

Country Brief : Brazil

Since taking office in January, the government of the new president, veteran left wing politician "Lula" da Silva, has followed conservative macro-economic policies and prioritised much-needed tax and social security reforms. There has consequently been a marked improvement in market sentiment towards Brazil, which was on the verge of a financial crisis at the time of the election last October. However, many supporters and allies of the government are becoming impatient for action on the major issues of poverty, unemployment and crime. The government faces a difficult challenge to balance the demands of its constituency, while at the same time consolidating the recent improvements in the markets for Brazil's currency and debt. There have been big improvements in Brazil's traditional vulnerabilities, inflation and the balance of payments. This has set the scene for lower interest rates, which should in turn help to boost economic growth, which is crucial if the government is to even begin to improve living standards.

Since winning the election last October, President "Lula" da Silva has achieved a marked turnaround in market sentiment towards Brazil, first through his selection of capable and moderate people to fill key economic posts, and then, since taking office in January, through his government's commitment to structural reform and conservative macro-economic policies. The government has:

- raised its primary budget surplus (ie excluding interest payments) in order to stabilise the public debt/GDP ratio
- continued with the inflation targeting approach to monetary policy
- laid the constitutional groundwork for central bank independence
- prioritised tax and social security reform, and by end-April had presented its proposals to Congress

Reform of the unwieldy tax system and the excessively generous public sector pension arrangements are seen as essential to improving the health of government finances. However, the previous government, headed by reform-minded President Cardoso, found it politically difficult and made little progress in this area.

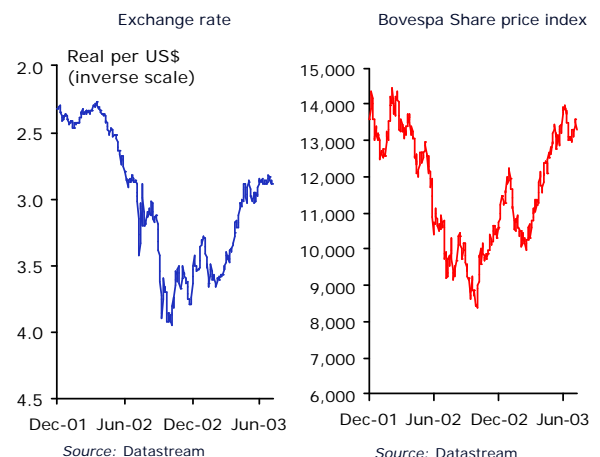
Market reaction has been favourable

Financial markets have endorsed these steps:

- From their low points in October last year, the currency and the Bovespa share price index had, by early July, recovered 38% and 61% respectively.
- Over the same period, Brazilian bond spreads over US Treasuries shrunk by two-thirds, to below 800 points, reflecting lower default risk.
- At the end of April, Brazil issued its first international bond in over a year, raising US\$1 bn.

Endorsement of the IMF was received in mid-June, when its executive board approved the third assessment of the August 2002 stand-by arrangement with Brazil, clearing the way for a disbursement of US\$9.3 bn. Also in June, the World Bank approved a loan of US\$404 mn to partially fund the tax reform programme.

Markets have rebounded since October



A crucial issue is whether this favourable market environment can be sustained. If it is, then the decline in inflation and interest rates, which has already begun, will continue, thus enhancing the growth outlook. Coupled with ongoing legislative reform, this will pave the way for a recovery of foreign investment.

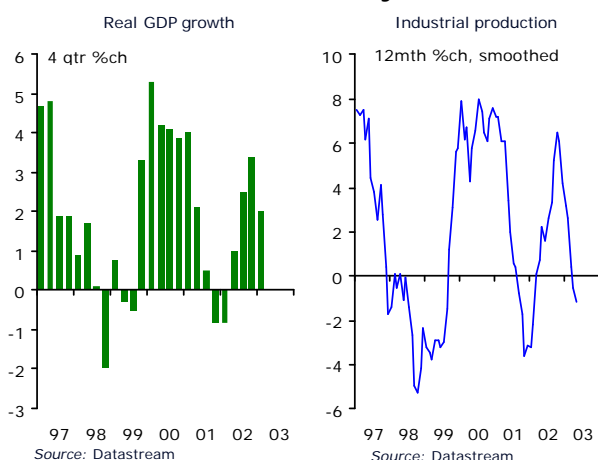
Is such a virtuous circle feasible?

There are reasons to suppose it won't be. It will require a broad consensus to carry through the economic reforms. Such consensus could easily be sabotaged by some of the very people who put Lula in power. Many supporters are getting impatient, waiting for improvements in living standards. The flagship "Zero Hunger Programme" has been much less effective than hoped. Recently

a group of economists in the PT released a manifesto calling for higher public spending, lower interest rates and a managed currency, sheltered behind capital controls. Federal public sector workers are on strike at the time of writing, protesting the proposed pension reforms. Illegal land occupations, organised by the landless movement (MST) a traditional ally of the PT, have restarted, presumably to put pressure on Lula to deliver on his pledges regarding agrarian land reform. There has also been criticism from the business sector protesting about potentially higher tax payments when the system becomes simplified (presumably because loopholes will be closed).

And to make the task of balancing the demands from both radical and conservative sides of politics even more difficult, the economy faltered in Q1/2003 (GDP declined slightly in seasonally adjusted terms) after showing stronger-than-expected growth in the two previous quarters. Moreover, unemployment rose to 12.8% in May, compared with 11.9% in May 2002. By mid-year, the central bank had revised down its growth forecast for 2003 from 2.2% to 1.5-1.8%, and raised its projection for year-end inflation to 10.2%, above its target of 8.5%.

Growth faltered early in 2003



There are positive signs.

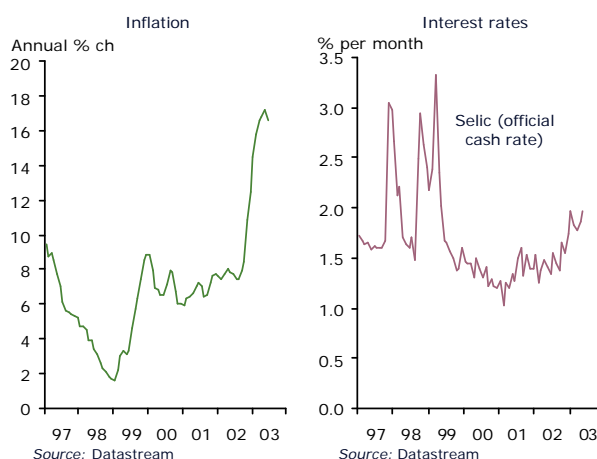
In the economic arena, inflation has peaked, exports have surged and the current account is close to balance. Government revenue growth has turned out to be stronger than expected, making it possible to unfreeze some spending programmes.

In the political arena, Lula has shown himself to be a skilful consensus-builder, for example persuading state governors and mayors to support his tax reform strategy. He has moved quickly to open discussions with supporters who have been critical of him, arguing that his first priority has been to avoid economic crisis and lay the groundwork for

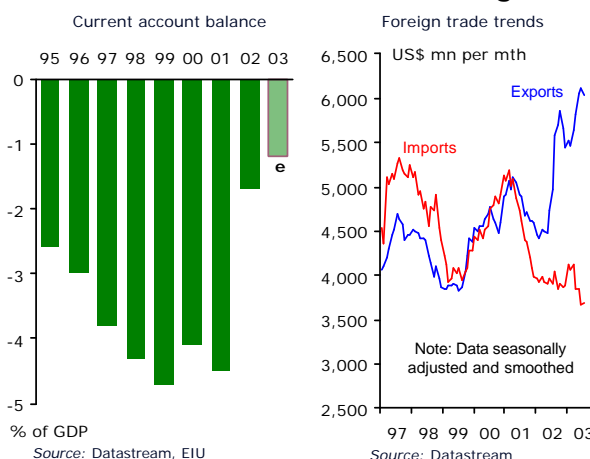
growth. Nevertheless, there have been some whose differences with Lula are apparently irreconcilable and he has taken steps to expel them from the PT. Also, the government's support in Congress has grown, partly through a formal pact with the centrist Brazilian Democratic Movement Party (PMDB) and partly through the realignments that happen in a political system where ideology and party discipline are less important than being on the winning side.

Observers believe that the PT-led government will be able to muster the required three-fifths majority for the constitutional amendments necessary to the tax and pension reforms, although this is not likely to be tested until closer to the end of 2003. In quarterly opinion polls, the government's approval rating fell slightly between March and June, but remains high at 70%. Lula's personal approval rating is lower, at 43%, but this is regarded as good. Among PT members, 95% consider both the tax and social security reforms to be important.

Inflation and interest rates are set to fall



Current account deficit is shrinking fast



A change in policy direction?

In coming months, there may, superficially, appear to be a change of direction in the government's policy programme. Thus far, a lot has been done, properly, to bring the financial markets on side. Now Lula needs to deliver on his pledges to fight crime, poverty and unemployment. The government has recently announced a "First Employment Programme" to assist young people to enter the workforce (and thus reduce juvenile crime) and a package of measures to address the effective exclusion of the poor from banking services, particularly credit. (The latter strategy is being led by the two biggest state-owned banks, which are offering small loans at a fixed rate of 2% per month, which is well below the normal lending rate. Apparently, all banks will eventually be required to lend 2% of their deposits to low income customers.) Other measures, such as agrarian land reform, highlighted recently, will also be in the pipeline. And while social programmes are in the limelight, tax reform will be going through a quieter, tedious and time-consuming process of committee examination. But it is most unlikely that the tax and pension reform strategies will be neglected. Indeed, delivering on social programmes will if anything, enhance the government's chances of consolidating support for these major reforms. Also, with so much having been achieved by its conservative macro-economic policies, there is little risk of a sudden loss of discipline. So the emergence of new social policies and associated legislation in coming months should be seen merely as an unsurprising shift in emphasis, not a change in direction.

Progress so far should encourage policy continuity

Although the task ahead will be difficult, it was a lot more difficult back in October, when, despite the US\$30.4 bn IMF package negotiated in August, the country was close to a financial crisis. Progress made since then should be sufficient to convince most people, that continuity of current macroeconomic policies is crucial. Nevertheless, there are risks, and if, for whatever reason, markets turn against Brazil again, then President da Silva's job will become much more difficult. He will still face the issue of balancing competing demands in the economic and social spheres for policy action, but without the prospect of stronger growth and with all the impediments of budget constraints and higher inflation and interest rates tending to impact on income distribution. Patience is needed on the part of Lula's constituency and in the marketplace; both sides must realise that neither side can have everything its own way.

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