At the mercy of the "sentiment of the market"

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Almost three years after Brazil changed from semi-fixed to floating exchange rates the economy is still exhibiting mediocre growth, high unemployment and perverse income distribution profiles. The economy has been crawling along, allowing little opportunity for adopting more effective policies to combat social exclusion and poverty.

Brazil's current state of external vulnerability has many roots: the indiscriminate free trade policies first implemented in the late 1980s; the financial liberalisation and capital account opening policies adopted during the 1990s; and the overvaluation of the domestic currency with respect to the US dollar, as an element of the stabilisation plan of 1994.

The stabilisation strategy relied heavily on the availability of imports made cheap by exchange rate overvaluation. Sustaining such a strategy, however, required maintaining high interest rates to attract capital inflows (enough to pay for the trade deficit) and, thus, increasing external debt.[2]

To grow, the Brazilian economy needs rising imports and, to pay for the imports, rising capital inflows. Heavily dependent on capital inflows and having lost most of its capital control instruments, the economy is constrained in its growth perspectives by the "sentiment of the market", as unforgettably put by former IMF Managing Director Michel Camdessus. In fact, if financial investors are happy with their perceived opportunities in Brazil, they will supply the means necessary to cover trade deficits. If not, growth is stalled by rising interest rates and fiscal austerity, which the government is forced to adopt to attract investors back to the country. Inflation has been beaten by the stabilisation plan, but sustainable output and employment growth have not been achieved. The economy lives through periods of stop-and-go growth, with stops lasting longer than go-times, depending on how international investors react to worldwide as well as domestic turbulence.

During the last months of 2000 and for the whole of 2001, financial investors actually had plenty of reasons to harbour bad feelings about the Brazilian economy. Even though the domestic currency (*real*) has not been overvalued for quite some time, exports took much longer than expected to react, and when the reaction timidly began, the US went into a recession, worsening trade expectations for everybody. In addition, the Argentine economy has been floundering since the end of 2000, with no end for the crisis in sight. Some degree of contagion to the Brazilian economy is inevitable under these circumstances.

In the first half of 2001, the federal government suddenly found out that the improvident energy policy it had adopted for years, which badly neglected needed investment in new production capacity, finally necessitated energy rationing that is still in force. On top of all that, political crises have been taking place almost without interruption since President Cardoso was inaugurated for the second term he coveted so much. This time, the crisis took place in the Senate, involving close associates of the president, and ended up in the dismissal of three senators, including the former and the then-current presidents of the Federal Senate.

Consequences of external vulnerability

All this hit an economy already in need of financing about USD 25 billion of current account deficit, besides rolling over outstanding foreign debts. As a result, interest rates were kept at very high levels by the Central Bank (19% of annual overnight rates for an annual inflation rate of about 7%). This was reflected in average interest rates of 55% in June 2001 (up from 51% in December 2000) being charged for credit to the private sector. At these rates, credit supply could only stagnate, bringing down the economy with it. According to IMF predictions (made public in December 2001), the economy should grow by only 1.8% in 2001 (a much lower rate than the one projected by the Brazilian government).

Under these circumstances, it should not be surprising that unemployment remains very high (6.2% in August 2001, not counting disguised unemployment in the form of "informal" jobs like street-peddling).

Three significant initiatives

Not everything was bad news. The federal government has begun to implement some potentially significant social programmes. The strategy seems to be to de-emphasise the Community in Solidarity initiatives, led by the First Lady, which used to be an umbrella campaign to include federal social programs, in favour of topic initiatives that may achieve greater visibility when they are announced one-by-one. Foremost among these is the *Bolsa-Escola* programme, in which very poor families are given a small grant if they keep their children (ages 7 to 14) at school. Although the program has been criticised for the small amount it grants per child, it is still a positive initiative, combining some attenuation of extreme poverty with a stimulus to families to give children at least basic formal education instead of putting them precociously to work. Some critics accept the principle behind the programme, but argue that if it focused on fewer communities in this initial phase, it could give families a higher grant and be more effective in improving their living conditions.

Another major advance is the initiatives to combat racial discrimination.

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2 Overvalued exchange rates cause current account imbalances (that is, the trade and services balance) to emerge because a cheap foreign currency stimulates imports and reduces exports. Cheap imports compete with local production preventing the latter's prices from rising. The flipside, of course, is increasing foreign indebtedness, since if one imports more than one exports, one has to borrow to pay for the excess imports.

The subject received a large amount of attention in 2001, as a by-product of the UN Conference Against Racism in Durban, South Africa. The position of the Brazilian government in Durban was praised as very progressive, but it has also been criticised because of its limited ability to be implemented domestically. Be that as it may, opening the debate around a subject that has always been deliberately ignored, not only by authorities, but also by a large share of the Brazilian population (which has for the most part happily accepted the myth of a racial democracy prevailing in the country), is in itself a great step forward. Beyond rhetoric, some measures have been taken, even if largely symbolic.[3]

Finally, one should not ignore the important victories obtained by the health authorities against multinational drug producers, inaugurating a pattern that is beginning to spread to other countries. The Ministry of Health has been praised for its anti-AIDS policies, which include the free distribution of drugs to those infected by HIV who cannot afford them. The government reserved the right to break patents protecting the manufacturers of those drugs if they tried to use their monopoly power to impose unreasonable prices on their medicine. The case was taken to the WTO, and despite the strong pressure of drug manufacturers, the Brazilian authorities held their ground. The right to treat events like the AIDS epidemic as national emergencies was recognised. This case serves as an important precedent to developing countries in their relations with monopolistic producers of strategic goods, such as special medicines. In the end, those firms had to retreat and accept the need to negotiate prices within reasonable parameters with the government.

Fiscal policy

One crucial side-effect of external vulnerability, as mentioned above, has been the need to maintain the good will of international investors so that they will finance balance of payments for large deficits. An important instrument of good will has been the offer of high interest rates on financial investments in the country.[4] Rising interest rates directly impact the service of public debt. If interest rates are kept low, capital flight ensues and, in a floating exchange rate system, the local currency is devalued. In either case, the impact on public finances is disastrous. By far, most of the public debt in Brazil is indexed either to overnight interest rates or to exchange rates. If the authorities allow the *real* to devalue, debt service will rise; if they raise interest rates to avoid devaluation, debt service will rise as well.

In December 1998, on the eve of the change in exchange rate rules when it was witnessing strong capital outflows, Brazil signed a Stand-by Agreement (SBA) with the IMF. One should keep in mind that the liberal policy mix implemented so far was done on the initiative of the local government. Liberalisation policies were adopted by local authorities because of the latter's political persuasion, not because foreign institutions imposed them (as was the case in the crisis countries in Asia). The coincidence of views between the government and the IMF did not prevent the IMF from attaching many sets of conditionalities to the SBA, among which was giving priority to pursuing positive fiscal primary surpluses (that is, fiscal surplus before servicing the public debt) for the duration of the agreement. Since the Brazilian government signed a new SBA in 2001, even before the first was actually concluded, the conditionalities remain. In fact, the Brazilian government has passed a law, the Fiscal Responsibility Act, giving priority to servicing public debt over other fiscal expenditures (including social expenditures).

The precedence of public debt servicing over other expenditures has led the federal government to cut planned expenditures and to withhold payment even from programmes that were actually budgeted. Thus, as is shown in the table below,[5] some of the social expenditures programmed for 2001 are not only far from completion, but virtually non-existent.

TABLE 1

Implementation of budgetary programmes in 2001

As of 16 November 2001

PROGRAMME	IMPLEMENTATION (%)
Urban infrastructure	0
Construction of federal highways	0
Electricity in rural areas	0
Energetic policy management	1,36
Basic sanitation	2,35
Energy in small communities	4,81
Social reinsertion of minors in conflict with the law	6,71
Innovation for competitiveness	9,88
Brazil in action	11,43
Struggle against poverty	11,49
Active Community	14,74
Quality and efficiency of the Health Single System	22,92
Support for health research	26,98
Protection of the Amazon	32,17
Quality school for all	32,27
Defence of children's rights	42,74

Source: SIAFI/STN – COFF-CD and PRODASEN – Prepared by INESC.

Conclusion

The difficulty of significantly improving living conditions for the majority of the country's population is not so much a problem of adopting the right specific programmes, as of giving too low a priority to social goals.[6] Government policy is dominated by concern with the "sentiment of financial markets", which leaves little room for any change of priorities. It is to be expected that 2002 will bring some change, being the year of general elections, but the latitude for any real change is limited in the strategy adopted by the present administration. One should expect only marginal improvements at best. ■

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3 Such as the decision by the Minister of Agrarian Reform to reserve quotas for the employment of Afro-Brazilians in the ministry's jobs and the debates around the creation of quotas for minorities at public universities.

4 International investors are not only foreign investors, but also residents that are enabled through financial liberalisation to take their money out the country and invest abroad. Thus, even if *foreign* investors do not invest in domestic securities, the authorities still have to keep the good will of domestic investors, lest they flee with their capital. With financial liberalisation it is not the nationality of the investor that matters, but their range of investment. Capital flight begins at home. Brazilian investors brought the former exchange system down in 1998, just as Mexicans did in Mexico in 1994, Thais in Thailand in 1997, and so on. Capital controls are needed not to prevent foreigners from leaving but residents from fleeing.

5 Prepared by Luiz Fenelon, of Instituto de Estudos Socio-Economicos (INESC).

6 This point was extensively debated in an article by Célia Kerstenetsky and Fernando Carvalho included in the Brazilian edition of Social Watch, *Observatório da Cidadania 2000*.