Policy Brief

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Brazil Under Lula: Learning From the Real Plan

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In the months leading to the presidential election in October 2002, Brazil experienced one of the worst economic crises in its history. As the then candidate of the leftist Worker's Party (PT) Luiz Inácio **Lula** da Silva moved up in the electoral polls, international capital flows reversed their course in fear of default. As a consequence, the value of the Brazilian real (BRL) nearly halved vis-à-vis the U.S. dollar (USD), inflation numbers soared due to more costly imports, and the economy stagnated.

The first four months of the Lula administration have been a very pleasant surprise for financial markets. Coherent fiscal, monetary, and exchange rate policies have been reaffirmed, and the dreaded debt default has been vigorously rebuffed. As a result, short-term capital flows have returned, recently causing a substantial appreciation of the real. After being out of the international capital markets for a long time, Brazil issued 1 billion USD in sovereign bonds on April 29, 2003, at a 783 bps premium over U.S. Treasury Bonds. Notwithstanding this initial success, the fundamental question is if Lula is capable of bringing sustained growth to Brazil, which is a necessary condition for the achievement of the just, albeit ambitious, social goals of the new administration.

The Real Plan

After many unsuccessful attempts, Brazil conquered hyperinflation with the Real Plan of July 1994. Then finance minister Fernando Henrique **Cardoso** rode the wave of the plan's success into presidential office. Starting January 1995, he served two four-year terms until 2002, when President Lula was elected. The economic policies pursued during Cardoso's two terms in office were remarkably different from each other, and an analysis of their determinants and consequences brings important lessons regarding the new administration's likelihood of success in achieving economic growth.

Figure 1 shows the most important macroeconomic indicators of Cardoso's two presidential terms. During most of the first term (1995-98), the implicit option taken was to postpone the vital fiscal belt tightening. The primary fiscal surplus (i.e., the surplus before interest

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payments) was low or negative throughout the period. With this lax fiscal policy, monetary and exchange rate policies had to bear the brunt of the adjustment. Inflation was kept low by an exchange rate rule that depreciated the BRL at 7% per year (see the steadily increasing portion of the exchange rate between 1995 and 1999 on the Chart, right-hand side scale). Interest rates were maintained at very high levels, generating large interest payments on government debt, and consequently large nominal (i.e., total) fiscal deficits. However, abundant capital inflows made possible the postponement of politically unpalatable measures. Current account deficits (i.e., foreign savings) were large and the government debt increased substantially. In a nutshell, during his first term, Cardoso had the means to balance the budget but not the right incentives to do so. Procrastination instead of true reforms was the result.

Figure 1.
Brazil: Select Macroeconomic Indicators, 1999-2002

		1995-98	1999-02
1.	GDP Growth %	2.6	2.0
2.	Inflation (CPI) %	9.4	8.8
3.	Fiscal Surplus		
	Primary	–0.2	3.6
	Nominal	–6.7	–6.0
4.	Current Account Deficit		
	USD Billion	26.4	20.1
	% of GDP	3.4	3.7
5.	Net Debt (% of GDP)*	41.7	56.5

* Refers to debt stock at period's end. Net debt in 12/1994 was 30.0% of GDP.

The 1997 Asian crisis ended of the period of plentiful, cheap capital inflows. The Chart (left-hand side scale) shows two measures of country risk: the EMBI+ and the EMBI+ Brazil (JP Morgan Emerging Markets Bond Index Plus). The former computes the average premium emerging markets (including Brazil) have to pay to float debt in international markets, while the later does the same for Brazil only. The Brazil risk was steadily falling until the Asian crisis, thereafter changing gears. With the reversal of capital flows, macroeconomic policy had to change. At the end of 1997, a last stunt was pulled consisting of 51 measures aimed at achieving fiscal balance and promoting growth, but only a few were actually implemented. In 1998, the Russian default and the Long Term Capital Management debacle further jeopardized international financial markets. In response, Brazil received the then largest IMF package in history. While the financial aid provided enough breathing room to delay changes until the year-end, only two weeks into his second term, Cardoso decided to float the real (see Figure 2 for the jump in the exchange rate in January 1999).

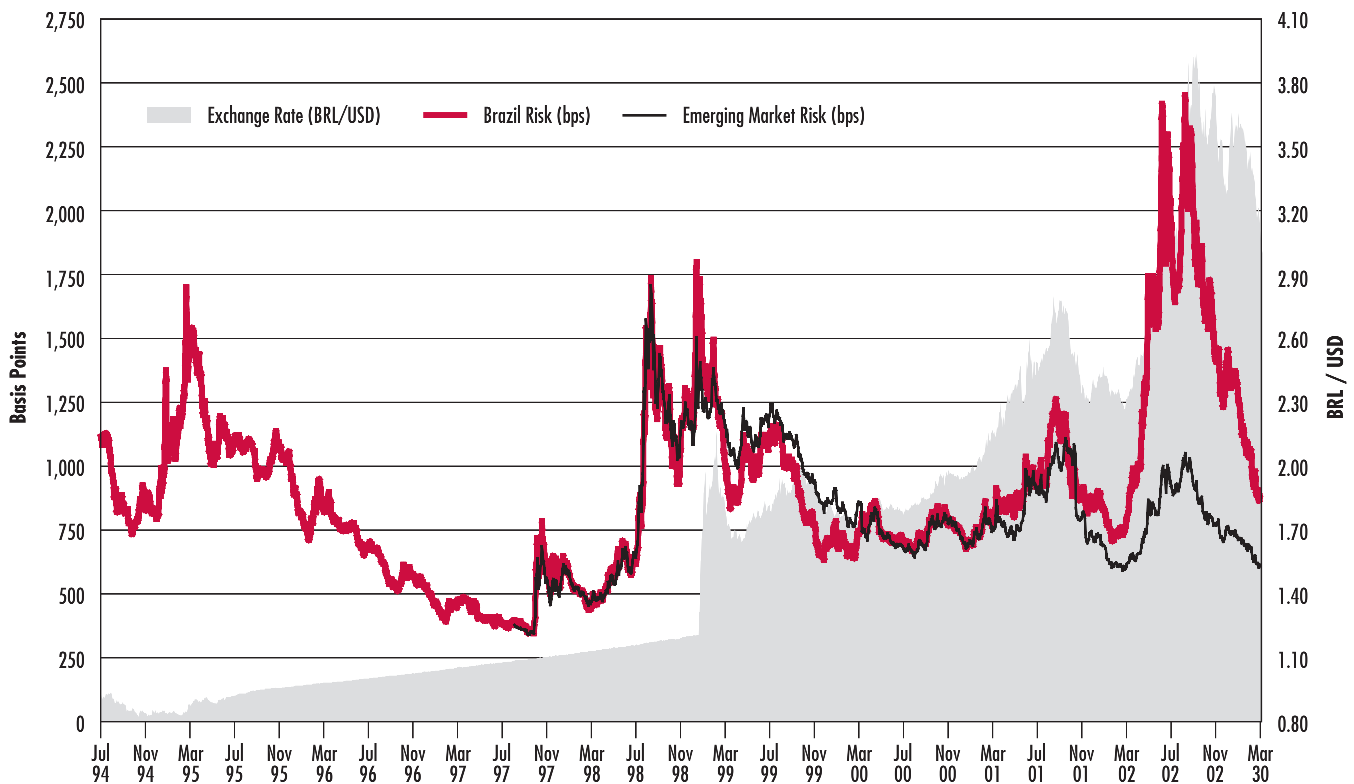
After initial turmoil, the newly appointed Central Bank governor, Armínio Fraga, managed to stabilize the currency, and inflation targeting was introduced as the monetary policy regime. Fiscal policy also substantially improved, thereby allowing Brazil to consistently meet the stringent primary surplus targets agreed with the IMF.

In 2000, the economy grew more than 4%, inflation met the 6% target, and the exchange rate depreciated less than 9%. The country seemed poised to resume sustained growth. Unfortunately, a combination of domestic and mostly international negative shocks (US recession and further tightening of international capital flows to emerging markets) shattered the freshly obtained optimism. In striking contrast with his first term, Cardoso *did* implement some of the essential, if politically painful, reforms, but poor market conditions did not allow him to reap the benefits. Despite the achievements on the macroeconomic front, Cardoso's last two years in office were marked by dismal growth, and an overwhelming majority elected Lula in October 2002.

During the campaign, however, the extreme adverse conditions that caused the large depreciation of the real made clear to the PT leadership that their original economic program—contrary to most of the reforms implemented by Cardoso — had become a liability. An electoral success could even happen, but the goal of resuming sustained growth would not be achieved, ultimately harming the party's social and political objectives. The Chart shows that during the second and third quarters of 2002 both the overall emerging market risk and the specific Brazilian risk increased. However, the Brazilian risk increased much more (the two lines diverge after being very similar for the preceding five years), signaling that the problem was the fear of Lula winning the election. Accordingly, Lula took a 180-degree turn and developed a market friendly program.

While many doubts still exist as to whether Lula will live up to his promises of economic reforms and market friendly economic

Figure 2.
Exchange Rate, Emerging Market Risk, and Brazil Risk



policies, the actions taken so far by the new finance minister, Antonio Palocci, indicate that reform is on the right track.

Challenges and Opportunities

It does not suffice, however, to follow up on the economic polices of the Cardoso administration. In order to achieve sustained growth, in addition to maintaining coherent macroeconomic policies, several other economic reforms must be undertaken; among them: tax reform, social security reform, trade negotiations, central bank independence, and a reformed bankruptcy law. Many of these reforms involve passing legislation that requires a qualified majority in both houses of Congress, which is never easy in any democracy, let alone in one where the ruling party does not have the majority (as it is currently the case for the PT). Also, trade negotiations require getting the United States and the European Union to change deeply rooted protectionist policies regarding specific products (soy, orange juice, sugar, steel, etc.), as well as fighting powerful domestic protectionist interests.

The lessons of Cardoso's two terms shed light on Lula's chances of success in returning Brazil to sustained economic growth. As far as domestic reforms are concerned, the resolve of the administration in pursuing its agenda is likely to depend on a fine balance between incentives and results. If international capital flows become too plentiful, as during most of Cardoso's first term, procrastination of the politically costly reforms may result. Alternatively, if the extreme lack of liquidity of 2001/2002 returns, the absence of good results to show its constituency may lure the government into abandoning the current economic program. Finally, as it has been the case throughout Brazilian history, growth prospects will depend on the state of the world economy in the next years. If the current low world growth persists, the chances of success of the Lula administration are substantially diminished.

About the Author

Márcio Garcia is Visiting Associate Professor at the Center for Research on Economic Development and Policy Reform (CREDPR). He is on leave from his permanent position as Associate Professor at the Pontifical Catholic University (PUC-Rio) at Rio de Janeiro, Brazil, where he has served as Chairman of the Department of Economics.

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