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Brazil's New Capitalism

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NO TURNING BACK

IN THE PAST DECADE, Brazil has entered the first stages of a modern capitalist reorganization. Its economic transition has been gradual, but the country has avoided Crippling setbacks. For many observers, Brazil seems finally to be pulling itself out of two frustrating decades of economic stagnation and political turmoil.

Not all observers accept these changes with unalloyed enthusiasm, however. The political left abhors what it portrays as an alienating, neoliberal destruction of Brazil's national development by international finance capitalism. But regardless of their preferences, everyone agrees that change is finally happening. As economic historian Ricardo Bielchowsky put it, Brazil's new economic model is radically different from its predecessor. In the new economy, investors have the freedom to make their own investment choices based on market changes. Of course, whether investors will use their new freedom to allocate resources effectively remains uncertain.

What makes Brazil's economic transition historic is that today's reforms break with an economic model that dominated the country for nearly 50 years. From 1940 to 1989, Brazil staked its hopes on a form of nationalist mercantilism that operated through state controls of commerce and credit. Centrally directed state enterprises provided infrastructure and services, while highly protected and subsidized industries and agriculture made up a dependent private sector. In 1974, Eugenio Gudin, a champion of economic liberalism, described this unique economic system as capitalist in principle but with more state control than in any other noncommunist country.

The old model fostered industrial development based on the country's large internal market. And it produced some significant strategic advances in oil, energy, and agriculture. Economic growth averaged more than six percent a year over three decades. But Brazil's robust growth came to a halt in 1980 when its economy was buffeted by extravagant bouts of inflation. To make matters worse, a mountain of unpayable foreign

debt, endemic corruption, and a chronic waste of capital all undermined fiscal discipline. When Brazil’s access to foreign loans dried up during the debt crisis of the 1980s, its state-centered economy went broke. Brazil has not resumed sustained growth of this kind since.

Today, by contrast, the "new model" reforms created by President Fernando Henrique Cardoso feature a political economy in which private enterprise, including foreign investment, is assigned an expanded responsibility for economic development. The role of the Brazilian state in a free market is being redefined, shifting the emphasis in public spending toward improving education and health services and alleviating poverty. The state still retains control of macroeconomic policy, operates important public credit facilities, produces oil and electric power, and regulates public services. But regulators acknowledge that private investors must be able to make profits if they are going to expand the supply of goods and services in a fast-growing market. In this new private-public partnership, the state facilitates private initiatives that provide capital and efficiency. The signs of a nascent capitalist reorganization are clear: sound money, trade liberalization, privatization and a shrinking state role in the productive sectors of the economy, a strengthened private banking system, growing capital markets, and greater investment from abroad. But Brazil’s transition to a modem capitalist economy remains incomplete. Many current assessments are cautious and tentative, overshadowed by Brazil’s long and painful record of false starts toward monetary stabilization and economic reform. Achieving any of Brazil’s desired economic goals depends on Cardoso’s successful implementation of the reforms now under way Anything short of both a consolidation of monetary stability based on fiscal discipline and a resumption of noninflationary economic growth will leave Brazil too weak to play a regional or a global role.

BRAZIL’S PROMISE

WHY DOES BRAZIL merit the world’s attention? First, because the stakes are high. Brazil has more than 165 million people and the world’s tenth-largest national economy—larger than Russia’s. Brazil has a modern domestic market served by modern credit systems, and its electronic communications sector includes ten million Internet users. The country’s industrial base is by far the biggest and most diversified in Latin America and is moving rapidly into advanced technologies. Commercial

agriculture is modern and competes worldwide in soybeans, sugar, orange juice, coffee, and processed animal proteins, with vast prospects for expansion. Among the "big emerging markets," which include China, India, and Indonesia, Brazil has the best economic and political prospects for becoming a modern, "first world" economy. This is the bet being made by foreign investors, who have poured in $300 billion in equity and loans to date.

Second, Brazil physically encompasses more than half of South America and shares borders with nine neighbors. It is the linchpin of the continent. This geopolitical reality makes Brazil the pivotal country for consolidating a regional common market and a stable political community in South America. Moreover, the integration of this region into the global economy as a viable trader lies in the economic and political interests of the United States and Europe.

Third, Brazil is one of the main testing grounds in the developing world for free markets, open trading, and private enterprise. The success of these systems in Brazil would have a political impact beyond the region, particularly in Africa, to which Brazil has ethnic, cultural, and historical ties as well as geographical proximity. Brazil is already cultivating relations with Nigeria, South Africa, Angola, and Mozambique, which it sees as promising trade partners.

BLAME IT ON THE REAL

IN OCTOBER 1998, President Cardoso was re-elected to a four-year term by a solid majority. It was the second time he had defeated the favorite of the left, Luiz Inacio "Lula" da Silva, a former autoworkers' union leader who heads the Workers Party. But Cardoso's path to this second victory was not easy. As his first term was ending, Cardoso, a member of the Brazilian Social Democratic Party (PSDB), was still riding the success of his 1994 Real Plan, which simultaneously tamed inflation and improved the purchasing power oflow-income consumers. The Real Plan defeated inflation initially by abolishing price and wage indexations. Monetary stability was maintained by higher taxation and high interest rates that contained consumer demand. During the election campaign in August 1998, however, the Russian debt crisis erupted and shook precarious emerging markets everywhere, including in Brazil. Thankfully for Cardoso, voters remained well disposed toward him despite the resulting economic slowdown and increased unemployment. And as the opposition offered no attractive

alternatives, Cardoso won with 54 percent of the vote, even while warning that a period of austerity would follow the election.

Cardoso's commitment to fiscal discipline, however, was soon undermined. First, the president failed to sell to his wobbly majority in the congress a key reform of the social security system designed to halt the snowballing deficit. Adding to this costly defeat, Itamar Franco, the newly elected governor of Minas Gerais (Brazil's second-largest state), repudiated that state's debts to the federal government. An opposition front of governors began demanding fiscal handouts from the center. Public opinion polls showed a sharp drop in Cardoso's approval ratings, and his besieged government looked weak. The opposition called for Cardoso's resignation, even impeachment.

Turmoil soon spread from the opposition parties to the president's inner circle. A "developmentalist" faction in the PSDB tried to unseat his economic team, led by Minister of Finance Pedro Malan. This faction managed to displace Gustavo Franco, the president of the Central Bank, and used Franco's replacement—who lasted two weeks in office—to devalue the real on January 13,1999. The devaluation was presented as a way of jump-starting the Brazilian economy by making cheap credit available and stimulating exports. Unfortunately, this move plunged Brazil into the worst moment of Cardoso's presidency.

Brazil's new economic model was suddenly facing a serious shock. The government's anti-inflation program was nearly derailed by the capital flight from Brazil after the Russian debt moratorium, the congress' failure to reduce deficit spending, and the bungling by monetary authorities of the real's devaluation. On January 15, with capital flight eroding Brazil's reserves, the real was allowed to float freely. The unintended result was a panic-driven massive depreciation of the real's exchange value by 60 percent in a few days. Soon, alarmed observers warned of an Asian-style recession, acute unemployment, a default on the public debt, and a return to inflation and indexation. The Real Plan looked as though it were about to implode.

INSULATED

IN FACT, nothing so grave took place. Instead of shrinking by five percent, as many international economists predicted it would, the Brazilian economy ended 1999 on an even keel, with its gross domestic product (GDP) rising and employment up slightly. Interest rates fell steadily during the year. The real strengthened on the free-

exchange market. Consumer prices increased less than 10 percent. Although wholesale prices rose nearly 20 percent (reflecting higher costs for petroleum imports), producers absorbed these increases without passing them on in retail prices. Consumers and supermarket chains firmly resisted any price rises—a fundamental change in Brazil's "inflationary culture." Only providers of public services, such as electricity and telephones, and the government-subsidized sugar and alcohol industries raised prices by more than the rate of inflation.

Even in the critical urea of Brazil's access to foreign capital, the January 1999 real crisis caused no lasting disruption. After an initial withdrawal of some short-term capital, investors poured in $29 billion in foreign funds—the highest yearly total of the decade. Some of this money took the form of direct investments for privatization in telecommunications, electric-power generation, and gas distribution. But there were also numerous takeovers, mergers, and portfolio investments. The inflow of capital fully financed Brazil's balance-of-payments deficit during a year when exports fell far short of expectations. As a result, Brazil drew on less than half of the $42 billion support package put together in December 1998 by the International Monetary Fund as a defense for the Real Plan.

Why did the Real Plan not implode? What ensured the ultimate success of the real's devaluation? Thanks to earlier reforms, enough economic fundamentals were in place to maintain stability. The banking system was solid, public-sector revenues were rising, privatization reduced losses in state enterprises, and agricultural and livestock output helped keep food prices stable. None of these conditions existed when earlier Brazilian stabilization plans had unraveled.

In retrospect, the devaluation was a blessing in disguise, and it marked a turning point for the Real Plan. Cardoso, a sociologist and politician known more as an artful compromiser than as a stern economic manager, began revealing a new political will. After flirting with advice to loosen up credit and stimulate the economy with "a little inflation," the president made a fundamental decision to persevere in his anti-inflation and market-opening policies without resorting to political wild cards. He stuck with Finance Minister Malan and the able economic team that backed orthodox remedies for fiscal problems. And when Arminio Fraga, a well-known Wall Street operator, joined the group as the new president of the Central Bank, the international financial community let out a sigh of relief. As for the developmentalists, they were defeated by Malan's resistance to their tactics and by Fraga's appointment to the bank.

BUY NOW, PAY LATER

THE DEVALUATION'S IMPACT on the national and global economies was ultimately softened. But the Brazilian government recognized that the Real Plan's underlying problem, and the cause of the 1999 devaluation, still festered: Brazil's national public debt had grown phenomenally. During the first four years of the Real Plan, the debt level rose from 30 percent of GDP to more than 50 percent. Annual interest payments on this debt soared to nearly 13 percent of GDP, the equivalent of 40 percent of tax revenues. This occurred despite steady increases in federal tax revenues, which had grown 30 percent since 1994. But spending had grown even faster, making the fiscal gap and the balance-of-payments deficit unsustainable. Brazil could no longer borrow its way out. It also had to close a $7 billion commercial-payments deficit generated by an excess of imports over exports.

One problem was built into the plan itself. The stability of the real was based on a strategy that overvalued the exchange rate and accepted heavy public borrowing as the anchor of the anti-inflation program. The theory was that fiscal discipline could wait and that borrowing would buy time until the congress got around to cutting the budget. This borrowing strategy initially achieved a dramatic reduction in inflation by banking on cheap imports to hold down domestic prices and on foreign and domestic loans to pay government bills. But the government failed to stave off the debt explosion that followed— the slowdown in inflation perversely deepened the fiscal hole, making debt more expensive.

Furthermore, the Real Plan aggravated public debt when it tackled another long-standing fiscal problem. The Brazilian government had been trying to increase its revenues through an "inflation tax" that increased tax returns by indexing them against inflation. But government spending on public salaries and payments to suppliers lagged, in real terms, because these items were not indexed. So employees and suppliers ended up worse off. This disguised government swindling of wage earners and creditors totaled more than to percent of GDP— a "tax," never approved by the congress, that fell far more heavily on the poor than on the rich. To counter the inflation tax, Cardoso again chose the risky strategy of borrowing now and cutting spending later. In a study of the Real Plan commissioned by the U.N. Economic Commission for Latin America

and the Caribbean, Rubens Penha Cysne summarized the problem well when he wrote that the government should have slashed spending, not increased debts.

Nonetheless, Cardoso should not get all the blame. Many of the debts that have appeared during the Real Plan were legacies from inflationary times, when problems of public finances were ignored. For instance, unfinanced entitlements—benefits voted into existence by politicians who never provided the means to pay—have overwhelmed Brazil's purse. Additionally, the treasury found itself obliged after 1994 to cover huge, escalating deficits in the social security system—deficits that now equal 10 percent of GDP each year. The Central Bank invested more than $21 billion to clean up the private banking system and another $30 billion to close down and privatize bankrupt state banks. As the majority shareholder in the Bank of Brazil, the government put up $8 billion to recapitalize this institution because of losses in loans never repaid by big farmers and other favored clients. In effect, the treasury wound up refinancing worthless obligations incurred by states and municipalities. Although the formal agreements required that borrowers put their finances in order, these deals always smelled of politics. Ultimately, the cleanups all came out of taxpayers' pockets.

The disastrous impact of these legacies on the current financial situation can be measured by the fact that treasury outlays to meet unfunded, "off budget" obligations have already exceeded the $80 billion in revenues generated by the privatization of state enterprises and concessions during the Cardoso government. As a result, the public debt has grown despite efforts to sell state assets and reduce both the debt and its crushing interest payments.

THE ROAD TO WELLVILLE

PUTTING Brazil's public finances in order is na Augean task. Although the Cardoso government has made respectable progress so far, further spending cuts must take place. A start was made in 1999, when Brazil achieved a federal budget surplus of 3.2 percent of GDP, thanks to a 6.7 percent increase in tax revenues and a cap on discretionary spending.

Reversing past deficits caused by ever-higher interest payments, however, will halt the growing public debt only if similar budget surpluses are maintained for the next three years. Such surpluses will require not only a tight control on spending but congressional approval of full-scale social security reform, tax reform, and a three-year

budget—known as the PPA—that ties public investments and social spending to specific sources of revenues.

The current PPA, which runs until 2003, is the charter document of Cardoso's economic model for his second term. The product of 30 months of work by 80 government economists and private consultants, the PPA provides a road map for putting the Brazilian economy back on track. It forecasts this year's growth at four percent, continuing at an annual rate of four to five percent until 2003. If achieved, this rate would be quite an accomplishment in light of the past two decades, when annual growth averaged two percent and Brazil's per capita income steadily declined. At least 40 million people in Brazil still live below the poverty line, with a monthly per capita income of $60 or less.

Prepared by the Ministry of Planning and the Ministry of Budget and Management, the PPA development document shuns unfinanced spending extravaganzas of the old, inflationary way. Instead, it advocates making investments compatible with the budget surplus targets. The PPA's authors have given priority to an assortment of economic and social investments, organized into 365 programs, that total $600 billion over four years. Most are public-sector investments that include heavy spending on education and health and on such productive state enterprises as Petrobrás, the oil company, and Eletrobrás, the energy company. Private investors, both domestic and foreign, and non governmental organizations are expected to supplement this financing. The goal is to increase Brazil's investment level to more than 20 percent of GDP this year—without increasing the public debt. Already, the PPA has prompted an electric power expansion of 13,000 megawatts over three years by private investors in partnership with Petrobrás and Eletrobrás. Investments of more than $20 billion would be financed almost entirely by private capital.

Other fiscal improvements have been made, as well. For instance, the fiscal adjustment carried out in 1999 reduced the public-sector debt to just below 50 percent of GDP. The surpluses anticipated by the PPA for the next two years should further reduce the debt level to about 46 percent of GDP. Moreover, the fiscal turnaround in 1999 included a surplus from states and municipalities that had saved nothing in previous years, proving the effectiveness of the recent debt-refinancing agreements made with subnational governments.

In addition to budgetary controls, spending caps and fiscal responsibility are badly needed at all levels of government. Brazil is a vigorous federal democracy in

which voting is frequent at the national, state, and municipal levels. Brazil has 27 state governors and 10 mayors of large metropolitan cities, each of whom represents a power center that is often at odds with the central government in Brasilia. Until recently, these state and municipal units have been reckless spenders, passing on to the national treasury one-third of all public—sector deficits.

One reason why spending was so rampant is that even though the poor suffered more from high inflation than did the rich, many politicians failed to get the message until recently. They stuck to the traditional populist view that spending is good and were therefore hesitant to vote for austerity measures they felt might backfire in the next election. Now the federal government has managed to challenge this bias toward spending. A recent special session of the congress produced surprisingly large majorities in favor of tightening budgetary controls and punishing fiscally irresponsible federal, state, and local officials. The result was the Law of Fiscal Responsibility which makes the waste of public monies by officials not just an administrative misdemeanor but a criminal offense, punishable by disqualification from public office.

If fiscal discipline prevails at the state and municipal levels, it will be one of the major accomplishments of the Real Plan. Cardoso has had to bargain at every step of the reforms with a multiparty bicameral congress riddled with parochial interests. Because of these efforts, a fiscal law has emerged that will signal a renewed chance at economic progress. In addition, a new fiscal federalism should accompany the law and oblige states and municipalities to borrow on private capital markets, no longer banking on the federal government to bail them out with "political criteria."

PROGRESS CHECK

MORE THAN 100 million Brazilian voters will get a chance to evaluate Cardoso and his reforms in October 2000, when nationwide municipal elections will be held. The results of these local contests, particularly those in major cities, will be watched closely for signs of the direction in which public sentiments are moving. Political analysts regard the municipal elections as the first round of the 2002 presidential elections that will produce Cardoso's successor.

The elections have two possible outcomes, each heavily dependent on the success of economic reform. If the public anger and insecurity that followed the real's devaluation in early 1999 continue into the next election, the opposition could harvest a

large protest vote. So hopes the affiance of the left, composed of Lula's Workers Party (PT), the Democratic Labor Party (PDT), the Socialists of Miguel Arraes, and the wing of the Brazilian Democratic Movement Party (PMDB) that supports Governor Franco. All of these groups share a visceral desire to humble Cardoso, but none offers an alternative program. Lula's classic riposte to critics asking for a PT government program is that "an opposition doesn't need a program, it needs to oppose."

But what if the reforms take hold and the Cardoso administration's new economic model begins to generate growth and jobs, as the government is predicting? Public moods often shift suddenly in Brazil, where politics is driven more by emotions than by rational calculations or party loyalties. In a more upbeat situation, candidates representing the centrist coalition that supports Cardoso could do well. These allies include Cardoso's own PSDB, the Liberal Front Party (PFL) of Antonio Carlos Magalhães (the powerful Bahian president of the Senate), and the catchall PMDB.

If the recent elections in the rest of South America are any indication for Brazil, predictions of a backlash and a protest vote against free-market reforms and trade liberalization are greatly exaggerated. Brazil's Real Plan belongs to the family of reforms that have been adopted by Argentina, Uruguay, and Chile. And the presidential contests that took place this year in those countries resulted in victories for Fernando de la Rua in Argentina, Jorge Batlle in Uruguay, and Ricardo Lagos in Chile—each fully committed to free-market reforms.

The results of these elections are also significant because they involve Brazil's partners in Mercosur, a customs union that will form the future common market of South America. This trading bloc, with $20 billion in regional trade, is currently negotiating to better coordinate macroeconomic policies, investment rules, and other aspects of integration. The prospects for moving toward a regional common market are improved by the fact that Mercosur member countries are on the same political and economic wavelength—they all share the goal of a free-market, globally oriented capitalist enterprise.

WAITING TO EXHALE

THE FUTURE of Brazilian reforms will largely depend on whether the economic revival Cardoso predicts for this year takes place in time to convince voters

that the new model is a successful strategy. To survive, Cardoso must prove that his model is capable of generating economic growth.

But macroeconomic stability alone, despite the virtues of low inflation and falling interest rates, is not sufficient to assure rapid growth. Instead, growth depends on a more dynamic initiative by the private sector. And therein lies the rub. Unfortunately, today's reforms contain a contradiction between fiscal policy and efforts to increase private investment. Cardoso's economic team is trying to raise public revenues through higher taxes—but that diverts savings away from private enterprise. The tax burden in Brazil is more than 30 percent of GDP, higher than in most developing countries. On top of the tax hikes, the public sector continues to borrow at high interest rates. This makes credit scarce and very expensive for Brazilians, who developed a near addiction to cheap public credit during the inflationary period.

Can the Brazilian private sector full its role in the new economic model as leader of the country's economic growth? With the opening of the Brazilian economy, foreign investors have rapidly expanded their positions in infrastructure, industry, banking, and commerce. They are bringing in billions in fresh funds and new technologies that can make Brazil competitive in the global economy. But foreign investment is not enough. Indeed, the privatization and acquisitions of Brazilian firms have already generated adverse nationalist reactions.

The local business community is fill of complaints over high taxes, costly credit, and government regulations. These protests raise doubts about the implementation of the new economic model as a private entrepreneurial system. One of the biggest questions is what role Brazil's big private banks will play. These banks are very profitable but invest far more in financing government debts than in supporting private investment. The capital markets in Brazil, therefore, do not play the part they should in underwriting the emergence of new firms. Brazilian private entrepreneurs do not seek capital through public share offerings—partly because savers are wary of equity after having had bad experiences as minority shareholders. So the Brazilian capital market must be reformed in order to make buying stocks more attractive.

At this stage in Brazil's capitalist reorganization, the essential question of entrepreneurial dynamics within the new model remains unanswered. Cardoso stated in March that he believes his government has been doing its part, so private entrepreneurs should now "do their stuff". Ultimately, the economy will grow if a strong capital market emerges, broadening public participation in Brazil's new capitalism.