COMMISSION ON GROWTH AND DEVELOPMENT

WORKING PAPER NO.45

Setting Up a Modern Macroeconomic Policy Framework in Brazil, 1993–2004

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About the Series

The Commission on Growth and Development led by Nobel Laureate Mike Spence was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth—an observation that has been overlooked in the thinking and strategies of many practitioners. Second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. Consequently, the Commission's mandate is to "take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers."

To help explore the state of knowledge, the Commission invited leading academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

Working papers in this series were presented and reviewed at Commission workshops, which were held in 2007–08 in Washington, D.C., New York City, and New Haven, Connecticut. Each paper benefited from comments by workshop participants, including academics, policy makers, development practitioners, representatives of bilateral and multilateral institutions, and Commission members.

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Abstract

This paper keeps an eye on the big picture and follows the long-lived virtuous circle that, beginning in the mid-1990s, led to the very successful setting up of a modern macroeconomic policy framework in Brazil, after a decade-long effort involving four presidential terms. It is an eventful and far from linear history that calls attention to the role of leadership and the complex learning processes that may be involved in the improvement of the quality of economic policy.

Contents

Setting Up a Modern Macroeconomic Policy Framework in Brazil, 1993–2004

Rogério L. F. Werneck [1]

1. Introduction

In mid-1993 the steering of macroeconomic policy in Brazil was at the lowest point of a long deterioration process that left the economy in an appalling situation. Eight years before, the two-decade-long military regime had reached its end, leaving the country the bitter legacy of annual inflation topping 200 percent. The return to democracy proved to be a rocky road. Tancredo Neves, an able and influential politician who had been elected by Congress the first president of the civilian regime, supported by a wide coalition of political forces, died before taking office, opening the way to a considerably less capable and less influential vice president (José Sarney). During the first three years of President Sarney's administration, Congress drafted a new constitution that was finally promulgated in late 1988. Unfortunately, the long and delicate political negotiations that brought about the new constitution took place exactly when the central government was notably feeble, due not only to the shortcomings of President Sarney but also to the resounding failure of no less than three stabilization attempts in 1986–87. The new constitution would become a source of severe additional difficulties. On the one hand, it amplified the scope for the historical rent-seeking behavior of many segments of the Brazilian society, imposing upon the federal budget a considerable additional burden. On the other, it entailed an important reduction of the union's fiscal resources in favor of state and local governments. After a fourth failed stabilization attempt, President Sarney ended his term in March 1990, leaving the country with a defaulted external debt and an 80 percent *monthly* inflation rate.

Fernando Collor, the following president, would make two other stabilization attempts—the major one on in his first day in office. Both attempts failed. Collor was impeached 30 months after taking office, in the wake of a serious corruption scandal. His mercurial vice president, Itamar Franco, was sworn in as president in early October 1992. Seven months later, in mid-May 1993, President Franco dismissed his third finance minister. On average, each of

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the first three finance ministers had lasted roughly 75 days in office. Having to choose a fourth, he appointed Fernando Henrique Cardoso.

This paper analyzes what has happened since then. The idea is not to retell well-known episodes, such as the launching of the Real Plan, but to keep an eye on the big picture and follow the long-lived virtuous circle that led to the very successful setting up of a modern macroeconomic policy framework in Brazil. This decade-long effort involved four presidential terms. It is an eventful and far from linear history that calls attention to the role of leadership and the complex learning processes that may be involved in the improvement of the quality of economic policy.

The next section briefly discusses the launching of the Real Plan stressing the role of leadership. Sections 3 and 4 analyze how the new macroeconomic policy agenda that followed the successful stabilization plan brought new challenges that could only be met after a relatively long and costly learning process. Section 5 addresses a related but quite different issue: the fast learning process that the opposition had to go through to keep the quality of the economic policy, after winning the presidential election in late 2002, amidst the unstable macroeconomic environment that stemmed from the high uncertainty that the election itself had triggered. Section 6 discusses challenges ahead.

Figure 1: Timeline

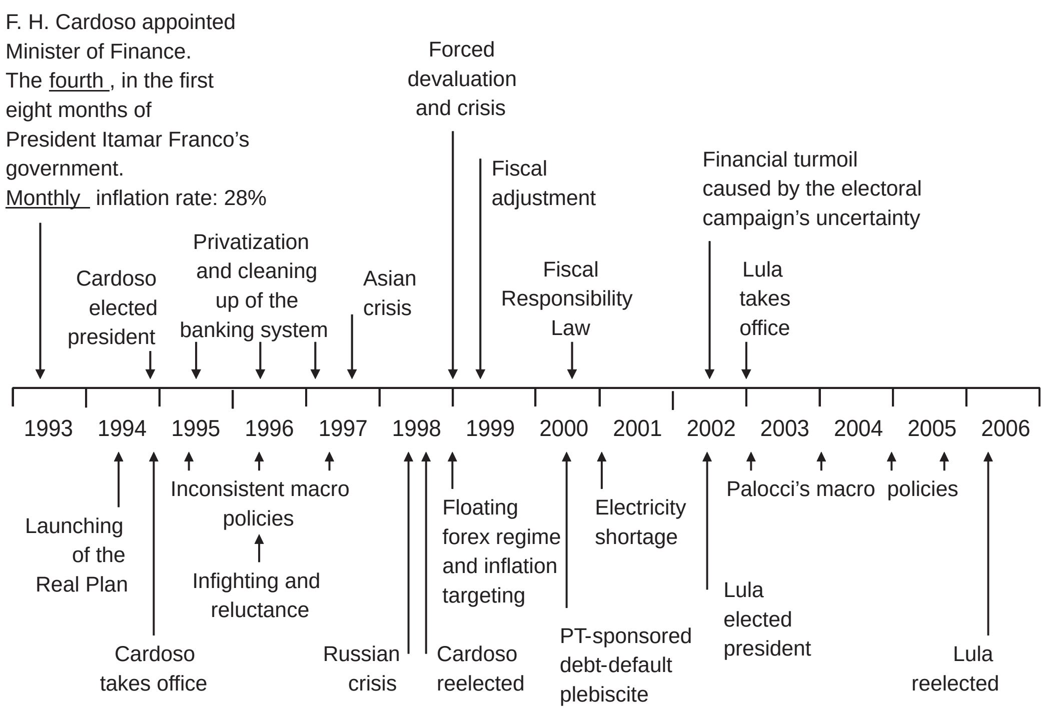


Figure 2: Brazil, 1995–2006 GDP Annual Growth Rate (%)

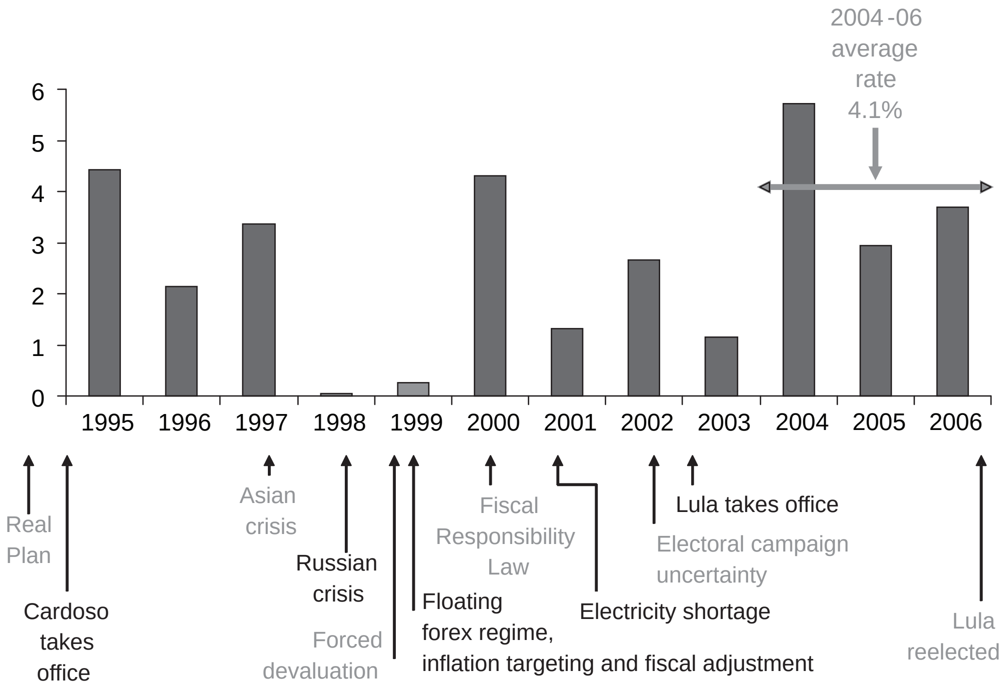


Figure 3: Brazil, 1993–2006 Trade Balance and Current Account Balance (US$ billion)

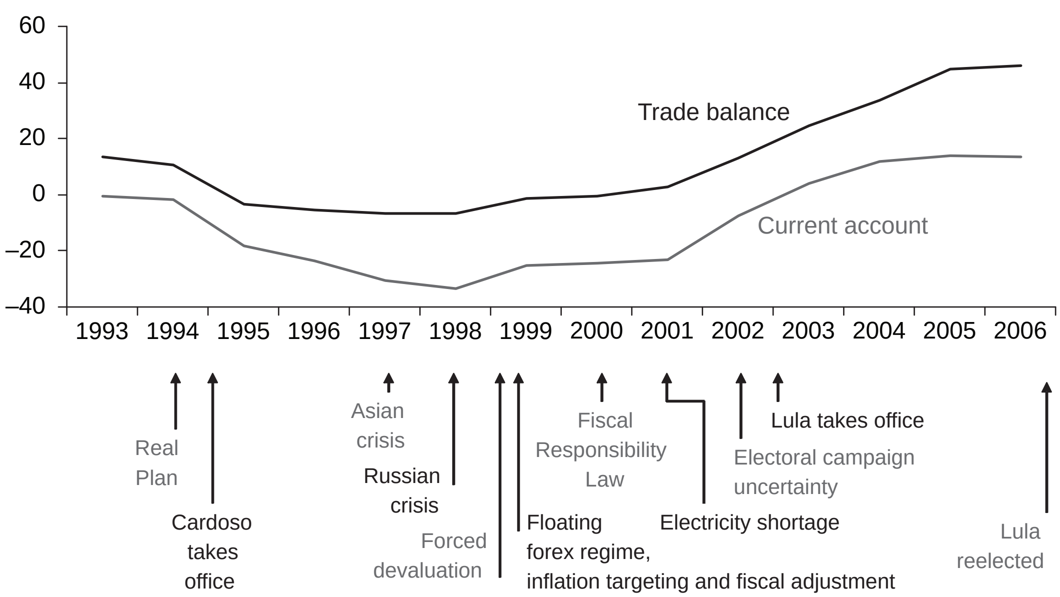


Figure 4: Brazil, 1993–2006 External Debt (US$ billion)

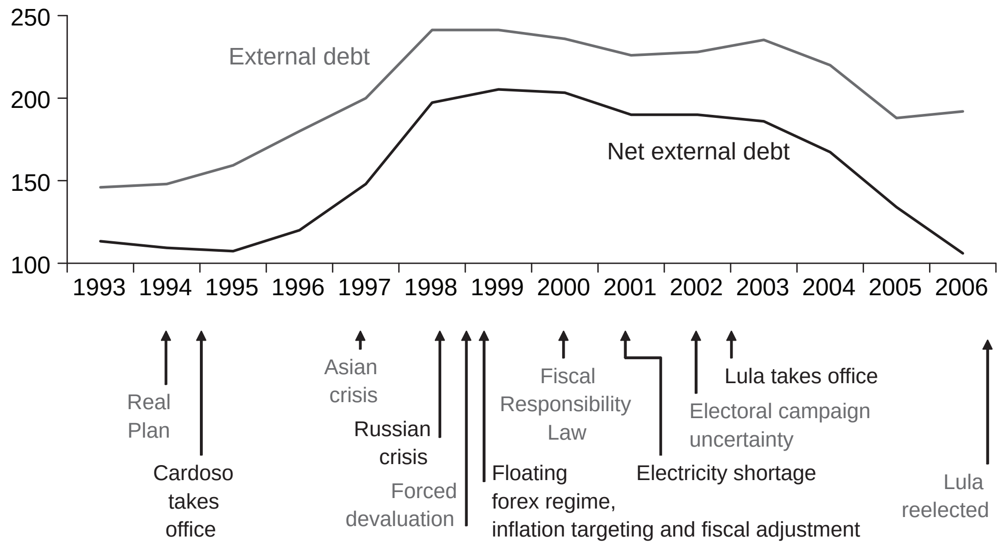


Figure 5: Brazil, 1993–2006 Real Exchange Rate (IPEA), 2000 Average = 100

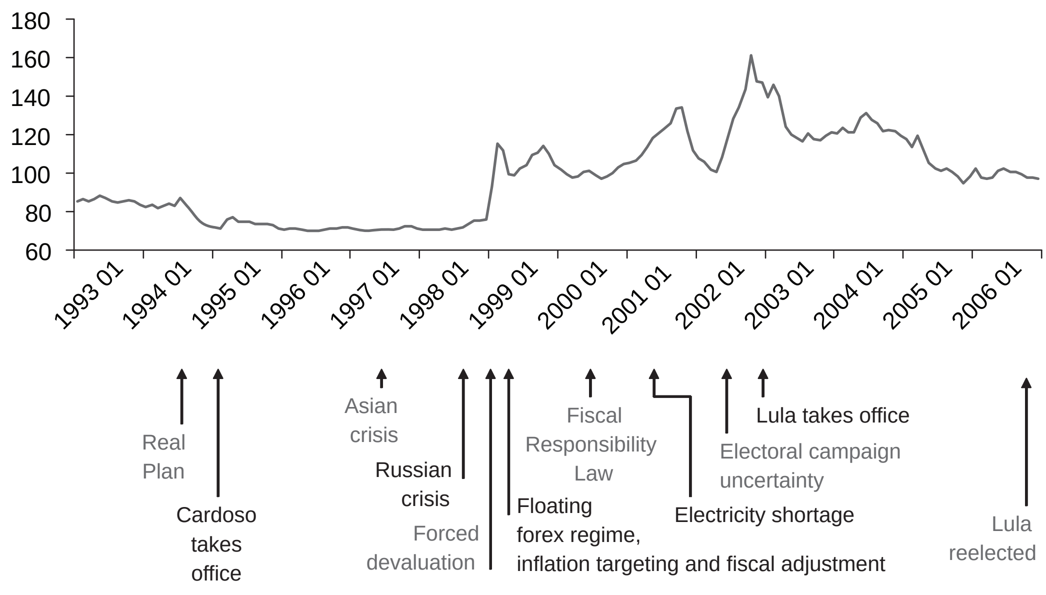


Figure 6: Brazil, 1993–2006 Annual Inflation Rate IPCA (percent)

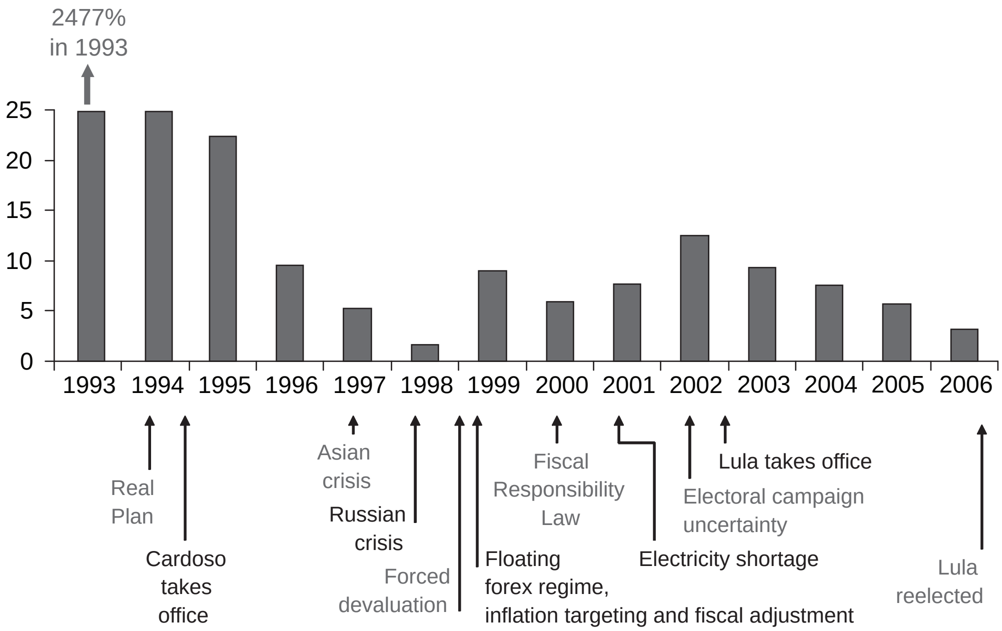


Figure 7: Brazil, 1993–2006 Public Sector's Primary Balance (% of GDP)

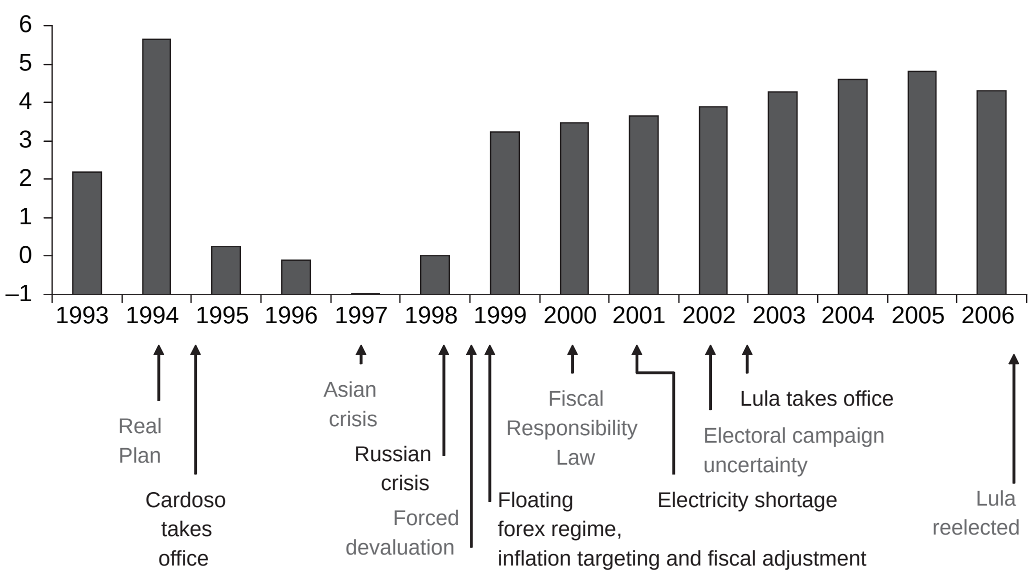
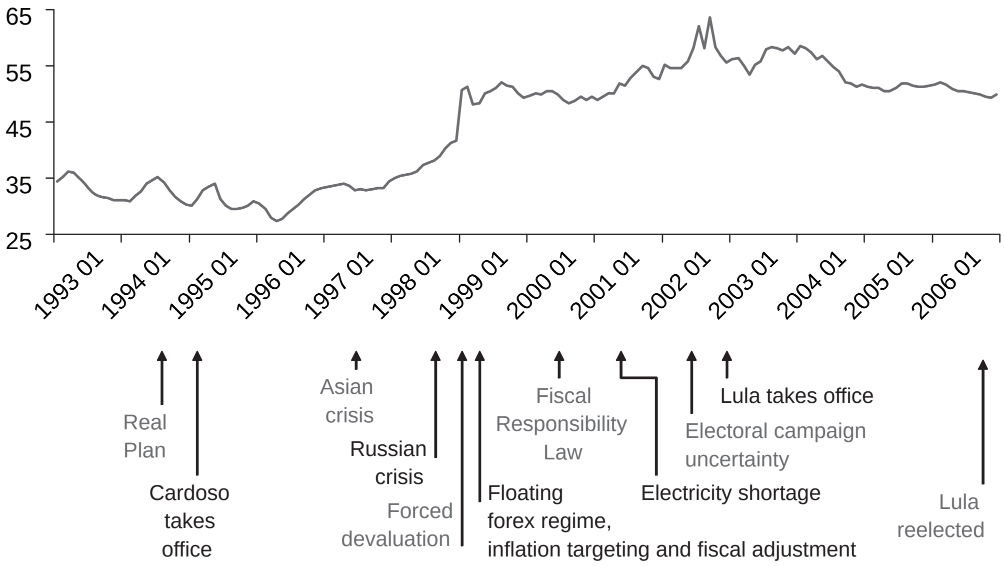


Figure 8: Brazil, 1993–2006 Public Sector's Net Debt (% of GDP)



2. Leadership and Quality of Economic Policy: Launching the Real Plan

It is hard to overstate the degree of disarray the country's macroeconomic policy framework had reached in May 1993, when Fernando Henrique Cardoso found himself in charge of the Ministry of Finance.[2] With the *monthly* inflation rate above 30 percent, the government was, once again, under a tremendous pressure to take action. No wonder Cardoso's taking-office speech mentioned three major problems to be faced: inflation, inflation, and inflation.[3] But, at the same time, there was much skepticism about the possibilities of President Franco's government. His performance during his first seven months in office had been deplorable. He had only 19 months left and in less than a year Congress would only have eyes for the national elections that would be held in October 1994. It was hard to believe he would have enough time to adopt any ambitious economic policy.

Gathering a competent economic team had become an extremely difficult task. As finance ministers tumbled one after another, at the whim of a histrionic president, both the new minister and the group he tried to attract to work with him knew they would not last long—probably a few months. Talented people had become hard to lure. The team that the new minister would finally be able to assemble would only make his fate even more helpless from the outset. In fact,

[2] See Werneck (1994).

[3] Cardoso (2006, p 16).

this had made the recruitment of even finance ministers and Central Bank governors increasingly difficult. Over the previous months, many talented candidates had refused invitations from the presidency.

It was remarkable that, under such adverse conditions, Cardoso managed to break the vicious circle and recruit a top-level economic team. How and why that happened deserves some speculation. There is no evidence supporting the idea that Cardoso somehow contrived to be appointed finance minister. It is true that seven months earlier he had unsuccessfully tried to convince President Franco to invite his close friend and fellow party member, José Serra, to be finance minister. But it seems that Cardoso never imagined, seriously, that he himself could be eventually invited to occupy that position in the cabinet.[4] There are therefore strong reasons to believe that both the invitation and the appointment really came as a surprise to him and his party.[5]

Five years before, Cardoso had played a key role in the founding of PSDB, the Brazilian Social Democracy Party, formed mainly as a split from the catch-all PMDB, the Brazilian Democratic Movement Party. His appointment to the Ministry of Finance in such unfavorable circumstances exposed both himself and the newly created party to a significant risk of reputation loss. But it could also be viewed, with proper optimistic eyes, as a window of opportunity. Cardoso seems to have made good use of a delicate combination of those two considerations in order to recruit the very small group that would constitute the embryo of his economic team. His own appointment was a *fait accompli*. He wanted help to get the best out of the difficult situation in which he and the party had been put.

One could argue that any of Cardoso's three short-lived predecessors that had occupied the Ministry of Finance since October 1993 could have used similar arguments to circumvent the difficulties of gathering an economic team that could handle the complex stabilization challenge. This conjecture sheds light on how Cardoso was in a much more favorable position to deal with the problem.

[4] In fact, an influential senator thought Cardoso should be the finance minister of President Franco's first cabinet. But, in his memories, Cardoso mentions that the idea horrified him. See Cardoso (2006, p. 39).

[5] After the traumatic impeachment of President Collor in September 1993, a broad political coalition had been formed to support President Franco's new government. Cardoso had accepted an invitation to join the cabinet as Minister of Foreign Affairs, a relatively comfortable position that was well sheltered from the most problematic and turbulent areas of the government. He was in New York, on his way back from an official trip to Japan, when he received a phone call from President Franco inviting him to become his fourth finance minister. The invitation left him in an odd position. It was hard to say no, but he was perfectly aware of how precarious the economic situation was and of the enormous challenges and risks the acceptance of the position would entail. He answered that, though he did not want to sound unsupportive, he thought President Franco should make an additional effort to avoid the dismissal of the incumbent minister. Thinking that such answer had given him some time to discuss the matter more carefully, he reports he was taken aback the next morning, when headlines in Brazil announced his name as the new finance minister. See Cardoso (2006, p. 41–42).

His political stature and the perception that he had a better chance of establishing a more stable relationship with President Franco seem to have made a big difference.

Cardoso's influence over a small group of well-trained economists, which had been working for years on the country's stabilization challenges and on how to put an end to high inflation, proved to be another very important difference.[6] Combining a distinguished academic career as a political scientist, a good image as a politician, and sheer personal charisma, he was seen by the group as a man that clearly stood out in the political landscape and belonged to a very special class of congressmen. In fact, some of those economists had participated actively in the discussions that led to the founding of PSDB and had joined the new party. Those that were not formally affiliated kept close ties with important party leaders, especially with Cardoso. Unsurprisingly, the economists that were party members were the first to join the economic team.[7] Others would only give informal help at first, but would fully join the economic team over the coming months.[8]

How exactly to deal with the alarming high-inflation problem was a far from settled issue. For both technical and political reasons, there was much resistance to the idea of resorting to an outright dollarization, as had just been done in Argentina. Much thought had been given to the design of an alternative plan, but all competing proposals had lots of loose ends to be dealt with.[9] The group would take months to develop a well-rounded plan. Cardoso quickly grasped the importance of assuring proper working conditions that would help the group carry on that complex development. In the implicit contract that was involved in his relation with the group, Cardoso agreed to avoid undue interference in the lab and accepted a very unhierarchical one-man-one-vote arrangement, which made the depuration of the free flow of ideas seem more legitimate within the group.[10]

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[6] That group was basically composed of economists that were or had been full-time faculty members of the Department of Economics of PUC-Rio, the Catholic University of Rio de Janeiro.

[7] "Moved more by the sense of political duty than by the belief in the possibility of doing of had to be done", remembers Cardoso (2006, p. 141).

[8] Edmar Bacha, Winston Fritsch, and Gustavo Franco joined first. Pedro Malan, who lived in Washington and was in charge of the external-debt renegotiations when Cardoso became finance minister, agreed to spend a week a month in Brasília to help the new economic team. In September 1993, he was appointed governor of the Central Bank. His job as debt negotiator was taken up by André Lara Rezende. Pérsio Arida joined the team in December 1993 as president of BNDES, the National Bank for Economic and Social Development. Francisco Lopes, at first, would keep only an informal relation with the economic team.

[9] Some members of the group had had a hands-on experience in the failed stabilization attempts of the Sarney government. A long list of mistakes to be avoided had been produced. There was also much to be learned from other high-inflation fighting attempts in other countries, especially in Israel and Argentina.

[10] This unhierarchical arrangement is stressed in Fiuza (2006), in a book largely based on evidence provided by Gustavo Franco.

Cardoso's academic background probably helped him to perceive that his peculiar little task force would have to work under very special conditions to be able to design a watertight inflation-fighting plan in time. Being in no position to lose the collaboration of any of those hard-to-attract economists, he had to settle for a decision-making process that seemed to belong much more to the realm of academic institutions than to the commanding heights of Brasília. That does not mean that the group worked with complete independence. Cardoso followed closely how ideas were evolving and had an active and obviously influential participation in the group's weekly meetings. But several group members report that, somehow, he managed to do that without choking the spontaneity of the internal debate. He seems to have played an important role in making the group strike the right balance between cooperation and competition that would allow it to show the required cohesion and, at the same time, remain well focused and ignited by the challenge to design and implement against the clock a complex high-inflation fighting plan. Cardoso would write later that the Real Plan had been a successful adventure carried on "by a small group of believers."[11]

In order to be able to run the Ministry of Finance, Cardoso had to recruit more than half a dozen economists. From his first day in office, he could count on the help a private industry executive and a small group of former aides that had worked with him in the Senate and in the Ministry of Foreign Affairs. Over the following months, he would also be able to enlist the help of a small but crucial part of the elite of the federal civil service. Altogether, economists and non-economists, they formed a surprisingly small band that Cardoso would later call his own Brancaleone's Army.[12]

Over those critical months, Cardoso's leadership proved to be extremely important in many other aspects, well beyond the narrow limits of his relationship with the economic team and close aides. In order to assure the successful launching of the Real Plan he would have to play a key leading role in many other spheres: in President Franco's problematic administration, in his own party, in assuring support from Congress and in the effort to convince public opinion at large that the plan he had been working on was quite different from the long row of previous failed stabilization attempts, and had a very high chance of being successful.

Histrionic and mercurial as he certainly was, President Franco knew perfectly well that, having burnt so fast most of his government's political capital, with the firing of three finance ministers in seven months, he had to play a different game with Cardoso. They had a long experience together in the Senate, where Cardoso's worldliness had caught Franco's more provincial eye. It was no accident that when Cardoso was first invited to join the cabinet, Foreign Affairs was the ministry Franco had in mind. For a government that had been clearly adrift, in the midst of a high-inflation disaster, the new finance minister

[11] See Cardoso (2006, p. 16).

[12] After Mario Monicelli's famous 1966 movie, *L'armata Brancaleone*. See Cardoso (2006, p. 137)

meant the last hope of finding the right track. Cardoso's ascendancy over Franco would rise steadily over the following months, as the president would become increasingly convinced that his political fate was definitely bonded to the success of the stabilization plan.

That does not mean that Cardoso's relationship with President Franco and other cabinet members was easy—far from it. Over and over, Cardoso had to mobilize his best negotiating skills to protect the stabilization effort from reckless decisions that could lead to a derailment of the plan. There was at least one critical moment in late February 1994 when the plan's consistency was under such a great risk that Cardoso was forced to openly threaten resignation. He had to do so in order to avoid the introduction of last-minute, ill-advised changes, proposed by the labor minister, in a crucial package that was being sent to Congress to set the legal framework of the Real Plan.[13]

To be able to build up a coalition that would assure proper support for the stabilization plan in Congress, Cardoso tried first to get unequivocal backing from his own party. During his first months in office, support from PSDB was half-hearted, at best. Some of the most preeminent PSDB leaders clearly thought that accepting the Ministry of Finance had been an unwise move. Among them there those who argued that the difficult situation in which the party had get into called for a careful damage-control approach, which demanded no more than some sort of palliative action in the high-inflation fighting front. The idea of implementing an ambitious fully fledged stabilization plan was deemed to be completely inadvisable. As Cardoso and his economic team pushed the plan forward, some key figures in the party tried to keep a careful distance from the preparations.

In a well-known meeting of the economic team with the main leaders of his party in September 1993, when the plan was still at a rough state, Cardoso managed to extract from Mario Covas, the influential governor of the state of São Paulo, a strong, though peculiar, kind of endorsement. Covas thought that there were many reasons to believe that the plan would not work, that it would come too late, and would cost the party a resounding defeat in the 1994 elections. Even so, he saw no way out; the plan had to be fully endorsed. But other party leaders were less sanguine and some preferred to remain reticent.[14] The mere sense of political loyalty, which had been so important in the recruitment of the economic team when Cardoso was unexpectedly appointed minister, proved to be insufficient four months later to bring about a broad and strong backing for the stabilization plan among the main PSDB leaders. Most of them were not sure they could grasp all the risks the plan would entail. And, compared to the economic team, they had much more at stake.

By December 1993, the stabilization plan started to seem a much less risky venture. As political forces began to be redeployed in preparation for the

[13] For details, see Cardoso (2006, p. 197).

[14] See Cardoso (2006, pp. 182-184).

presidential election of late 1994, the idea of forming a broad center-right coalition to bet on the success of the plan gathered strength. Over the following months that idea opened way for the building up of support in Congress for the approval of the highly controversial legislation that was required to make the plan feasible. Making the impressive, but fragmented and unruly, coalition that was formed in Congress move in the right direction, without botching the detailed legislation that was being voted against the clock, was a tremendously challenging political operation that had to be extended for several months. Cardoso's standing in Congress, persuasiveness, and negotiating skills made a huge difference.[15]

But there were still another crucial front that had to be simultaneously faced. Public opinion at large had to be convinced that what was being prepared in Brasília was not just another blundered high-inflation fighting plan, which would prove to be disastrously ineffective in a couple of months. The dire consequences of a long row of failed stabilization attempts, from 1986 to 1990, had left strong misgivings about what else the government could have in store. There were widespread fears of a new wage and price freeze and of arbitrary measures that, as in 1990, could limit the liquidity of financial assets. Those fears, of course, were ready to trigger all kinds of defensive anticipatory moves that were bound to be highly destabilizing. Unless those expectations could be disarmed, the new plan would not have even a scant chance of success.

Having those difficulties in mind, Cardoso's economic team had devised a plan that, in contrast with all previous stabilization attempts, involved neither a wage and price freeze nor any kind of arbitrary or surprising measure.[16] The plan was to be totally transparent. All measures were to be clearly announced months before being adopted. But given all mistrust that had been gathered, public opinion had to be convinced that the new plan was really different from previous stabilization attempts and that the government had no hidden cards.[17] That was no small task, for it could only be properly accomplished if the more enlightened parts of public opinion could have a reasonable understanding of the logic of the plan, so as to be convinced that it had a good chance of success. Being a highly talented communicator, Cardoso played a key role in successfully meeting that challenge—first as finance minister and, after March 1994, when he had to step down to run for the presidency, already as a campaigning candidate.

[15] For details, see Cardoso (2006), pp. 187–200. Interestingly, Cardoso acknowledges that the "disorganization of traditional political forces since the impeachment of President Collor … opened way for the decisive action of our Brancaleone`s Army and the Real Plan was approved in Congress," and is convinced that "in normal conditions, those that were being benefited by the inflation would have opposed the changes more fiercely, defending their interests…" Cardoso (2006), p. 205.

[16] For an early detailed account of the launching of the Real Plan, see Franco (1995).

[17] "Amidst many doubts I harbored only one fundamental certainty. That only a program that could be explained and understood would be able to bring down inflation and keep it low…" Cardoso (2006), p. 146.

3. Infighting and Reluctance: Policy Making in the Aftermath of the Real Plan

The steering of economic policy was bound to become a much more complex operation under the new administration that took office in the beginning of 1995. On the one hand, the policy agenda suddenly looked much broader than when all efforts had to be concentrated in putting an end to high inflation. A full range of other policy issues were demanding urgent attention. Of course the consolidation of the newly established low-inflation regime was far from over. But how exactly that consolidation should be assured soon proved to be a highly controversial issue. On the other hand, the peculiar decision-making arrangement that had prevailed till the launching of the Real Plan could not be maintained under the new administration. Inevitably, as Cardoso formed his new Cabinet, the small and homogeneous economic team that had been responsible for the stabilization plan had to share control over the economic policy with economists of different shades and with politicians that back in 1993–94 had preferred to keep a prudent distance from the plan. Pedro Malan was appointed finance minister and José Serra, who had just been elected senator by the state of São Paulo, was nominated planning minister.

All the ingredients for a major split on how to conduct the economic policy were in place: difficult choices, widely different views, intellectual rivalry, and power disputes within the economic team of a very popular government, which had just been elected in the wake of the tremendous success of the ongoing economic policy. Some infighting seemed unavoidable. To be able to keep a consistent economic policy, Cardoso would have to be prepared to play a very determined role in arbitrating conflicting views and clearly setting the direction that should prevail. But Cardoso would have to go through a long learning process before being finally compelled to play that decisive role.[18]

For the next four years both the exchange-rate policy and the fiscal policy would prove to be important bones of contention. But dispute over the exchange-rate policy emerged first. The new government took office already under a deteriorating external environment, in the wake of the late 1994 Mexican debacle. An appreciation of the newly created currency over the second half of 1994 had helped to keep inflation under control in the crucial immediate aftermath of the stabilization plan. Import tariffs had also been brought down to soften the market power of leading industrial price setters, as the highly protected automakers. Concern over the extent of the contagion of the Mexican crisis soon triggered dissention within the new government on what to do about the exchange-rate policy.

Part of the economic team feared that a premature depreciation could put the delicate virtuous circle of falling inflation in jeopardy. Worried about the

[18] Arguments along similar lines are also explored in Abreu and Werneck (2008).

effects of the worsening external environment on the country's foreign accounts, another part of the economic team argued that there was no time for delaying a devaluation. Some also thought that the import tariffs reduction that had been announced months before should be immediately reverted. In early March 1995, in a climate of very strong disagreement, a blundered Solomonic half-way depreciation attempt led to a sizeable loss of international reserves. By mid-year, after a long tug-of-war within the economic team, tariffs on imported cars were reset well above the levels observed before the 1994 tariff reduction.[19]

The end of high inflation brought new and important challenges. Part of the banking system was not prepared for the sudden change. Bold, politically costly measures become unavoidable. On the one hand, the Central Bank had to intervene in some large private institutions, under protests of powerful politicians that played a prominent role in the broad coalition that supported the government. On the other hand, the Central Bank had to intervene in shaky state banks that were being overtly used by governors to finance their overspending. Particularly difficult was the intervention in Banespa, by far the largest state bank. It took place the day before Cardoso took office, under strong protests from Mário Covas, Cardoso's close party ally who was also taking office as governor of the state of São Paulo.

Another challenge was the fast deterioration of fiscal accounts. Over the long high inflation period, all levels of government had introduced strict tax indexation provisions in order to protect the real value of their revenue. In contrast, on the expenditure side, they had artfully delayed disbursements and made good use of inflation to erode the real value of budget allocations. Unsurprisingly, the sudden end of the high-inflation regime brought a rapid increase in the real value of their expenditures. To avoid a serious deterioration of public accounts, a strong fiscal adjustment effort would have to be made. But the new government seemed unprepared for a fiscal consolidation effort at that time. The fiscal policy in 1995 was worryingly lax. And the split and overwhelmed economic team took some time to perceive how fast the fiscal situation was deteriorating. The overall primary surplus of the public sector was reduced from 5 percent of GDP in 1994 to roughly zero in 1995.

The situation called for a determined fiscal adjustment in 1996. Imposing a hard budget constraint on state and local governments had become particularly urgent. But the federal government seemed to be moving in the opposite direction. In late 1995 Governor Covas, supported by an impressive group of São

[19] The dissention within the economic team of the new government would follow different lines in different issues. Disagreement over the foreign-exchange rate policy opened a serious split in the core economic team that had been responsible for the Real Plan in 1993–94. But in the case of the protectionist restoration episode, the tug-of-war was basically between the original core economic team and newcomers that had recently joined the government. Of course, the outcomes of those conflicts were not independent. Having split over the foreign-exchange policy, the core economic team of 1993–94 could not resist the mounting protectionist pressures.

Paulo's PSDB party members that included some of Cardoso's most influential ministers, strongly demanded that the control over Banespa should be handed back to the state of São Paulo. After what remains to this day an intriguing political calculus, Cardoso gave in and publicly promised that the bank would be given back to the government of São Paulo, as demanded, and all privatization plans aborted.[20] In fact, the bank was never given back. But the government's weak stance was a major blow to the credibility of the idea that it could be committed to a serious fiscal adjustment effort at that time.

As a matter of fact, it soon became clear that the government had found a more important use for the considerable political capital it had amassed in the wake of the success of the Real Plan. In early 1996, the idea of extracting from Congress a constitutional amendment that would allow the president to be reelected started to gather strength in Brasilia. Antagonizing mayors, state governors, and the broad coalition that supported the government in Congress with tough fiscal adjustment measures did not seem to be the right thing to do at that moment. The fiscal situation would continue to deteriorate during 1996.

Even after the reelection amendment was approved by Congress in early 1997, the government remained unable to show conviction about the need of a serious fiscal adjustment. Suffice it to say that a major issue that divided the economic team over the first half of 1997 was whether privatization proceeds should be used to redeem public debt or to finance a major investment program. By mid-year Cardoso decided to step in and announce a fifty-fifty arrangement.

In the wake of the fast appreciation of the currency, external accounts were worsening fast. The current account deficit was expected to reach almost 4 percent of GDP in the end of 1997. Part of the economic team, strongly supported by core leaders of the PSDB, pressed for an immediate devaluation and more interventionist policies that could promote economic growth, arguing that public accounts would improve naturally in a fast-growing economy. But key members of the economic team resisted to those ideas, pointing out that a devaluation would be excessively risky and, in any case, unthinkable without a previous sizeable fiscal adjustment. As the reluctant government remained lost in that debate, macroeconomic inconsistency was being alarmingly exacerbated. The country would soon face a major reality shock.

4. Policy Learning in the Wake of External Shocks

The wake-up call was the meltdown of Thailand and the precipitation of the Asian Crisis in July 1997. With the Brazilian economy so vulnerable to contagion, the government finally concluded it was about time to shake off ambivalence and straighten its economic talk. Emblematic of this new resolution was the

[20] Unfortunately, Cardoso does not even mention the late 1995 Banespa episode in his memories.

rapid change of mind that led the president to promptly put an end to the public dispute over the use of privatization proceeds, announcing that the resources would be entirely channeled to redeem public debt. But moving fast from talk to action in other areas was not so simple.

As the crisis gathered strength in Asia, reached Hong Kong, China, and threatened the Republic of Korea, Brazil became an obvious target for speculative attack. In the end of October, the Central Bank was forced to double the already high basic interest rate to more than 40 percent per year. And in early November the government had to announce a hastily sewn crazy quilt of as many as 51 fiscal adjustment measures, adding up to a combined effect of 2 percent of GDP, in a frantic attempt to flag a credible turnaround in the fiscal regime.

Implausible as it may sound, the attempt seemed to have worked. By March 1998, the crisis had lost momentum in Asia and the measures that had been announced in Brazil had apparently been able to keep the speculative attack under control, and to avoid the devastating effects that had been observed in the more seriously affected Asian economies. But, in fact, the degree of macroeconomic inconsistency had not been convincingly reduced. There had been no major change in the foreign exchange policy and the current account deficit was still widening. The year-end fiscal accounts of 1997, published in late February, had shown that the fast deterioration of the primary balance of the overall public sector, which had started back in 1995, had not been stopped in 1997. The combination of that deterioration with extremely high interest rates had given rise to a worrying public-debt dynamics. The situation called for a sizeable and credible fiscal consolidation effort, probably stronger than the adjustment of 2 percent of GDP that had been promised in November. Again, however, the government was turning its eyes to other pressing priorities.

In six months crucial elections would be held with much at stake: the presidency, 27 state governorships, the Chamber of Deputies, one third of the Senate and the legislative assemblies of all states. Unsurprisingly, the idea of going on with the fiscal adjustment plan started to sound ill-timed in Brasilia. Across the wide and heterogeneous coalition that supported the government, marching on to the elections under a strict fiscal austerity program began to be seen as an unfailing recipe for a political disaster. As the external environment seemed to be improving fast, the government felt confident enough to discreetly put most of the fiscal adjustment effort on hold till the elections. Having to choose between political risk and economic risk, the president decided that he could take more of the later in order to reduce the former. By July, as Cardoso started to show a comfortable lead in the polls and all seemed reasonably quiet on the external front, there was much self-congratulation in political circles in Brasilia for the successful bet that had been made. The celebration was a bit too early.

The Russian default in August 1998 caught the government—and the country—in a very vulnerable position. With such an important election less than two months ahead, the government found itself paralyzed, unable to react as it should to the devastating contagion that was gathering strength fast. Soon there were widespread fears in Cardoso's camp that the higher economic risk that the government had decided to take some months before was being rapidly converted in downright political risk, as the president's reelection suddenly seemed endangered.

In early September the government decided that it could not wait for the elections—still four weeks ahead—to show concrete mobilization in the face of the mounting crisis that was leading to an awesome loss of international reserves. A new institutional arrangement to enforce a tight centralized control on public expenditures was announced. Breaking at last its strong four-year-long resistance to the adoption of clearly set fiscal targets, the government made known that immediately after the elections it would announce targets for the following presidential term. Those measures were reinforced in mid-September by a stern address of Cardoso to the nation stressing his new and strong commitment to a major fiscal adjustment. In early October 1998, when the country finally went to the polls, a majority of voters, worried with the seriousness of the economic situation, thought that it could not afford the firebrand proposals of the opposition and that, given the choice, it would be wiser to reelect the president.

Few weeks after the election the government finally announced a "fiscal stability program" strongly based on tax hikes that would allow the public sector primary surplus, which was near zero by the end of 1998, to reach 2.6 percent of GDP in 1999 and as much as 3 percent of GDP in 2001. The idea was to stabilize the net public-sector debt at 44 percent of GDP. The program also contemplated the possibility of submitting to Congress a social-security reform and new fiscal responsibility legislation that would finally impose tight budget constraints on the three government levels. That program became the core of a stabilization effort that opened the way to a US$40 billion external support package. The package was built around an agreement quickly negotiated by the economic team with the IMF, other multilateral institutions, and G-7 governments, in the wake of widespread fears that, if left uncontrolled, the Brazilian crisis could unfold into bigger problems for the world economy.

Though a key purpose of the agreement was to give the government adequate conditions to maintain the crawling peg as its foreign-exchange policy, by mid-December Cardoso was seriously discussing the possibility of going ahead with a controlled devaluation attempt, despite the strong opposition of both the finance minister and the governor of the Central Bank. He was being convinced that a devaluation would both allow a less painful fiscal adjustment and work as a shortcut to a quick recovery of the economy. In early January 1999, a few days after the new presidential term had begun, the replacement of the governor of the Central Bank opened room for the change in the foreign-exchange policy.[21]

Far from working as planned, the abandonment of the crawling peg snowballed into an uncontrolled devaluation process with devastating destabilizing effects that lasted the best part of the first two months of 1999. The damage was much amplified by two important factors. On the one hand, as the change in foreign exchange policy was seen as a serious break of the agreement with the IMF, it led to the immediate loss of support from multilateral institutions and G-7 governments. On the other, as the turmoil unfolded, the Central Bank remained precariously manned, exactly when it was most needed. The institution was run by four different governors over a 60-day period. On March 3, the exchange rate (R$/US$) reached a peak of 2.16, from 1.21 two months earlier. This upsurge of more than 78 percent had led the currency to lose 44 percent of its value.

Why the crisis started to subside at that point deserves some speculation. It is easy to find other examples of uncontrolled devaluation experiences in emerging markets, in which the ensuing crisis had much more powerful and prolonged devastating effects. Looking for peculiarities of the Brazilian experience at that moment, one should perhaps give some credit to the way Cardoso dealt with the crisis, after he managed to overcome his initial paralyzing puzzlement. Not sacking the finance minister and not losing the rest of the economic team together with the Central Bank board seems to have helped a lot. It is true that, as Minister Malan had strongly opposed the idea of attempting a controlled devaluation at that moment, that clear stance may have helped to avoid his sacking. But when things go wrong in such a scale and serious adversity prevails, politicians often do not resist the temptation to pass responsibility through and chop heads off. It was remarkable that Cardoso proved to be wise enough to perceive that containing losses in his economic team would be the easier way to shorten the crisis. That decision certainly helped the government to attract competent people to crew the Central Bank at that difficult moment.[22]

Control started to be reestablished in early March, when a brand new Central Bank board—headed by Armínio Fraga, a well regarded economist with Wall Street experience—opened way to a renegotiation of the agreement with the IMF. The new adjustment program had three clear objectives. The fiscal situation had suddenly become even become more precarious than it seemed to be in the beginning of January. The basic interest rate had been hiked to 45 percent and the devaluation was having an alarming effect on the largely dollar-linked public-sector debt. The adverse debt dynamics called for a major fiscal adjustment, much stronger than the fiscal consolidation effort that had been

[21] For a detailed account of the involved decision-making, see Lopes (2003).

[22] For a more detailed analysis of the decade long collaboration between Cardoso and Malan, see Werneck (2002).

envisaged three months before. That was the first objective of the new program. The second was to make sure that the external accounts would be consistent with the narrowing external financing possibilities the country was having to face. The third involved the challenge of absorbing the massive devaluation shock without losing control over inflation.

In the wake of a powerful virtuous circle, the following months witnessed a surprisingly rapid improvement of the country's economic situation. Alarm at the awesome proportions of the destabilization process helped the government to mobilize a strong coalition in Congress and quickly overcome resistances to the approval of the required fiscal-adjustment measures. On the inflation-fighting front news was improving fast. The effects of the inflationary shock triggered by the devaluation proved to be much more manageable than had been feared. As pessimism about the fiscal accounts and inflation receded, the prompt response of foreign-capital inflows brought a fast appreciation of the currency, which allowed the Central Bank to cut the basic interest rate at breathtaking pace—from 45 percent in early March to less than 20 percent in the end of July.

Of course, the combination of a sizeable primary surplus, a considerably less depreciated currency, and much lower interest rates led to a drastic positive reassessment of the public-debt dynamics, which in turn provided a strong reinforcement to the confidence-building process. By mid-year, the economic situation had improved so fast that the Central Bank felt that it was safe to announce that the newly launched inflation-targeting policy would aim at a rate of 8 percent in 1999 and of 6 percent in 2000. It had also become clear by then that the toll the crisis would take on the level of activity would be much lighter than the 3.5 to 4.0 percent fall in GDP that the government itself had forecast only months before, in March. In fact, the economy would show a positive growth rate of 0.3 percent in 1999.

Despite the surprisingly weak immediate effect of the huge devaluation on the trade balance, external accounts were also improving. Although the US$6 billion trade balance deficit observed in 1998 was eliminated in 1999, the adjustment seemed somewhat disappointing, given the extent of the devaluation. It is true that after the early 1999 overshooting, the real had gone through a sizeable appreciation under the newly adopted flexible exchange-rate regime. But in spite of the appreciation, in early 2000 the exchange rate, at more than R$ 1.7/US$, was still roughly 40 percent above its pre-devaluation level, implying a very strong real devaluation no matter which price deflator was chosen. Disappointment with the immediate effects of the devaluation on the trade balance would give rise to an important controversy within the government over the advisability of resorting to more interventionist trade and industrial policies. This controversy would last to the end of Cardoso's second term.

In early 2000 the economy seemed in a much better shape than one year before. The turbulence triggered by the devaluation had been left behind. Inflation was under control and an impressive fiscal consolidation effort was taking place. The year 2000 turned out to be the best year of Cardoso's second term. Inflation would be kept at 6 percent, exactly as targeted. The public sector primary balance would reach 3.3 percent of GDP, in sharp contrast with the one percent of GDP deficit of 1997. It is true that, given the political difficulties of cutting back expenditures, the fiscal-adjustment effort had been mostly revenue-sided, strongly based on highly distortive cumulative taxes. But it had led to a complete reassessment of the sustainability of fiscal accounts, as it was deemed sufficient to allow the public-sector debt to be stabilized at around 50 percent of GDP. Most important, the government had managed to extract from Congress in 2000 approval of a well-designed Fiscal Responsibility Law, which would finally impose a tight budget constraint on the three government levels. The trade balance was still improving slowly, but the strong inflow of foreign capital seemed to have given the economy leeway to wait for the effects of the devaluation on trade accounts to be fully felt. But the most welcome measure of success of the economic policy that had been adopted since the turbulent days of early 1999 was the fact that the economy had been able to resume economic growth. The GDP growth rate reached 4.3 percent in 2000.

It was only natural that under those circumstances, the business community had become very optimistic about the economic prospects of the country. It was prone to believe that good economic performance was bound to lead to a smooth political transition in the presidential election of late 2002, as Cardoso would probably be able to elect his successor. The crucial stabilizing economic role played by those beliefs in early 2001 could only be fully understood months later, when the political scenario quickly changed as the probability of the opposition winning the 2002 presidential election rapidly increased. The looming difficulty stemmed from the radical economic ideas the opposition had flagged in the late 2000 municipal elections. The Workers' Party (PT) had led a national campaign that combined local issues with an informal national plebiscite, supported by all top party leaders and economists, in which voters were asked whether they thought the public debt and the country's external debt should be paid back or not. Of course, the huge destabilizing effects those ideas could induce would be kept dormant only as long as there were no fears that the opposition could have the opportunity to put them in practice. And in early 2001 there was still a widespread belief among the business community that the Workers' Party was not going to have that opportunity over the following presidential term.

Those beliefs would be much shaken over the following 18 months. During the first quarter of 2001, the external environment worsened fast. Already in February the quick deterioration of the economic situation in Argentina exposed the Brazilian economy to the risk of still another wave of contagion. At the same time, the outlook of the world economy was becoming gloomier, in the wake of mounting evidence of a slowing U.S. economy after a decade-long expansion.

On the domestic front, unconnected difficulties would amplify even more both economic and political uncertainties. In March, serious political strife between key political actors of the complex government-supporting coalition raised serious doubts on the outcome of the approaching presidential election. Those doubts became even more serious in April, when the government found out that, due to the mismanagement of an excess-demand situation in the electricity markets, it had to announce that the country was quickly heading toward an alarming electrical energy shortage that would inevitably cut short the economic recovery. The need to impose unpopular electricity-rationing measures on small businesses and residential consumers compounded the involved political costs. The already high levels of economic and political uncertainty that all those difficulties were entailing were boosted to an unimaginable degree on September 11, by the terrorist attacks in the United States.

Over the previous months, the economy had become much more vulnerable. In the wake of the growing uncertainty, the currency went through another strong depreciation movement. The basic interest rate had to be hiked to 19 percent from 15.25 in February and the Central Bank was struggling to keep inflation at the target. Widespread pessimism was having fatal effects on consumer sentiment and business confidence. The expected GDP growth rate for 2001 was being quickly revised downwards. Rising interest rates and a fast depreciating currency revived worries about the public-sector debt dynamics. Concern over the possible contagion effects of a fully fledged debacle in Argentina led to a new preventive agreement with the IMF in August, involving a US$15 billion support program. Despite all those difficulties, the situation improved somewhat in late 2001, after the worse effects of September 11 were felt and the country seemed to be leaving the energy crisis behind. However, the still high degree of economic uncertainty would soon suffer another major jolt, which would trigger a long destabilizing process that would gather overwhelming strength immediately before the presidential election.

5. The Opposition Takes Power: Grudging Pragmatism, Quick Learning, and Repressed Dissent

By mid-March 2002, hopes that a government-supported candidate could win the October presidential election started to dwindle rapidly, as it became clear that an irremediable divide had been opened within the complex government-supporting coalition. The watershed incident was a Federal Police raid that set off a campaign-funding scandal that crippled the candidate being promoted by the conservative Liberal Front Party (PFL); the candidate happened to be faring particularly well in the polls at the time. The PFL was by far the second most important pillar of the coalition. In the wake of the incident, the party decided to quit the government and to refuse to endorse José Serra, the remaining government-camp candidate, who was being supported by Cardoso's Brazilian Social Democracy Party (PSDB). In fact, Serra's candidacy was also facing difficulties in other segments of the coalition and even his own party. Over the following months it would become increasingly clear that he would be unable to defeat Lula da Silva, the front-runner candidate of the Workers' Party (PT).

As the room for self-deception on the outcome of the presidential election quickly grew smaller, widespread fears of a possible debt default let loose devastating destabilizing forces in financial markets, as investors stampeded to prevent losses. The nominal exchange rate jumped from R$2.4/US$ in the beginning of March to 3.4 by the end of July, when the Emerging Markets Bond Index (EMBI) country-risk premium reached more than 2,400 basis points.

Concerned with the unfolding of such turbulence, the economic team tried to approach key members of the PT to make them see the importance of containing the turmoil in financial markets. The less radical party leaders had already perceived that the newly elected government would have to face a very difficult economic situation if the turbulence could not be curbed. Some of them even feared that Lula's victory could be jeopardized. In late June, Lula was convinced to address the nation in an open letter stressing his commitment to sound macroeconomic policy, in an attempt to calm down investors. But financial markets remained skeptical, to say the least.

As the turbulence continued to gather strength, the economic team tried to negotiate a new loan agreement with the IMF that could help control the situation. Having just tried to rescue Argentina and Turkey, the main developed countries had good reasons to resist the idea of bailing out still another large emerging market economy. But those resistances were eventually overcome in the wake of growing concern with the Brazilian crisis and fears that it could suck in other South American economies, at a time when both Argentina and Uruguay were already facing serious economic problems.

But there were complex problems to be solved. How could the IMF sign an agreement with an outgoing government without any assurance that it would be honored by the newly elected one? The IMF had already faced a similar situation in Korea, five years before, during the Asian crisis, when an agreement had been approved by all candidates in a pre-election deal. Could the same solution be replicated in Brazil? The economic team had to persuade the Workers' Party to participate in a similar deal. However, it faced some resistance, despite the decisive collaboration of Antonio Palocci, a gifted young politician who had become the main interlocutor of the economic team in the PT. Party leaders were convinced that controlling the turbulence was indeed urgent. They even acknowledged that a clear commitment to a sound economic policy could help to attract precious middle-class swing voters. But they still resisted to the idea of a formal pledge to honor the main terms of an agreement with the IMF, an institution most of them were accustomed to bashing. Part of the leadership thought that increasing the support from middle-class voters would be of no use if it meant a perhaps greater loss of support from radical-left voters. But pragmatism finally prevailed, as a critical part of the most radical party members were finally convinced that some commitment to the agreement would make Lula's election a still safer bet.

The new IMF agreement, involving the largest loan ever made by the institution—US$ 30 billion over a 15 month period—was announced in early August. Most of the disbursement was supposed to be made in 2003, after the end of Cardoso's term. A carrot of US$24 billion was being offered to the newly elected government. After some unavoidable hesitation, each of the leading presidential candidates, including Lula, had a separate meeting with Cardoso and pledged to honor the backbone of the agreement. It was a most important rite of passage. For Lula, it meant a timely freer hand to drop the radical talk and make a decisive move towards the center.

But financial markets remained unconvinced; they were somewhat relieved but highly skeptical. It is true that the exchange rate showed some appreciation in August, at the end of a sharp four-month-long depreciation path, and the EMBI country-risk premium fell to 1,600 in early September, from 2,400 basis points in late July. But a sizeable part of the respite has to be attributed to a short-lived improvement of the government-supported candidate in the polls, as Ciro Gomes, the third important candidate, slipped fast behind. But in September the remaining hopes that Serra could beat Lula disappeared fast. It became clear that the front-runner would win the first round of the election and, endorsed by the remaining candidates, would be able to easily defeat Serra in the runoff election. The month ended with the exchange rate at R$3.9/US$ and the EMBI country-risk premium again at 2,400.

In early October, Lula did in fact win the first round of the election, but the Workers' Party thought that there was no time to wait for the runoff. The main party leaders hurriedly launched a major campaign to convince financial markets and the most conservative part of the public opinion that their fears were unfounded. The idea to be conveyed was that the party had dropped its radical talk and was ready to maintain the macroeconomic policy that was being followed by the outgoing government. Those efforts became much more effective when announcement of the main names of the new government's economic team—headed by Palocci as finance minister—helped to give credibility to the otherwise incredibly fast metamorphosis the Workers' Party was going through. But of course the party had still a long way to go in a confidence-building process that was only starting and was bound to last many months more.

While the PT tried to placate financial markets, the outgoing government did its best to keep the situation under control. Just after the first-round election, the Central Bank finally launched a three-step hike in interest rates that lifted the basic rate from 18 to 25 percent. The year ended with the exchange rate at R$ 3.5/US$, in a clear appreciating trend, and with the EMBI country-risk premium at 1,400 basis points, in a fast descending path.

The turmoil had taken a very heavy toll. With ups and downs, the high uncertainty wave that had been formed back in 2001 had lasted more than 20 months. Economic growth had been reduced to 1.3 percent in 2001 and to 2.7 percent in 2002. Amidst the adversity, the flexible exchange-rate regime had been a great help, allowing the economy to bend without breaking, but depreciation had entailed a major inflationary shock. With the expected annual consumer-price inflation at more than 13 percent by the end of year, there was a big challenge ahead for the recently adopted inflation-targeting regime that would have to be faced by the Central Bank of the newly elected government. But the depreciation had also brought an important positive effect. The long-awaited adjustment in the trade balance was finally being strongly felt. There had been an overall improvement of US$20 billion in the trade balance during Cardoso's second term, which had helped to reduce the current account deficit from US$33.4 billion in 1998 to US$7.6 billion in 2002.

Of course, there was much to worry about with the combined effects that devaluation and high interest rates were having on the public-sector debt dynamics. Even so, it was starkly clear that there had been a major change of fiscal regime. Thanks to the Fiscal Responsibility Law that had been approved in 2000, a hard budget constraint had finally been imposed on subnational governments. For four years in a row, the public sector had been able to keep its overall primary balance between 3 and 4 percent of GDP, in sharp contrast with the fiscal performance of Cardoso's first term. If the newly elected government could in fact put an end to the wave of uncertainty, then both the exchange rate and the basic interest rate were bound to converge to levels that would make the public-sector debt dynamics much more manageable than they looked in the end of 2002.

The end of Cardoso's second term also witnessed another change of utmost importance. The country had certainly gone through a rough passage in 2002, but at the end of the day a crucial political change had taken place. After being defeated no less than three times, the Workers' Party had finally won the presidential election. However, the winner had to dust off old beliefs and drop radical talk as it hastily moved to the center and adopted as its own the macroeconomic policy of the outgoing government. It was no small change. What seemed to be an unbridgeable gap between government and opposition had been replaced by a surprisingly broad common ground of shared, sensible ideas.

It is still too early to have the required historical perspective that will allow a full understanding of the complex events behind the fast metamorphosis the Workers' Party went through in 2002. But some facts are well established. The initial movement towards the center, which led to the open letter to the Brazilian people in June, was a highly controversial decision. It was only accepted by the party's radical wing as a pragmatic political extravagance, with the understanding that it would mark the furthest shift to the right that the party would accept to make sure that Lula would win the election. How then was it possible that the party's *aggiornamento* went well beyond that point in the following months? A large part of the explanation stems from the dynamics of the electoral campaign, the growing concern with the difficulties the financial turmoil could bring to the newly elected government, and the complex relationship that was established between the leadership of the Workers' Party and top members of the outgoing government. At first, that relationship was limited to subtle games, like the maneuver that finally constrained Lula to publicly pledge to honor the main points of IMF agreement in August. Later on, the relationship involved a much richer flow of ideas, based on levels of understanding and collaboration that only a few months before would be considered unimaginable. On the Workers' Party side, Antonio Palocci played a crucial leading role. But, of course, a great deal of the credit for smoothing the transition has to be attributed to the outgoing government.

Doubts about the real commitment of the newly elected government to a consistent macroeconomic policy would disappear fast in the first months of 2003. The long wave of uncertainty had left much damage behind. With the annual expected inflation above 13 percent, the public-sector debt in a worrisome path, and financial markets uneasy and disbelieving, the situation called for very orthodox economic measures. Skeptics could not hide their astonishment when they found out that Lula was really prepared to face those challenges, giving strong support to Palocci's conservative economic policy. As the basic interest rate was lifted even more and a tighter fiscal target announced, the remaining reluctance of the financial markets was rapidly broken. The confidence-building process was much helped by the fast improvement of the trade balance, in the wake of the prolonged depreciation and stronger world demand for Brazilian exports. Sounder external accounts and rapidly falling uncertainty led to a fast appreciation of the exchange rate and to a rapid fall of the country risk over the first half of 2003.

But there was still room for disbelief, in the form of widespread doubts on whether the government would show the required conviction to continue to follow a consistent macroeconomic policy, despite the growing criticism from within the PT. The successful approval of a politically costly social-security reform in Congress in mid-2003 helped to make the government's new convictions more credible. As the level of uncertainty declined and inflation seemed to have responded favorably to the tightening of monetary policy, the Central Bank found room to carefully bring down the basic interest rate from 26.5 percent in June 2003 to 16 percent in May 2004. The resulting fast increase in the level of activity helped the government to keep criticism from within the Workers' Party under control. After growing only 1.2 percent in 2003, the economy showed a strong 5.7 percent growth rate in 2004. Especially comforting was the fact that the recovery had been accompanied by an impressive strengthening of the external accounts. The increase in the trade surplus, from US$13.1 billion in 2002 to US$33.7 billion in 2004, allowed the current account deficit of 1.7 percent of GDP observed in 2002 to be converted into a surplus of almost 2 percent of GDP in 2004. The long-awaited structural adjustment of the balance of payments could finally be observed in full force, with no small consequences for the outlook of the economy.

It was a fortunate outcome that the newly converted government could reap so rapidly the fruits of the unpopular policies it had to adopt in the first year of the presidential term. That good fortune helped to appease the more radical wings of the PT, reinforced the position of those that had defended the party should move to the center, and greatly strengthened the support of the economic team in the government. For the country, the success of the economic policy adopted by the Lula government brought the consolidation of a common ground of sensible economic ideas that, back in the end of 2002, was still a mere promise that could have not been fulfilled. For an excessively long period, Brazil had to deal with the ever-present specter of a change in government that could turn economic policy upside down. The turmoil of 2002 provided dramatic evidence of how destabilizing widespread fears of such a reversion could be. It goes without saying that, as the country finally left those fears behind, its horizons broadened fast.

6. Challenges Ahead

The much-improved outlook of the Brazilian economy should not hide the fact that the country still has enormous economic and social challenges ahead. On the macroeconomic policy agenda, the main problems are in the fiscal front.[23] Since the early 1990s, the overall primary expenditures of the three government levels have been expanding twice as fast as the GDP. To keep public accounts under control, the gross tax burden had to be raised from 25 to 35 percent of GDP over the period. As nothing has been done yet to put an end to the expenditure-boosting process that is at root of this problem, the tax burden is still being hiked between 0.5 and 1 percent of GDP, year after year.

In the second half of 2005, Palocci tried to convince Lula that in order to contain the rampant expansion of primary expenditures, a major long-run fiscal adjustment program had to be launched. But the idea met fierce resistance in the government and was finally abandoned altogether when Palocci quit the Ministry of Finance in early 2006. Palocci's fall entailed substantial changes in the economic team that would soon leave most of the burden of keeping a consistent macroeconomic policy on the shoulders of the Central Bank. Hopes that after being reelected Lula would finally push forward the required long-run fiscal adjustment effort proved to be unfounded. More worryingly, the rapid expansion of public expenditures, which at first seemed to stem from simple procrastination of the required adjustment, has more recently been openly

[23] See Werneck (2005).

defended by the PT and top officials in the government as a welcome process that should not be restrained. The arguments that are being used to make such a defense suggest that a sizeable part of the unwise economic ideas that haunted the country for so long only have been dormant—not forgotten.

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This paper keeps an eye on the big picture and follows the long-lived virtuous circle that, beginning in the mid-1990s, led to the very successful setting up of a modern macroeconomic policy framework in Brazil, after a decade-long effort involving four presidential terms. It is an eventful and far from linear history that calls attention to the role of leadership and the complex learning processes that may be involved in the improvement of the quality of economic policy.

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The mandate of the Commission on Growth and Development is to gather the best understanding there is about the policies and strategies that underlie rapid economic growth and poverty reduction.

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