evaluate impacts of a change in taxation rules of investment funds according to their maturation period effective since early 2005.

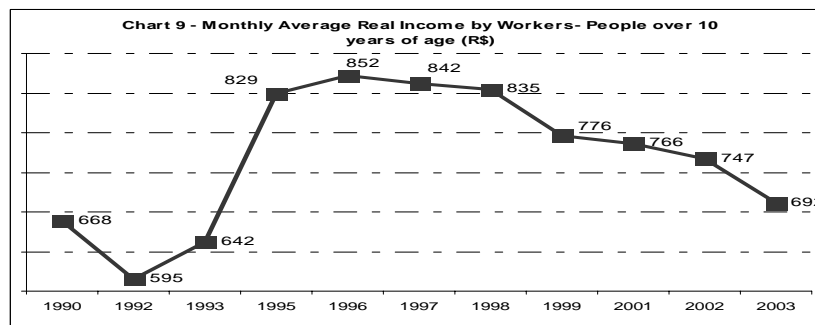
riod, low economic return, environmental risks – the expansion of these investments shall be conducted without the decisive participation of the public sector. This is a contradiction in view of the current magnitude of the interest rate and fiscal surplus.¹⁴

The clearly regressive fiscal policy and successive fiscal adjustments have not even allowed compensatory policies to struggle against unemployment, social scarcity (education, healthcare, land reform etc.) and to tackle poverty problems. Sustained economic growth emerges as a necessary condition for facing these matters by means of employment expansion, wage recovery, and further taxation (Salm 2005). In 2004 growth recovery led to a decrease in the unemployment rate of the economically active population from 13.1% in April to 9.6% in December (see Chart 8). Precarious labor conditions increased in metropolitan areas despite this unemployment rate drop. The number of employees working 40 hours a week and earning less than a minimum wage was 2.7 million in December 2004 according to the Employment Monthly Survey by IBGE. This figure was 2 million in March 2002. Seven hundred and twenty thousand people were added to the number of underpaid employees corresponding to 36% (Soares 2005). Thus, the ratio between underpaid workers and total workers rose from 8.7% to 14% in the same period. This increase in underpaid employees represents the most perverse face of workers' real average income decline. It dropped consecutively for the seventh year (see Chart 9). Accrued income losses reached 18.8% in the period 1996-2003.

14 Some sectors support the participation of private capital in developing a physical infrastructure in the country in view of funding and fiscal restrictions in the public sector which limits its investment capacity. Nevertheless, private capital requires the establishment of a secure legal environment with reduced risks to performing infrastructure investments. This is the reason behind the debate on the role of Regulatory Agencies, the Bankruptcy Law, and the Public-Private Sector Partnership. However, the existence of a stable legal environment does not exclude the conflict between investments in limited or uncertain profitability fields and the high level of the real interest rate. It remains an obstacle to expanding infrastructure expenditures. The historic experience seems to suggest that the recovery of such investments, even in partnerships with the private sector, requires the structuring of coordination and support mechanisms (credit, tax) as well as long-term economic prospects (Biasoto 2004).



Source: IBGE Foundation – *Monthly Employment Survey* (a new methodology since March 2002) <<http://www.ibge.gov.br>>.



Source: IBGE Foundatin – *National Household Sample Survey* <<http://www.ibge.gov.br>>.

Note: This survey was not conducted in the years of 1994 and 2000.

Although the labor market has shown a recovery – new positions and formal employment –, the economic recovery did not reflect an average increase in purchasing power. This means that new positions paid lower wages. Moreover, more members of the same family had to find a job as an attempt to offset the income loss by the head of the family. This phenomenon helps explain the increase in underpaid workers, since these people tend to accept lower waged-jobs and frequently poorer work conditions. According to the IBGE survey the majority of this group is comprised of women, non-white workers and those without a formal contract or self-employed ones (young and elderly people). Unfortunately, this mismatch between the income and occupation evolution shall not be relieved, because the Central Bank promotes a

deceleration in productive activities by means of interest rate increase to achieve the inflation target. This restricts any prospects in increasing workers' employment and income.

The persistent stop-and-go dynamics amplifies the obstacles to reversing the picture on social exclusion which is aggravated not only by poor economic growth, but also by changes imposed by the modernization of the productive structure itself as a consequence of the dismantling of institutions of the so-called "wage society" – increase in insecure work contracts, non-affiliation to trade unions, subcontracting, employment deindustrialization, growth in personal services –, as well as extremely low wages. Under these circumstances, poverty and social exclusion affect larger and larger portions of the working class.

In conclusion, financial liberalization and IMF rules force an increasing fiscal surplus to pay the public indebtedness (foreign and domestic) which perpetuates the financial fragility of the public sector and hinders infrastructure funding and expansion of social expenditures. The macroeconomic model makes it very hard, if not impossible, for the implementation of an autonomous fiscal policy which characterizes a modern public sector able to sustain and foster an expansion in income, employment, physical infrastructure, universalization of public policies, and income redistribution.

4. Final Considerations

There is an intense debate over the improvement of the macroeconomic model in the country. The flexibilization of strict inflation targets is suggested by adopting stable targets and not declining ones over time, the extension of terms to achieve them, the pursue of a core target and not the full index, and so on. These changes would allow a lower real interest rate, and reduce the deleterious effects on production, employment, investments, public debt stock, and exchange rate. As to the elevated fiscal surplus targets, the IMF itself signaled a US\$ 1 billion-drop per year in the primary surplus for the period 2005-2007 in order to make possible infrastructure investment projects (roads, ports etc.) approved by its supervisory team. Lower real interest rates and further public investments would sustain economic growth and meet expectations of public debt solvency (a drop in the

net public debt-GDP ratio over time). Finally, the debate on how to restrict currency overvaluation considers the introduction of a Financial Transactions Tax (IOF) on short-term foreign currency transactions to restrict speculative capital inflow attracted by high interest rates. Reserve purchase and derivative transactions by the Treasury and the Central Bank would be insufficient to constrain the appreciation of the Brazilian currency with future impacts on the trade balance and external adjustment.¹⁵

Finally, in the 1990s, capital account liberalization and financial deregulation were defended as policies capable of mitigating income and consumption fluctuations in developing countries. The assumption was that net foreign capital inflows would foster growth and employment. The reality proved to be totally different. The emerging economies – Mexico, Eastern Asia, Russia, Brazil, Turkey, Argentina and so on – faced several financial and currency crises since international financial markets were subject to liquidity constraint and expansion cycles.

15 A former president of the Central Bank, Affonso Celso Pastore, supports the idea that the Real has been appreciating with the short-term capital inflow. This may both reduce the current account balance and hinder the implementation of the monetary policy. Foreign investors amplify the demand for CDI (Interbanking Certificate of Deposit) contracts or 180 to 360-day swap contracts at the Futures and Goods Stock Exchange (BM&F) by raising their prices and reducing the long-term interest rates. Thus, capital movements introduce a distortion into the interest rate framework: although the Central Bank raises the short-term interest rate, capital inflows reduce the long-term interest rate and weaken the efficacy of the monetary policy. The use of the IOF on capital inflows was then suggested (Lamucci 2005). The introduction of the IOF does not initially seem enough to restrict the excessive valuation of the Real since the appreciation trend has been determined by derivative transactions abroad and at the BM&F, i.e. merely virtual transactions, without any movement of net capital inflows. The interruption of this speculative movement would require more radical decisions such as: prohibition of derivative transactions at the BM&F by foreign investors; margin rise in derivative transactions by reducing their leverage level; forcing banks to impose higher capitalization in foreign currency transactions and derivatives; taxation of capital gains from speculation and arbitrage against the dollar etc. (Farhi 2005; Guimarães 2005). Decisions announced by the Central Bank on the evening of 4th March 2005 signalled the opposite direction, i.e. the full convertibility of the Real. The deepening of the Brazilian currency market deregulation facilitates foreign currency transactions by domestic and international investors and increases safety and speculative and arbitrage movements, both in periods of high international liquidity and in periods of high risk aversion. See also Cardim de Carvalho/Sicsú (2004).

From 1999 on, developing countries started to show current account surpluses led by Asian and oil-producing countries. Experiences in Asian countries (China, Korea, Hong Kong, India, and Thailand) seem to show that the achievement of positive trade balances and reserve accumulation have enabled technological progress, as well as the implementation of laxer monetary policies favoring the expansion of domestic credit, production and employment. Reserve accumulation – through high trade balances and non-borrowing of new loans – meets the demand for strong currency liquidity and ensures exchange rate stability. Finally, the defense of a devaluated exchange rate, current account surpluses, and high reserve accumulation has become crucial in a world of high capital mobility and asymmetry between currencies (Belluzzo/Carneiro 2004). This seems to demonstrate that strong national states can accomplish development projects if they strengthen their autonomy, i.e. not depending on international financial markets.

As a counterpart, developing countries have become net exporters of financial resources to developed economies (Cintra/Farhi 2003). Developing economies transferred US\$ 1.23 trillion in the period 1998-2004, according to the IMF (2004). Because of risk asymmetry, foreign fundraising by these countries pay 3%-4% interest on their reserve stocks (invested in T-bonds or in bonds of developed countries' corporations).

Under these circumstances, preventive controls on capital inflows and outflows need to return to the economic agenda in order to allow more room for manoeuvre in the conduct of domestic macroeconomic policies. As pointed out by *The Economist* (May 3, 2003: 4):

[...] the global capital market is a turbulent and dangerous place, especially for poorly developed economies that may be ill-equipped to navigate it. [...] for some countries, imposing certain kinds of control on capital will be wiser than making no preparations at all.

This stance survives even in surprising corners. Some IMF representatives came to the conclusion that “there is little evidence that the financial integration has helped developing countries stabilize fluctuations in consumption growth” (Prasad et al. 2003). Only industrial countries with large domestic financial markets and convertible currencies benefited from this situation.

Other studies, such as that conducted by Epstein et al. (2003) show that the countries which continued to control capital flows and the exchange rate succeeded in achieving higher growth rates, lower production and income fluctuation, and reduced vulnerability in external accounts. The most successful countries were Chile, India, Singapore, Taiwan, Malaysia, and China. By pursuing this path, the Argentinean and Colombian administrations implemented preventive controls on short-term capital flows. Capital that was not assigned for direct investment in companies or foreign trade will have to remain at least 180 days within the country. The purpose is to prevent an excessive appreciation of the domestic currency which jeopardizes exports.

An IMF report acknowledges that liberalizing reforms implemented by Latin American countries – trade and capital account liberalization, deregulation of domestic financial systems, and state reform – did not achieve their goals in terms of growth in their gross domestic product, their balance of payment, and their public sector. As Singh et al. (2005) remark:

Few countries succeeded in managing the transition – from current account deficit with fixed exchange rate – , especially in an environment of high international capital mobility. [...] The imposition of controls on capital inflows may have played a role in Chile.

The Brazilian macroeconomic framework – floating exchange rates, high real interest rate, along with decreasing quantitative targets for inflation and fiscal surpluses – ensured monetary stability, a temporary adjustment of external accounts, a relative reduction of the public debt, and preservation of financial wealth in the domestic currency though in the short term. It is responsible for triggering expansion and contraction cycles. However, it does not seem able to foster social and economic development by expanding employment, raising real wages, and improving income distribution. Based on the Brazilian macroeconomic equation, up to the present moment, there is no historic experience of sustained development.¹⁶ Contrary to common beliefs of conventional theory, the floating exchange rate does not lead to higher autonomy in fiscal and monetary policies under conditions of financial

¹⁶ The Brazilian experience is not unique. For a criticism of the Chilean model, see Valdivia (2004) and Carcanholo (2004); for the Mexican model, see Palma (2003).

liberalization, high external liabilities and low international reserves. Even when the current account deficit is reduced, the floating exchange rate does not exclude an exchange risk and the Central Bank is still forced to intervene (for appreciation or devaluation). This fact has an impact on the public debt stock and requires increasing fiscal surpluses (Carneiro 2004). The use of a restrictive monetary policy to mitigate the effects of the floating exchange rate on domestic prices also increases the required funding by the public sector. In addition, it also increases the opportunity cost for private investments. Finally, the perverse relationship between exchange, monetary, and fiscal policies govern the stop-and-go behaviour of the GDP and have deleterious impacts on employment and income distribution.

Contrary to the statement by the Minister of Finance Antonio Palocci, that “experiments failed in Brazil”, boldness would be required to interrupt the vicious circle of the “light failure” of the Brazilian economy: even if it does not enter into default, it does not create development either. This seems to demand the build-up of an alternative political coalition – founded on production and labor interests – in order to overcome the alliance of creditors which is the basis of the Brazilian current political and economic power.

Bibliography

- Afonso, José Roberto R./Araújo, Érika Amorim (2005): *Mais tributos com menos demanda pública: o (duro) ajuste brasileiro*. Paper presented at the XVII Cepal Fiscal Policy Conference, Santiago, 26 January 2005 (unpublished).
- Baer, Monica/Cintra, Marcos Antonio Macedo (2004): *Brasil: investimento estrangeiro direto e estratégias empresariais*. Santiago: Comissão Econômica para a América Latina e Caribe, September (unpublished).
- Barros, Maria Cristina Mendonça/Baer, Monica (2004): “O que o crédito ao consumidor pode significar para 2005?”. In: *Folha de S.Paulo*, December 29, pp. B2.
- Belluzzo, Luiz Gonzaga de Mello/Almeida, Júlio Sérgio Gomes (2002): *Depois da queda: a economia brasileira da crise da dívida aos impasses do Real*. Rio de Janeiro: Civilização Brasileira.
- Belluzzo, Luiz Gonzaga de Mello/Carneiro, Ricardo (2004): “A insustentável leveza do crescimento”. In: *Política Econômica em Foco*, no. 4. Campinas: Centro de Conjuntura e Política Econômica/Instituto de Economia/Unicamp, May/October, pp. 1-11. <<http://www.eco.unicamp.br>> (25.10.2006).
- Biasoto Jr., Geraldo (2004): “O crescimento como condição da sustentabilidade fiscal”. In: *Política Econômica em Foco*, no. 4. Campinas: Centro de Conjuntura e

- Política Econômica/Instituto de Economia/Unicamp, May/October, pp. 92-107. <<http://www.eco.unicamp.br>> (25.10.2006).
- Carcanholo, Marcelo Dias (2004) “A falsa via chilena: lógica, contradições e limites do modelo”. In: *Revista da Sociedade Brasileira de Economia Política*, no. 15, pp. 34-61.
- Cardim de Carvalho, Fernando J. (2005): “O sistema financeiro brasileiro: a modernização necessária”. In: Sicsú, João/Paulo, Luiz Fernando de/Michel, Renaut (eds.): *Novo-desenvolvimentismo: um projeto nacional de crescimento com equidade social*. Barueri: Editora Manole/Rio de Janeiro: Konrad-Adenauer-Stiftung, pp. 329-346.
- Cardim de Carvalho, Fernando J./Sicsú, João (2004): “Controvérsias recentes sobre controles de capitais”. In: *Revista de Economia Política*, vol. 24, no. 2 (94), pp. 163-184.
- Carneiro, Ricardo (2003): “A política macroeconômica da era FHC ao governo Lula: da trindade impossível à autonomia necessária”. In: Velloso, João Paulo dos Reis (ed.): *Governo Lula: novas prioridades e desenvolvimento sustentado*. Rio de Janeiro: José Olympio Editora/Instituto Nacional de Altos Estudos.
- Carvalho, Carlos Eduardo (2005): “Dívida pública: um debate necessário”. In: Sicsú, João; Paulo, Luiz Fernando de/Michel, Renaut (eds.): *Novo-desenvolvimentismo: um projeto nacional de crescimento com equidade social*. Barueri: Editora Manole/Rio de Janeiro: Konrad-Adenauer-Stiftung, pp. 379-399.
- Cintra, Marcos Antonio Macero/Farhi, Maryse (2003): “Os limites da inserção internacional dos países emergentes no limiar do século XXI”. In: *Ensaio FEE*, vol. 24, no. 2, pp. 351-402.
- Epstein Gerald/Grabel, Ilene/Jomo, Kwame Sundaram (2003): *Capital Management Techniques in Developing Countries: an assessment of experiences from the 1990's and lessons for the future* (unpublished).
- Farhi, Maryse (2004): “Metas de inflação e o medo de crescer”. In: *Política Econômica em Foco*, no. 4. Campinas: Centro de Conjuntura e Política Econômica/Instituto de Economia/Unicamp, May/October, pp. 73-91 <<http://www.eco.unicamp.br>> (25.10.2006).
- (2005): “A valorização da taxa de câmbio do real”, Suplemento 4. In: *Política Econômica em Foco*, no. 4. Campinas: Centro de Conjuntura e Política Econômica/Instituto de Economia/Unicamp, March <<http://www.eco.unicamp.br>> (25.10.2006).
- Fraga, Arminio/Goldfajn, Ilan/Minella, André (2003): *Inflation Targeting in Emerging Market Economies*. Brasília, D.F.: Banco Central do Brasil, June. <<http://www.bancocentral.gov.br>> (25.10.2006).
- Furtado, João (2004): “O comportamento inovador das empresas industriais no Brasil”. In: *Fórum Nacional, Seminário Especial – Mini-Fórum em homenagem aos 40 anos do Ipea*. Rio de Janeiro: Instituto Nacional de Altos Estudos, September. Fórum Nacional. <<http://forumnacional.org.br>> (25.10.2006).
- Gunimarães, Cristina Borges (2005): “A apreciação do real tem origem nos juros elevados”. In: *Gazeta Mercantil*, March 7, p. A6.

- IMF (2004): *World Economic Outlook*. Washington, D.C: International Monetary Fund, September. IMF: <<http://imf.org>> (25.10.2006).
- Lamucci, Sérgio (2005): “Pastore sugere taxar capital de curto prazo”. In: *Valor Econômico*, February 22, p. A16.
- Palma, Gabriel (2003) *The Mexican Economy Since Trade Liberalisation and NAFTA: on the “De-linkaging” of a Dynamic Export Expansion and the Collapsing of an “Export Multiplier”*. Cambridge: Faculty of Economics and Politics, University of Cambridge, United Kingdom, July (unpublished).
- Prasad, Eswar/Rogoff, Kenneth/Wei, Shang-Jin/Kose, M. Ayhan (2003): *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*. Washington, D.C.: International Monetary Fund, March. IMF: <<http://www.imf.org>> (25.10.2006).
- Prates, Daniela Magalhães (2004): “A assimetria das contas externas”. *Política Econômica em Foco*, no. 4. Campinas: Centro de Conjuntura e Política Econômica/Instituto de Economia/Unicamp, May/October, pp. 49-72 <<http://www.eco.unicamp.br>> (25.10.2006).
- Resende, Marco Flávio da Cunha (2004): *O padrão dos ciclos de crescimento da economia brasileira: 1947-2003*. Belo Horizonte: CEDEPLAR/Departamento de Economia da UFMG (unpublished).
- Salm, Cláudio (2005): “Estagnação econômica, desemprego e exclusão social”. In: Sicsú, João/Paulo, Luiz Fernando de/Michel, Renaut (eds.): *Novo-desenvolvimentismo: um projeto nacional de crescimento com equidade social*. Barueri: Editora Manole/Rio de Janeiro: Konrad-Adenauer-Stiftung, pp. 189-216.
- Singh, Anoop/Belaisch, Agnès/Collins, Charles/Masi, Paula De/Krieger, Reva/Meredith, Guy/Rennhack, Robert (2005): *Stabilization and Reform in Latin America: A Macroeconomic Perspective on the Experience Since the Early 1990s*. Washington, D.C.: International Monetary Fund, February. IMF: <<http://www.imf.org>> (25.10.2006).
- Soares, Pedro (2005): “Emprego precário cresce 19% em 2004”. In: *Folha de S.Paulo*, February, p. B1.
- Valdivia, Manuel Jesus Hidalgo (2004): *Chile: al compás del capital extranjero*, Santiago (unpublished).