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***Does it Take a Lula to go to Davos?
A Brief Overview of Brazilian Reforms, 1980-2000***

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Does it Take a Lula to go to Davos? A Brief Overview of Brazilian Reforms, 1980-2000

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Abstract: What are the determinants of economic reform efforts? This paper tries to throw light on this question by examining recent reforms in Brazil, a country which followed a gradualist approach and was a late-starter among Latin American economies. We argue that these first generation reforms (trade liberalization, stabilization, privatization and the adoption of a new macro-policy framework) were driven by the drastic growth slowdown and re-democratization of the 1980s. We argue that their gradual and democratic implementation not only respond for their sustainability but also shows that the country is ready for a second generation of reforms focusing explicitly on institutional deficiencies.

JEL Codes: H11, O11, O23, O40, O54.

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1. Introduction

The last two decades witnessed profound changes in economic policy as well as radical institutional transformation around the world. In the 1980s, the drive away from heavy government intervention in the economy towards arrangements based more on the market mechanism started to take off in most Latin American and East Asian countries. These changes become even more radical with the collapse of socialism (in the late 1980s) and the subsequent process of transition towards a market economy in the 1990s that took place in the Eastern European and former Soviet Union countries. One of the major lessons from the last two decades is that the success of economic reforms does not rest solely on changes in economic policies (that is, on the adoption of “good policies” as prescribed in the Washington consensus). It goes beyond: successful economic reforms need to be carried out in a supportive institutional framework. Thus one of the most pressing questions for economists today is, therefore, what are the determinants of economic reform efforts?

This paper tries to throw light on this question by examining recent economic reform in Brazil, a country which followed a gradualist approach and was a late-starter among Latin American economies. The reforms we focus on are basically the adoption of a new macroeconomic policy framework and market-friendly reforms in the 1990s. We argue that this new policy regime have laid solid foundations for the resumption of economic growth. Although the country’s ability to consolidate and deepen its commitment to reform and to carry out needed institutional changes are key issues remaining, our outlook is optimistic.

The literature on economic reform and economic performance is large and rapidly growing. One recent paper that is close to ours in spirit is Card and Freeman (2002) account of the effects of two decades of reform in the United Kingdom on economic performance. Our paper is also closely related to the large literature on economic reform in Latin America, from which we highlight the contributions by Easterly, Loayza and Montiel (1997), Fernandez-Aria and Montiel (1997) and Lora (2001). Finally, our paper is also motivated by the literature on

economic growth and institutions, for instance, the work of Acemoglu, Johnson and Robinson (2001) and, focused on the Latin American experience, Campos and Nugent (1998, 1999).

The paper is organized as follows. Section 2 discusses the growth performance of the Brazilian economy in comparative perspective. Section 3 discusses economic reform in Brazil in the last two decades, with emphasis on the structural reforms of the 1990s as well as the *Real Plan* (1994). Section 4 highlights the changes in the policy regime that occurred in the late 1990s, with the currency devaluation and the adoption of inflation targets and rigid fiscal discipline. Section 5 concludes with a discussion of the main challenges that may lie ahead.

2. Growth and reform

The objective of this section is to discuss the growth performance of the Brazilian economy over the long term in comparative perspective. The poor performance of the Brazilian economy in the years between 1980 and 2000 is at odds with the country's growth record in the rest of the twentieth century. Indeed, for several decades Brazil was one of the fastest growing economies not only in Latin America, but in the world as well.

As Figure 1 shows, the growth of Brazilian per capita GDP has been remarkable in the first three quarters of the last century. These rates are consistently high for the first half of the century (Brazil is the only country to have grown consistently at above 2 percent) and this well differentiated performance accentuates in the third quarter, culminating with the "Brazilian Miracle." In this light, the 1980s and the 1990s are all the more disappointing (although only Chile shows consistently positive growth rates for these latter two decades).

[Insert Figure 1 About Here]

How impressive was this growth performance in global terms, that is, if we also take into account non-Latin American countries? Even including the 1980s and 1990s, the growth of Brazilian per capita GDP in the last century is among the five fastest in the world. Japan

and South Korea have grown at higher average rates, but Spain, Chile and Mexico have clearly not.

In the period 1950-80, annual growth fell below the 4% mark in only four years. In contrast, during the 1980s per capita income fell by an average 0.5% per year, growing a mere 1.1% during the 1990s, netting just 0.3% per year over these two decades.

It is also clear that the performance in the 1980s is strikingly different. Such a contrasting performance is due to a constellation of factors. The 1980s are a direct result of the 1973 and 1979 oil shocks, of the 1982 debt crisis and of the evidence of the limit of the import substitution development strategy. However, it is important to mention that re-democratization also marks the 1980s with consequences in terms of the formulation and conduction of economic policy that are still largely unknown.

Persistent inflation followed (Figure 2) as well as a sequence of unsuccessful stabilization plans (in 1986, 1987, 1989, 1990 and 1991). In annual figures, inflation progresses from about 100% in 1980 to 200% in 1983 to 500% in 1987 to 1500% in 1989. In the 12 months preceding the Real plan the rate reached 5,150%.

[Insert Figure 2 About Here]

Despite the similar performance in terms of GDP growth, the 1980s (known as the “lost decade”) and the 1990s differ in at least three important aspects. First, while the 1980s were a period of high inflation and failed stabilization plans, the 1990s were marked by the fruits of a successful stabilization program. Second, whereas the 1980s saw high and often rising levels of state intervention, the 1990s can be characterized as the “decade of market-oriented reforms”. Third, and largely as a consequence of the first two, while the 1980s ended with a feeling of hopelessness, without a clear consensual diagnosis of the crisis and with the

country close to hyperinflation, at the end of the 1990s there were signs of a return to a trajectory of sustained growth.

Growth accounting results are also useful in highlighting these differences. As it can be seen from Table 1, the most striking difference is not related to the accumulation of capital or labor, but to a major increase in the contribution of productivity. As the later is calculated in a standard way (as a residual), we interpret this change as deeply associated with the major reform efforts that took place in the 1990s. In the next sessions, we try to open up this “black box” by taking a closer look at the major components of the reform effort before turning to their potential relationship with the resumption of sustainable economic growth in Brazil.

[Insert Table 1 About Here]

3. Major economic reforms in the 1990s

A full assessment of the radical transformations that occurred Brazil in the 1990s, and indeed a proper understanding of why the Real has succeeded where previous stabilization attempts failed, have to take into account the supply-side reforms carried out in that period. These reforms comprised a number of initiatives aimed at raising productivity through reduced regulatory intervention and increased competition in the economy, mainly trade liberalization, privatization and deregulation.

3.1. Trade Liberalization

In order to gauge the importance of trade liberalization in the 1990s note that over the previous two decades Brazil had become one of the most closed economies in the world. The strategy of import substitution was taken to extremes. One indication is that the imports’ share of domestic consumption of manufactured goods reached 4.8% in 1989 (Moreira and Correia, 1998). These policies were unsustainable and as the foreign exchange constraint lessened in

the late 1980s, Brazil gradually moved towards a more open and neutral trade policy.

In 1988-93 the degree of protection to domestic producers was greatly reduced. Two major reforms, in 1988 and 1989, brought the average tariff on imports down from 51 to 35 percent. Most non-tariff barriers were eliminated in 1990, with the ban on imports of computer products ending in October 1992. In addition, a pre-announced schedule of tariff reductions brought the average nominal import tariff down from 32.2% (with a 19.6% dispersion) in 1990 to 14.9% (with an 8.2% dispersion) in the second semester of 1993. Trade liberalization was particularly significant for consumer goods: tariffs for durable consumer goods declined by 66 percentage points, while elimination of the negative import list gave domestic consumers legal access to foreign goods that had in practice been banned for decades.

With respect to exports, trade policy has also become more neutral since the mid-1980s and especially after 1990. Several subsidies were discontinued in 1983-85. As the Collor government took office (in March 1990) export subsidies were eliminated and tax incentives reduced (Sucupira and Moreira, 2001).

A crucial development in terms of trade policy for Brazil was the establishment in 1991 of Mercosur, the regional trade agreement initially comprising Argentina, Brazil, Paraguay and Uruguay. Mercosur has been fulcrum in attracting FDI to Brazil, which has helped make the country a regional export base for many multinational corporations (Pineiro and Moreira, 2000). Overall, Brazilian exports to its Mercosur partners increased 235% from 1991 to 2000, while imports increased 244%.

The impact of trade liberalization has been dramatic regarding both the degree of trade and investment integration into the world economy, and the extent to which it has contributed to encourage technological modernization (Moreira and Correia, 1998, and McKinsey, 1998). Non-oil imports increased from US\$ 11.0 billion in 1987 to US\$ 44.3 billion in 1995, reaching US\$ 49.4 billion by 2000. Imports of consumer and capital goods, in particular,

expanded substantially in the 1990s. Stiffer competition and easier access to foreign intermediate and capital inputs have stimulated domestic producers to improve their competitiveness (Muendler, 2001).

Yet export performance tarnished what would otherwise be a remarkable response to trade liberalization. Exports were slow to respond. After signs of a strong recovery in 1992-94, export growth moved into a downward trend, reversed for only a brief period in 1997.¹

The appreciation of the exchange rate seems to have played a large role in this slow response. Contrary to expectations (see, e.g. Papageorgiu, Michaely and Choski, 1991), trade liberalization in Brazil's was not followed by a real exchange rate devaluation. Currency appreciation was only broken in January 1999, when the slowdown in international markets and the Russian default, pushed the government to float the exchange rate, a decision which produced a major devaluation (see below). This change in relative prices did not take long to show its impacts.

[Insert Chart 1 About Here]

Apart from an exchange rate appreciation, exports also suffered from the lack of investment in infrastructure a consequence of the public finance crises of the 1980s and from an inefficient tax system. In the former, considerable progress was made in the second half of the nineties through privatization of the state enterprises (see next section). The tax system, though, has yet to be reformed.

3.2. Privatization

Although Brazilian privatization started out in the 1980s, it was only in the following decade that it actually gained momentum.² In March 1990, the Collor Government launched the

1 See Pinheiro e Moreira (2000).

2 Brazilian privatization during the Collor administration is discussed in Pinheiro and Giambiagi (1994). For a Latin American perspective, see also Baer (1994).

“National Privatization Program,” expanding the Program to include the larger (and oldest) state enterprises. In September 1992, President Collor was impeached and replaced by Vice-President Franco, who continued the privatization process at its previous pace. Together, the two administrations sold 33 state-owned enterprises (SOEs), with results amounting to US\$ 11.9 billion, including both proceeds and debt transfers. Particularly important in that period was the divestiture of the steel sector, which had been developed after World War II under public guidance and that until the eighties was perceived as critical for national security.

Brazilian privatization reached its peak during President Cardoso’s first term (1995-98), when 80 companies were sold, generating US\$ 73.3 billion in total revenues (Table 3). Two related developments allowed such a substantial expansion in the size and scope of privatization. One was the engagement of state (province) governments in the privatization effort, leading to the sale for instance of several electricity distribution companies. A second development was the decision to amend the constitution to discontinue public monopolies and end discrimination against subsidiaries of foreign companies. This constitutional change allowed to extend the privatization efforts to telecommunications, electricity and mining (the Brazilian largest SOEs were all in these sectors). During this period, other important sectors such as railways and ports, were also partly or totally transferred to the private sector.³ 6

The widened privatization played an important role in sustaining the *Real* Plan, especially in Cardoso’s first term (Pinheiro and Giambiagi, 2000). With the sales of 1997-98 Brazil attracted large volumes of foreign direct investment, which helped to finance the high current account deficit (in 1997-2000, the ratio between FDI inflows associated with privatization and the current account deficit averaged almost 25%). Privatization was also instrumental in averting an explosion in public debt, despite a fiscal deficit growing since

3 See the papers in Pinheiro and Fukasaku (2000) for further discussion on privatization during President Cardoso’s first administration.

1995. Carvalho (2001) shows that the use of privatization proceeds decreased the public debt and resulted in the latter being, in December 1999, 8.4% of GDP lower than what it would have been in the absence of privatization.

More important in the long run, however, is the significant change that privatization brought to the way former state owned enterprises are managed. Under private control, these companies became more customer oriented, technologically updated, and equipped with better information systems and human resource management, with fewer but in general better motivated employees. The impact of these changes as well as of greater access to capital on output, productivity and investment has been positive.⁴ Becoming more efficient and adopting better commercial practices these firms were able to greatly increase their profitability, raise their creditworthiness, and in turn facilitating the financing of new investments. The results have been impressive in both industry and infrastructure, in which all sectors registered the rehabilitation of physical networks and increases in productivity, even when these gains have been more pronounced in some sectors than in others. One of the greatest successes is telecommunications. The density of fixed lines more than doubled after privatization, reaching 20.2 fixed lines (against 9.6 in 1996) and 15.0 cellular phones per 100 inhabitants (against 1.6 in 1996) in 2001. In manufacturing, privatization has also been successful. In infrastructure, however, privatization is just a step in the regulatory reform process, which will not be complete until sound regulation is in place and well-functioning regulatory agencies are fully operational. In this sense, in infrastructure it is necessary to go beyond reductions in technical losses, better management, and rehabilitation of existing facilities, and be able to foster a large expansion in output capacity and to translate productivity gains into lower prices to consumers. And in these areas the degree of success of the new regulatory framework is relatively heterogeneous across sectors, reflecting the varying quality of sector

4 For analyses of the impact of privatization on performance SOE see Pinheiro (1996).

regulation.

[Insert Table 2 About Here]

For various reasons, the privatization process decelerated to almost a complete halt in President Cardoso's second term (1999-2002). One was the decline in popular support for privatization. Another reason was a consequence of changes in the fiscal regime and a large inflow of non-privatization related FDI and the rising technical and political complexity of privatizing the remaining SOEs. This the state remains the owner of sizable assets in sectors such as oil, electricity, water and sanitation sectors and is likely to remain so until increases in the quality of sector regulation.

3.3 *Stabilization*

Unveiled in 1994, the *Real* Plan can be seen as the logical macroeconomic counterpart to the market-oriented reforms carried out in the 1990s, both in the sense of magnifying their impact on growth and of generating the political conditions to pursue them.⁵ The plan was successful. It should be mentioned is worth noting that in 1986-91 there were five stabilization plans, based on price freezes or variants, all of which failed.⁶ The difference in the case of the *Real* Plan was a virtual currency, known as the Real Unit of Value (URV), pegged to the dollar. The government set a period of 4 months for economic agents to adjust to this new unit. During this period, not only the exchange rate, but also some basic prices such as public-sector salaries, pensions, the minimum wage and tariffs charged by public utilities were

5 See Pinheiro and Giambiagi (2000) for an analysis of this bi-directional relationship in the case of privatization.

6 For an overview of the history of Brazilian inflation see Tullio and Ronci (1996).

compulsorily converted into URVs. At the end of this 4-month period (on June 30, 1994), during which inflation in the old currency reached almost 50% a month, the URV was converted into the new currency, the *real*. The entire monetary base in the old currency was then physically replaced in just a few days.

In the years following the *Real Plan*, the economy's performance was mixed. The Plan was very successful in reducing inflation: in the 12 months preceding the Plan, accumulated inflation was 5,154% (by the IGP). After the launching of the Plan, 12-month cumulative inflation fell almost continuously and ended 1998 at 1.7%.

As noted, one of the drawbacks was that Brazil has had since 1995 large fiscal and current account deficits, which over time led to mounting public and external liabilities, compounding the original disequilibria. In the case of the fiscal accounts, the primary consolidated result for the public sector, which excludes interest payments, fell from an average surplus of 2.9% of GDP in 1991-94, to an average deficit of 0.2% of GDP in 1995-98.

Until 1994, it was relatively easy to control real public sector expenditures with the aid of price increases, by delaying actual spending. Inflation facilitated management of intra-government political disputes for resources. With the fall in inflation, the "political price of saying no" became explicit and, in practice, the greater difficulty of opposing external and internal demands for funds also helped to boost the real level of public expenditure. In addition to the fall in inflation, the deterioration in the fiscal accounts was associated to a more expansionist fiscal policy and to structural flaws in the public sector finances.

The rise in the current account deficit, in turn, was the result of demand enhancing and demand switching effects of the *Real Plan*. Aggregate demand went up as a result of higher real public spending and booms in private investment and consumption. Further, the government was interested in using the exchange rate as an anchor in the stabilization plan and the effects of these high interest rates attracting foreign capital preceded a substantial

appreciation of the exchange rate. Between June 1994 and February 1995, the real exchange rate appreciated by 30% (Figure 4).⁷

[Insert Figure 4 About Here]

The appreciation of the *real* and increases in aggregate demand caused an inversion in the trade balance, which shifted from an US\$ 11 billion surplus in 1994 to a US\$ 3 billion deficit in 1995. The deterioration of the trade balance was compounded by an increase in interest and dividend payments (that more than doubled between 1994 and 1998), leading to rather high current account deficits (4% of GDP in 1997). The risks of these mounting imbalances did not go unnoticed.⁸ Yet the government believed that the prevailing situation in international capital markets - marked by high liquidity and wide access to capital by emerging economies – made possible a strategy of gradual adjustment.

The worsening of the current account and the fact that a large part of its deficit was financed by short-term capital flows made the economy more dependent on external financing and, consequently, more vulnerable to external shocks. This rise in vulnerability was prompted by the Mexican crisis in March 1995, reaffirmed by the Asian crisis in October 1997 and made unbearable by the Russian default in 1998. Brazil's tribulations in late 1998 and early 1999 resulted not only from structural imbalances -- the traditional Latin American fiscal and external predicaments -- but also from the policy regime's lack of credibility.

It became clear with the Asian crisis that adjustments were necessary, forcing the government to gradually change course in two ways: first, through the nominal devaluation of the real (around 8% per year), in an environment in which domestic inflation was very close

7 The figure presents the real R\$/US\$ exchange rate, with CPI representing the US consumer price index, and IPCA, the Brazilian consumer price index. The appreciation of the R\$ - which was initially set equal to US\$ 1 – was more than 15% in the first months of the Real Plan. To this must be added a not insignificant residual inflation.

8 See, inter alia, Goldfajn and Valdés (1996) and Cardoso and Goldfajn (1997). For a defense

to international levels, leading to an annual real devaluation of approximately 6% in 1998; and second, by improving the primary result of the consolidated public sector by 1% of GDP relative to 1997. Despite the significance of these measures, they were insufficient to reduce the magnitude sufficiently of the macroeconomic imbalances.

In this environment, the burden of monetary policy in sustaining exchange rate stability increased with annualized interest rates rising above 40% in October 1998, negatively affecting output and the public accounts. That this policy framework was unsustainable was now clear.⁹ Between the first days of August and the end of September 1998, Brazil lost US\$ 30 billion in international reserves. The announcement in October that an agreement with the International Monetary Fund (IMF) was under consideration brought some respite. Yet the rejection by the National Congress of an important fiscal adjustment measure and the announcement of a moratorium on federal debt by the State of Minas Gerais precipitated events. Between the end of December 1998 and the first days of 1999 Brazil lost between US\$ 500 million and US\$ 1 billion a day in reserves. On January 15, after rejecting suggestions of “Malaysian-style” capital controls, the authorities let exchange rate float.

The currency crisis can indeed be seen as the final act of the first Cardoso administration. For all its problems, this administration was instrumental in deepening and consolidating the market oriented reforms initiated in the early 1990s. The privatization of public utilities, increases in productivity, the strengthening of the financial system and, above all, the control of a runaway inflation are gains whose importance can hardly be overestimated. Yet, the failure to move quickly in solving the country’s main macroeconomic imbalances left major obstacles in the road to recovery. The fiscal reforms of late 1998 and

of the exchange rate policy of that time, see Franco (1999).

9 Therefore, they combined elements of the two types of currency crises described by Krugman (1998), associated with the so-called models of first and second generation. As argued by Drazen and Masson (1994), there comes a time when commitment to “even more austere” policies becomes ineffective.

early 1999 and the January 1999 devaluation were the first steps towards overcoming these hurdles.

4. Reform as the century turns

The immediate aftermath of the Brazilian currency crisis was not surprising: substantial overshooting in the devaluation in the first months of the crisis, which did not last more than a year. Yet, while in Mexico the overshooting was eliminated via inflation, in South Korea the adjustment occurred mainly through a nominal appreciation, with a very limited role for inflation. In Brazil, there were fears that the appreciation of the real would follow Mexico's footsteps, given the country's inflationary record, explaining the reluctance to let the exchange rate float in the first place. In practice, adjustment was similar to that of South Korea. The R\$/US\$ exchange rate that stood at R\$1.21 before the devaluation, peaked at R\$ 2.16 at the height of the crisis, before ending 1999 at R\$ 1.79. The nominal devaluation amounted to 48%, against a consumer inflation of 9%, i.e. a pass through of less than 20%.

The fact that the devaluation coincided with slow growth explains partly why inflation did not explode, as widely feared.¹⁰ There were also other important factors: a) the management of monetary policy, with an accurate and timely "fine tuning" of interest rates; b) the renegotiation of the IMF agreement, which signaled to a credible fiscal adjustment and provided room for the Central Bank to intervene in the currency market; c) the announcement of moderate increases in the minimum wage; and d) the decision to adopt an inflation target regime.

The limited impact on inflation and the sound balance sheets of financial institutions help explain why devaluation did not lead to a drastic recession as in Mexico and South

¹⁰ In December 1998, seasonally adjusted monthly industrial production was 10% below its historic peak reached at the end of 1994, and 7% below the near-term maximum of mid-1998.

Korea.¹¹ With close to 50% nominal devaluation, a 10% consumer inflation and a modest expansion in GDP, driven by an improvement in the trade balance, Brazil carried out a relatively successful transition in exchange rate regimes.¹²

Underlying this process were important changes in the economic policy regime, which, by effectively dealing with the inherited macroeconomic imbalances paved the way for a new cycle of sustainable growth. Among them stand out: the adoption of a floating exchange rate regime, replacing the quasi-fixed regime in place until 1998, and the implementation of fiscal and inflation targets.

The new exchange rate regime gave monetary policy greater room for maneuver. It also enhanced the flexibility of the price mechanism to adjust to the structural changes that Brazil has been going through since the beginning of the nineties. The potential cost was the risk of increasing exchange rate volatility.

The adoption of fiscal targets under the umbrella of the IMF agreement led Brazil to adopt fiscal rules (Bayoumi and Eichengreen, 1995). Brazil has moved, then, from a situation in which the fiscal deficit was the variable which would square the mismatch between the society demands for public goods and its willingness to accept taxation, to a scenario where a rigid fiscal target is established and the adjustment falls on revenues or expenditures.

A host of extraordinary measures, such as temporary taxes or proceeds from the sale

11 On the relatively sound situation of Brazil's financial sector, see Standard & Poors – S&P (1999). The external crisis of 1999 found the Brazilian financial system relatively well adjusted to the parameters established by the Basle Accord. Moreover, Banks were well prepared for the prospect of devaluation, especially after the Asian crisis of 1997. To a certain extent, Brazil benefited from the fact that the Mexican and Asian crises had already happened, since this gave the banks considerable time to prepare for a possible crisis.

12 The change in the trade balance was much less impressive than in the case of Mexico and South Korea, in the absence of a large contraction in GDP, as in Mexico and Korea. Moreover, Brazil experienced a sharp deterioration in its terms of trade in 1999, with a 13% fall in the average price of exports. Despite this, in volume terms, exports of goods grew by 9%, while imports fell by 15%, compensating the moderate falls in investment, public-sector spending and consumption, and causing GDP to grow 0.8%.

of state-owned enterprises, allowed revenues to rise as a percentage of GDP, despite the low growth and high unemployment (Appendix). This led to a consolidated primary surplus for the public sector of almost 4% of GDP, in sharp contrast to the situation in previous years.¹³

The adjustment also benefited from a series of important fiscal reforms, such as: a) establishment of needed restrictions on retirement in the public sector; b) approval of a new formula for calculating pension benefits; c) renegotiation of state debts against collateral associated with federal government transfers to states, providing the former with the legal instruments to enforce the negotiated terms (this implied a need for all levels of government to make their own adjustments, since they will no longer be able to count on treasury bailouts); d) approval of the Fiscal Responsibility Law, inspired by similar legislation in New Zealand, which establishes parameters of behavior for the various levels of government, and defines ceilings for spending on payrolls for the various parts of the public sector; e) privatization of several local state (province) banks; and f) privatization of the majority of companies owned by state (province) governments.

Finally, the adoption of inflation targeting meant a fundamental change in policy making in Brazil.²² The targets set were strict, since they were fixed more than 2 years in advance, with no room for mid-term adjustments. The targets set for 1999-2002, using the IPC as a benchmark, were, respectively 8%, 6% and 4%, 3.5% with a 2 percentage points margin of error on either side in all cases. The system worked very well in the first two years but a succession of external shocks left actual inflation out of those boundaries. Still the important medium term objective in terms of expectations was fulfilled.

13 When the December 1998 agreement with the IMF was renegotiated after the devaluation, the level of future inflation and the consequent level of interest rates and the nominal deficit for 1999 were still highly uncertain. As a consequence, the agreement was signed taking the performance criterion as the floor value for the primary deficit, instead as the ceiling for the nominal deficit, as usual in IMF programs.

After a promising start, the economy began to face major difficulties both domestically and abroad. First came the deepening of Argentina's recession and the sharp downturn of the US economy, which reduced capital flows to Latin America and curtailed the market for Brazil's exports. Second the energy crisis in the second quarter of 2001. The worst draught in the last seventy years (hydroelectricity accounts in average for 90% of Brazil's power supply), coupled by regulatory shortcomings and low investment, forced the government to ration electricity to avert energy blackouts. Last, in third quarter, came the terrorist attacks in the United States, which thrown the world economy, and particularly the emerging markets, in disarray, delivering yet another blow to the already bleak prospects of capital flows to and exports from developing countries. 2002 brought, in addition to electoral uncertainty, the two sides of the Argentinean contagion (first, financial and later the real contagion with the dramatic decline of Brazilian exports) and the credit crunch for emerging markets.

5. Conclusions

In the last two decades, Brazil's economic performance fell short of its potential. GDP growth averaged 1.5% a year between 1981 and 1990 and 2.7% in the following ten years, well below the more than 7% a year achieved in the previous 30 years. In the early 1990s, though, Brazil began to pursue a far-reaching agenda of market-friendly reforms, in an effort to regain the economy's lost dynamism. The history of these reforms can be divided into three periods. In the first (1991-94), Brazil abandoned the import substitution regime by opening up the economy and privatizing industrial firms. The economy performed well, but inflation was not tamed. In 1995-98, the Cardoso government started privatizing the infrastructure sector and brought inflation down from 5000% a year to close to 2% in 1998. Delays in floating the exchange rate and lack of fiscal discipline led to mounting current account and fiscal deficits. In the third and final period, after 1999, a new macroeconomic policy framework was implemented based on fiscal discipline, inflation targets and a floating exchange rate.

The shocks – the energy shortage, Argentina’s crisis and the worst world recession since the 1970s – were a powerful blow to the economy’s fundamentals, particularly in face of indicators such as public-debt-to-GDP ratio and the current account deficit. Yet, as demonstrated by the 1999 currency crisis and its aftermath, the new policy regime seems equipped to deal with short term disturbances, particularly those caused by external shocks. Moreover, one has to look over the long term to assess the implications of extensive reforms such as those carried out during the 1990s. One could, for instance, draw a parallel between these reforms and those implemented in the mid-1960s, under the “Government Economic Action Plan” (PAEG, Plano de Ação Econômica do Governo). In both cases, there were long overdue policy and institutional changes that needed to be implemented. The 1960s reforms ended up paving the way for the so-called “Brazilian Miracle” (1968/73), a period of unparalleled rapid growth. Likewise, by dealing with bottlenecks inherited from decades of anti-trade bias and macroeconomic mismanagement, the 1990s reforms may pave the way for a new cycle of rapid growth.

This outcome, however, will fundamentally hinge upon the ability and political will of the next administration (2003/06) to reaffirm the country’s commitment to free trade, to the new macroeconomic regime and to the institutional changes under way. This would require, first, a move to reinforce the institutional side of the new regime and second, an effort to pursue the so-called second generation of reforms, which are essential to boost investment, productivity and exports, three ingredients of a sustainable growth path.

Although the economy has implemented major reforms, which paved the way for a sustainable recovery, results were slow to come in light of a number of policy missteps, particularly at the fiscal and exchange rate management, and a series of external shocks. This delay seems to have produced “reform fatigue” which has reduced political support for a second generation of reforms, which are key to complete and consolidate the achievements of the 1990s. If, despite fatigue, a pro-reform approach prevails in 2003 and afterwards, the

1990s might pass into history as laying the foundations of a long spell of prosperity.

Even though the country seems to be in a good position to withstand the current difficulties, it would be wrong to say that the nineties have exhausted Brazil's growth agenda. At least two big challenges remain ahead. First, there is the need to consolidate the new macroeconomic policy regime. One can mention, for instance, the need to take the fiscal adjustment beyond temporary sources of revenue, such as ad hoc taxes and the lack of an independent central bank, with a clear mandate to support the currency and fight inflation.

Second, there are important microeconomic and institutional reforms, related to investment, productivity and exports, which are essential to any sustainable growth scenario. There has already been progress in some of these areas: the investment rate, which in the first half of the nineties remained below 15% (1980 prices), rose to 19% recently; total factor productivity, which had declined an average 2.4% per year in 1980-91, showed an annual increase of 1.7% in 1991-2000 (Bacha and Bonelli, 2001); and exports, as mentioned in section 2, after a lackluster performance throughout the decade, showed signs of recovery after the 1999 devaluation. Yet, the likelihood of consolidating or even building on these gains will be greatly enhanced if the structural and institutional reforms are deepened or extended towards areas such as the labor markets and the tax and judicial systems.

On productivity, whereas there is still a considerable agenda to push through in terms of trade liberalization, privatization and deregulation, it seems unlikely that these factors alone will be enough to keep productivity growing at the rates seen in 1990s. The major source of future gains seems to be on deregulating the labor market and on upgrading the skills of the labor force, an area where Brazil lags behind even by Latin American standards (Ranis and Stewart, 2001). The benefits of higher and more efficient investment in training and education are likely to be threefold: it might speed up the catching-up process; it would lay down the groundwork for a move towards more productive, technology-intensive sectors, with positive externalities for the whole economy; and it would reduce inequality, historically

the black spot of Brazil's growth record.

On export performance, the sustainability of the momentum gained after the 1999 devaluation will depend heavily on the government's ability to promote investments in infrastructure, to carry out a tax reform, to deepen the capital markets and to provide a better institutional support and improved market access for exporters. In the case of infrastructure, as mentioned earlier, considerable progress was made in the second half of the nineties through privatization of state enterprises. Yet, there is still a lot to be done, particularly in areas such as energy (as show by the severity of the recent crisis) and transport. Tax reform is an imperative given the characteristics of the present system, which penalizes producers with cumulative taxes. Financial deepening is a key pre-condition to bring small and medium firms into exporting and to allow firms to survive in sectors such as high-unit-value capital goods, where competitors count not only on more advanced capital markets, but also on state sponsored export credit agencies.¹⁵

On the institutional front, government support to disseminate information can be a powerful tool to promote exports. There are already initiatives in this direction—for instance, the export promotion agency (APEX)— yet, compared to what has been done in East Asia, there is still a long road ahead. Finally, there is the issue of market access, where the current and the next government face crucial negotiations, particularly in agriculture and antidumping, involving Mercosur, the FTAA (Free Trade Area of the Americas), the European Union and the WTO.

15 For a discussion of Export Finance in Brazil, see Sucupira and Moreira (2001).

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Figure 1: Per capita growth rates LAC, 1900-1998

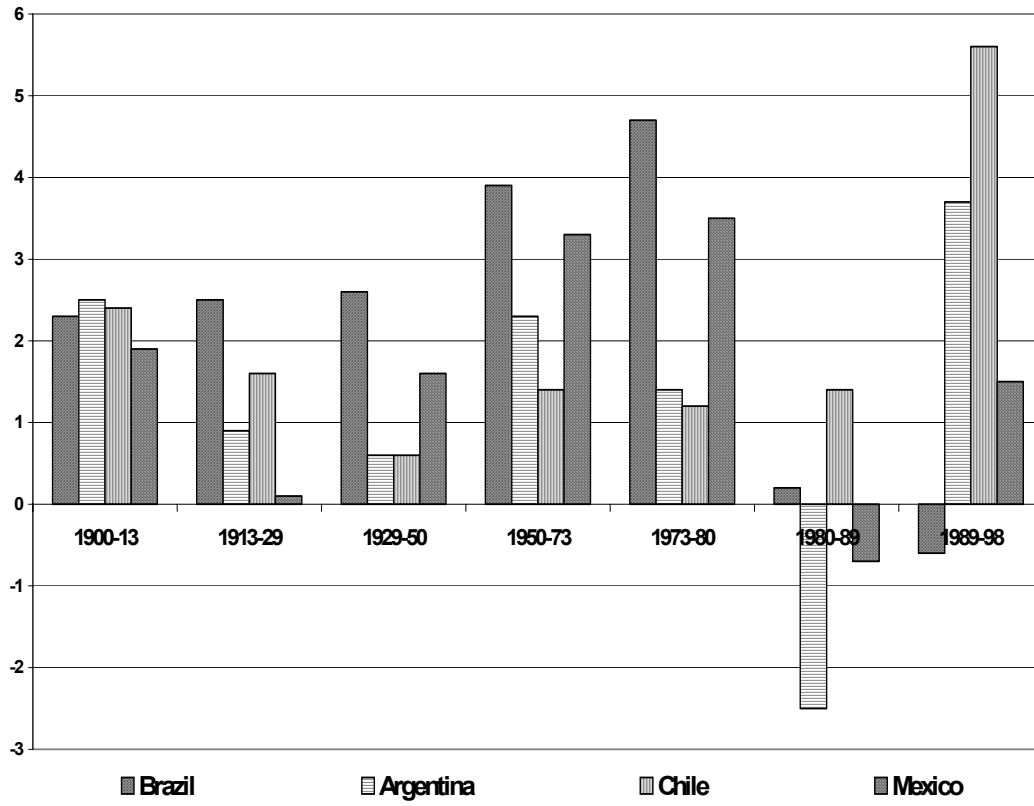


Figure 2: Monthly inflation (IPCA), 1980-2001

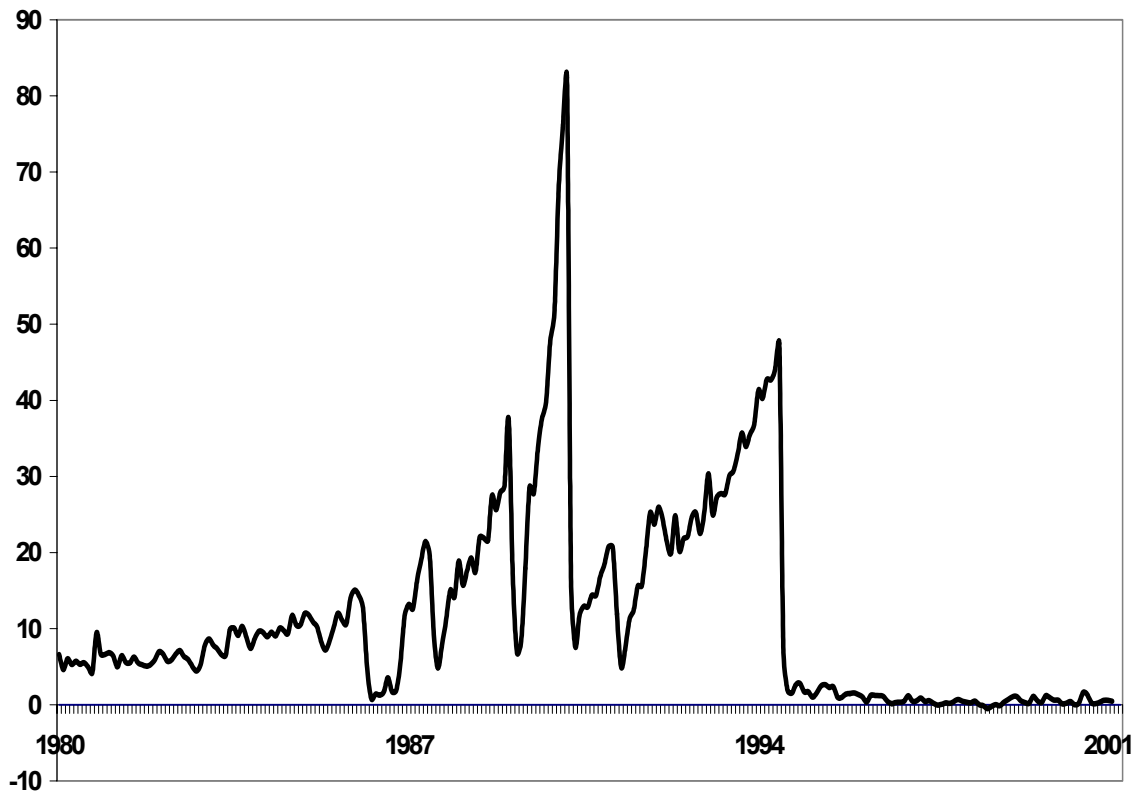
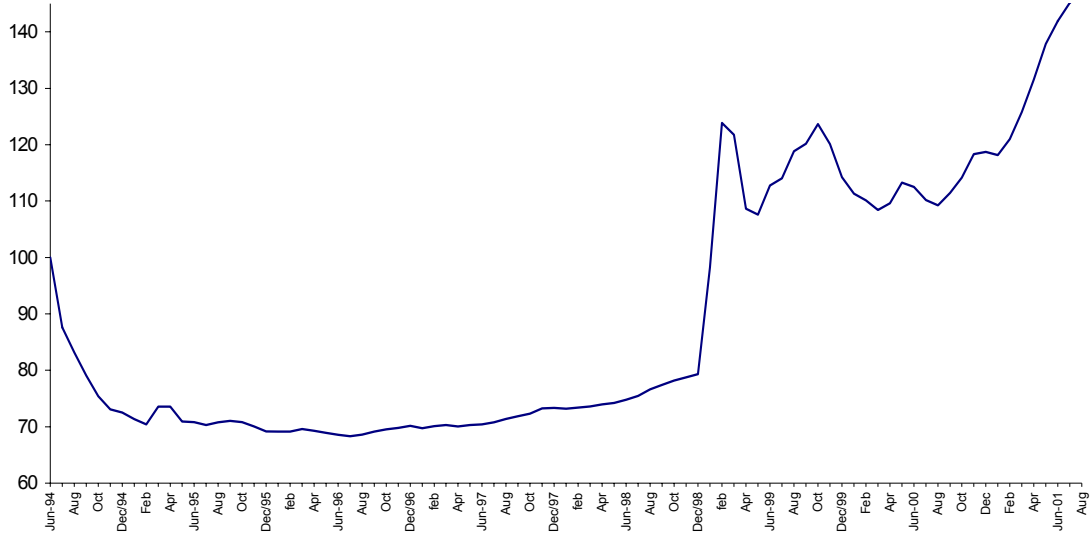


Table 1 Growth Accounting Results, 1980-2000				
	GDP	Labor	Capital	Productivity
1980-1990	2.25%	1.63%	1.35%	-0.73%
		(72.53%)	(59.86%)	(-32.39)
1991-2000	2.62%	1.03%	0.86%	0.90%
		(37.55%)	(31.12%)	(32.20%)

Source: Teixeira (2001).

Chat 1: Real Exchange rate*



Source: BACEN

* Based on Brazil's IPCA and US CPI. An increase means a devaluation.

Table 2
Brazil: Economic Indicators

	1993	1994	1995	1996	1997	1998	1999	2000	2001
GDP (US\$ billion) /a	429.7	543.1	705.5	775.8	807.7	787.7	528.6	593.8	500.0
GDP growth (%)	4.9	5.9	4.2	2.7	3.3	0.2	0.5	4.4	2.0
Industry (%)	7.0	6.7	1.9	3.3	4.7	-1.5	-1.6	5.0	1.5
Agriculture (%)	-0.1	5.5	4.1	3.1	-0.8	1.9	7.4	3.0	3.5
Services (%)	4.5	1.8	1.3	2.3	2.6	1.1	1.5	3.7	2.0
Inflation (IGP, january/december, %)	2708.6	1093.8	14.8	9.3	7.5	1.7	20.0	9.8	9.0
GDP deflator (%)	1996.2	2240.2	77.6	17.4	8.3	4.7	4.4	8.5	8.1
Real interest rate (%) /b	7.1	24.4	25.0	16.3	18.5	26.7	15.3	10.8	10.5
Unemployment - IBGE (%)	5.3	5.1	4.6	5.4	5.7	7.6	7.6	7.1	6.5
Current account deficit (% GDP)	0.1	0.2	2.5	3.0	3.8	4.3	4.7	4.1	4.7
National accounts (% GDP, current prices)									
Final consumption	77.7	77.5	79.5	81.0	80.9	80.9	80.6	79.2	na
Private	60.0	59.6	59.9	62.5	62.7	62.1	61.7	60.4	na
Government	17.7	17.9	19.6	18.5	18.2	18.8	18.9	18.8	na
Gross capital formation	20.9	22.2	22.3	20.9	21.5	21.2	20.5	23.0	na
Investment	19.3	20.8	20.5	19.3	19.9	19.7	na	na	na
Change of inventories	1.6	1.4	1.7	1.7	1.6	1.5	na	na	na
Goods and non-factors services	1.4	0.3	-1.8	-1.9	-2.4	-2.1	-1.1	-2.2	na
Exports	10.5	9.5	7.7	7.0	7.5	7.6	10.6	9.9	na
Imports	9.1	9.2	9.5	8.9	9.9	9.7	11.7	12.1	na
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	na
Tax burden, National Accounts (% GDP)	25.3	27.9	28.4	28.6	28.6	29.3	31.7	32.0	32.5

na : Not available

/a GDP divided by the average exchange rate (R\$/US\$).

/b Gross rate (SELIC). Deflator: "Centered IGP". Since 1995, CPI.

Sources: IBGE, IPEA and FGV. For 2001, authors' forecast, based on the results of half of the year.

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