TEXTO PARA DISCUSSÃO

Nº 110

Preliminary notes on the economic strategy of the new Brazilian Government

Edmar Lisboa Bacha

PUC-Rio – Departamento de Economia
www.econ.puc-rio.br

Setembro de 1985

1. Introduction

The coming into power early this year of the first civilian government in twenty-one years was a watershed in Brazil's political history. The transition from military rule was surprisingly pacific. After a constitution amendment to institute direct elections for President failed to obtain the required two-thirds majority in Congress, two civilians competed in January for the votes, of an electoral college rigged to facilitate the victory of Paulo Maluf as the candidate of the government party. In fact, a three-way split of the 1atter – which paralleled a similar split among the mi1itary – guaranteed by a sizable margin the election of Tancredo Neves as President (nominated by the main opposition party) and José Sarney as Vice-President (nominated by the main group splitting from the government party).

In a turn of events which would surprise even the inhabitants of Garcia Marques Macondo. Tancredo Neves was hospitalized on the eve of his inauguration and died forty days afterwards. Jose Sarney then began to preside over the complex political arrangement composed by Tancredo Neves to guarantee his coming into power – the problem being that the maintenance of this arrangement presumed the command of the master politician, which Tancredo Neves was.

If such delicate political situation were not enough, José Sarney inherited from the military an extremely difficult economic situation, as indicated by an overall fixed investment ratio barely over 15 per cent of GDP, a suspended IMF agreement, and an annualized inflation rate of nearly 300 per cent in the first three months of 1935.

This paper is organised as follows. The following section argues that current domestic financial problems – i.e., low investment ratios, and high inflation rates and public sector deficits – are partially a consequence of the successful adjustment of the Brazilian economy to the external shocks of the early eighties. The economic game plan of the recently released First National Development Plan of the New Republic is summarized in the third section. A brief discussion of the perspectives for the country in the near future closes the paper.

2. External adjustment, domestic maladjustment

The opinion is frequently expressed that Brazil did a marvellous job at adjusting its external accounts after 1982, but that it failed miserably in the job of putting its domestic house in order. At first sight, the available statistics seem to support this view. In 1982, Brasil exhibited a trade surplus of $ 780 million; this went up to $ 6.5 billion in 1983; and to $ 13 billion in 1984 (in 1985, the estimated surplus is $ 12 billion). Therefore, a current account deficit of $ 14.8 billion in 1982 changed into a surplus of $ 500 million in 1984. Similarly, gross international reserves, which stood

at $ 4.0 billion in December 1982, built up to $ 11.6 billion in June 1985.

Meanwhile, year-end inflation rates shoot up from 103 per cent in 1982, to 165 per cent in 1983, and to 209 per cent in 1984 (in 1985, the expected inflation rate is 220 per cent). Similarly, the ratio to GDP of the public sector deficit went up from 15.8 per cent in 1982, to 20.9 per cent in 1983, and to 23.3 per cent in 1984 (a value similar to the latter is expected for 1985)[1].

From this evidence, the following conclusions are frequently drawn. The First is that Brasil did only half of the needed adjustment, and now needs to do the other half. The second is that the international community could and did help when external disequi1ibrium was the problem. Now that the problem is purely domestic, it should be solved by internal means, without the need of external support. This interpretation is only partially correct. For current domestic maladies are in good measure a consequence of the successful external adjustment performed by the Brazilian economy since 1982.

Consider first the question of inflation. This is a chronic phenomenon in Brasil, as important a part of its present economic 1ife as coffee beans were of its past. The most impressive thing about Brazilian inflation is not so much that it is so high, but that it does not accelerate rapidly, as both the Phillips curve and the German hyperinflation would lead one to believe. In fact, most Brazilian economists today are convinced that the country's inflation has little to do with excess demand theories of either the monetarist or the Keynesian variety. After a series of failed attempts at controlling Brazilian inflation through monetary stringency, the most recent IMF staff reports are finally conceding that in Brazil demand contraction is a very inefficient way of reducing inflation, because of the widespread backward looking indexation schemes, which characterize most nominal in the country.

The step not yet taken by the IMF economists is to realize that the difficulty is generated not by the government mandated indexation formulae, but more importantly by a myriad of informal indexation arrangements, devised, after a long learning period, by rational economic agents, which are forced to act in a context of chronic inflation. In such a situation, the most important reason why inflation is 200 per cent per year today is that it was 200 per cent per year last year.

Liquidity has to come from somewhere, and the place from where it usually comes, is the government budget deficit. However, this normally tends to expand in step with inflation, for the simple reason that government taxes and expenditures both tend to increase uniformly when prices speed up. Thus, starting from a situation with a positive deficit, the monetary base would tend to

[1] Inflation rates are measured by the IBGE broad consumer price index [IPCA]; public sector deficits are measured by the IMF concept of public sector borrowing requirements [PSBR] – the data for 1982 may not be comparable to that for 1atter years. It should also be noted that the PSBR ratio to GDP is an increasing function of the inflation ratio, for the simple reason that the numerator is calculated as the difference between successive year-end values of the non-financial public sector liabilities, most of which are continuously revalued according to observed inflation rates.

follow passively the difficulties of the inflation rate as determined by supply shocks and indexation practices.

Experience shows that in Brasil inflation shifts up in steps. A rough description of nearly twenty years of inflation is as follows. From 1968 to 1973, inflation stabilized at 20 per cent per year. Because of the first oi1 shock, inflation went up to 40 per cent in the 1974-79 period. The second oi1 shock, together with the December 1979 maxi devaluation, set a new inflationary plateau of 100 per cent per year in the 1980-82 period. Finally, the February 1983 maxi devaluation and a food supply shock made inflation shoot up to 200 per cent per year in the 1983-85 period.

With some oversimplification, the mechanics of this process can be described briefly. Indexation is widespread, but not perfect. Wages, in particular, are held down by the rule of 100 per cent backward indexation at fixed intervals (currently, wages are revised every six months according to the cost of living increases in the previous six months, with a two-month observation lag; at the month about 1/6 of the private sector wage bill is due for readjustment). Industrial prices respond immediately to domestic wage and import price pressures. The exchange rate is a crawling peg, which is devalued daily according to the current monthly inflation rate. These mini devaluations are at times superseded by a midi devaluation (as in the second quarter of 1985) or more rarely by a maxi devaluation (as in December 1979 and in February 1983). It is the 1agged wage adjustment, which makes inflation jump to a new plateau, rather than accelerate continuously, when an import price shock occurs, as caused by OPEC or a maxi devaluation.

Maxi devaluations are inflationary – but they work. Costs go up but the relative attractiveness of exporting or replacing imports increase. Industrialized Brazil reacts as expected, expanding exports and replacing imports. The trade balance improves at the cost of a higher inflationary plateau. This has been the experience of Brazil since the mid-sixties, as documented in the relevant econometric 1iterature. The conclusion is that inflation jumped from 100 to 200 per cent per year mostly because of the February 1983 maxi devaluation, which was forced on the government by the need to produce the mega-trade-balance-surpluses of the subsequent periods.

Consider secondly the question of Brazil's low fixed investment rate. The country is modern but not fully industrialized. Fixed investment requires complementary imports, which is not the case with consumption expenditures. When investment contracts, domestic demand falls, but not by as much as in response to consumption spending cuts. Part of the reduction in investment demand falls on capital goods imports. Hence, contracting investment is a more efficient way than cutting consumption to improve the trade balance, while protecting domestic output and employment levels. It is also politically easier to cut investment than consumption. Hence, it is no wonder that, in Brazil as elsewhere in Latin America, it was investment demand, which experienced the brunt of the adjustment in response to the foreign exchange scarcity of the early eighties. From 1982 to 1985,

(Brazil's Central Bank forecast), fixed investment tell from 21.2 to 14.4 per cent of GDP.

Consider finally the public sector deficit. There are many facets to it. Undoubtedly, the Brazilian government spends big and badly, as governments usually do, in the South as in the North. However, government spending as such has gone down significantly in the 1ast few years. In constant 1964 cruzeiros, federal government expenditures tell from 37.7 trillion in 1982 to 33.8 trillion in 1984. Excluding debt Service and transfers to states and municipalities, spending tell more sharply from 27.6 trillion in 1982 to 20.8 trillion in 1984. A similar picture is revealed for the federal State enterprises. Their total spending in 1984 cruzeiros fell from 90 trillion in 1982 87.5 trillion in 1984. Excluding debt service, the spending of state enterprises dropped from 82 to 77 trillion in the same period[2].

A uniform series unfortunately is not available on the fiscal expenditures, which appear on the so-called Monetary Budget (which is an aggregation of the accounts of the Central Bank and the Banco do Brasil). It is in this budget that most of the public sector debt Service, both domestic and foreign, is taken care of. The aggregate public sector borrowing requirements, as calculated by the IMF, will also not do, for an adequate separation between debt service and operating expenditures is not provided there. Hence, the following argument cannot be adequately documented at this point, but it is worth mentioning nonetheless.

For the past few years, the Brazilian government has been offering the private sector the opportunity to prepay its foreign debts through the deposit of an equivalent amount in cruzeiros to a special account at the Central Bank. Facilities at the Monetary Authorities also exist to provide domestic credit to private firms anxious to get rid of their foreign currency denominated debts. The propensity to use these facilities increased enormously after 1982, as the real devaluation of the cruzeiro significantly raised the cost of carrying foreign debt. Thus, foreign currency deposits in the Monetary Authorities were equal to the monetary base in December 1982: in the following period, the ratio between them changed markedly. During the second half on 1984, the foreign currency deposits in the Monetary Authorities became nearly three times as high as the monetary base.

As a private firm deposits in the Monetary Authorities the cruzeiro equivalent of its foreign debt, the Brazilian government loses the opportunity to finance itself through the inflation tax. In fact, the government exchanges with the private sector an interest-free cruzeiro liability for an interest paying dollar liability. When it extends cheaper domestic credit to replace private foreign debt, the government loses future revenue to .the tune of the negative interest differential involved in this financial intermediation operation. In both cases, the government budget is burdened by new expensive financial obligations, while increasing the net worth of the private sector. This socialization

[2] The figures are from Tables 1 and 2 in the First National Development Plan of the New Republic. Brasília: September 1985.

of private losses succeeded in maintaining mostly intact the financial health of the private sector in Brasil, but it was also responsible for a significant increase of the public sector deficit in 1983-85.

Thus, the February 1983 maxi devaluation hit the public sector not only because it already held the lion's share of the country's external debt, but also because it effectively nationalized a good chunk of the external debt of the private sector.

Finally, the suppression of the country's access to the international financial market was a case of too much too fast. In 1982, foreign savings represented 8.7 per cent of Brazil's GDP: two years afterwards, it was practically null. The government tried to adjust its spending, as we have seen. However, that was not nearly enough. In addition to the higher real cruzeiro cost of the foreign debt, taxes were eroded by the recession while public sector prices were being held down to avoid burdening private sector costs. Private sector employment also went down; consequently, the political pressure to expand public sector employment increased significantly. In the end, budget deficits failed to decrease as required, and could not be financed from abroad. Rather than throwing its not on the sea of international financial markets, the government was forced to go fishing on the small ponds of the domestic financial markets. Domestic interest rates soared, the private sector was crowded out, and an untenable financial situation became manifest, once the government proved unable towards the fourth quarter of 1984 to continue repressing public sector wages as a means of controlling its deficits.

In 1985, the federal government is estimated to be paying $12 billion of interest on its domestic and external debts. This is equal to one-half of its total tax intake. The fact that non-interest spending is not larger than the tax intake itself is of little help, except to ensure that the real value of the government non-monetary liabilities grow by no more than the real interest rate[3]. The seriousness of the federal government budget problem derives from the fact that currently real domestic interest rates hovers around 15-20 per cent per year. Hence, the growth rate of the government non-monetary liabilities is much higher than the anticipated GDP growth rates of the country.

3. The first PND/NR: outline of an economic strategy

It is in this critical content that the federal government has recently submitted to the Brazilian Congress the First National Development Plan of the New Republic (PND/NR). This document is very different from traditional planning documents in Latin America. It does not project public investment or give guidelines for private investment. Rather it is a plan for adjustment of the government accounts, and for a radical shift of government spending towards poverty eradication

[3] If the monetary liabilities do not grow at all, then the growth rate of the non-monetary liabilities will be exactly equal to the interest rate.

programs.

The plan starts from the presumption that, after years of import substitution under the aegis of public sector investment, Brazil's private sector is now strong enough to command a sustainable economic recovery, once three financial obstacles are dealt with, namely, the public sector deficit, the external debt, and the inflation rate. A close linkage between these three obstacles, along the lines of the previous section, is also recognized; hence, a simultaneous attack is proposed.

Formally, the plan deals with two basic identities, the government budget constraint and the balance of payments constraint. These two identities are projected into the future assuming a GDP growth rate of 6 per cent per year, which is 1 percentage point lower than the post-War II historical growth rate of the Brazilian economy. This is thought to be the minimum required growth rate to prevent underemployment from expanding[4].

Under most likely world scenarios and observed propensities to import, no major problems are anticipated in the external front. The balance of payments is maintained in equilibrium without the need of "new money" from the banks. Net external debt is expected to remain constant in nominal dollar terms, while trade surpluses in the order of $12 to $14 billion are generated in spite of an increasing import bill. This scenario presumes that a realistic exchange rate policy is maintained and that import Controls are not relaxed. In this context, the Plan is surprisingly mild in setting the government objectives for the renegotiation of the country's external debt. Besides a tightening up of domestic "relending" operations, the only novelty, *vis-a-vis* the recent Mexican deal, is the commitment not to cut the country's growth rate in case the world scenario turns out to be worse than projected. This means that the country's response to additional protectionism, world recession, or other external shocks will be a partial capitalization of interest payments rather than a reduction of needed imports.

Much more difficult is the situation in the domestic front. The plan reveals little about the government's strategy to deal with inflation, except to note that its eradication is linked to the elimination of the government budget deficit, and that inflation will not be fought at the cost of a reduction of the targeted 6 per cent GDP growth rate. The projections are made under the presumption that the inflation rate will be kept constant at its current plateau of 200 per cent per year. Monetary growth is also targeted at 200 per cent per year, hence maintaining the inflation tax at its current levels[5].

[4] Labor force growth is estimated to be 2.6 per year in the 1985-90 period. The population growth rate is 1ower than that – 2.07 per cent per year – and projected to fall to 1.67 percent per year towards the end of the century.

[5] This does not mean that government economists are convinced that inflation can be maintained at its current levels. In fact, the results of the 'heterodox shock' strategy to eradicate inflation now been implemented in Argentina is being followed very closely from Brasília; while an evaluation is also been made of tine political conditions for the implementation of a 'social pact', to deal with inflation through a new incomes policy. The tentative nature of these demarches explain why the Plan is so elliptic about the government anti-inflation strategy.

The government budget constraint is built up as follows. The monetary base grows *pari-passu* with inflation, while external debt is constant in nominal dollar terms, and the real growth of domestic debt is set equal to the exogenously imposed 6 per cent GDP growth rate. Under these circumstances, the Plan presumes that real domestic interest rates will settle down to 16 per cent per year. Social expenditures are another constraint in the government budget equation. In order to fulfil President Sarney's commitment to double their value, these are assumed to increase by 100 per cent in real terms in 1986 and to be kept constant at this higher level in the following years. Finally, non-social expenditures of the federal government and its state enterprises are kept constant at their 1986 levels throughout the period.

Under this basic scenario, balancing the budget will require a significant 'fiscal effort', both in 1986 and 1987. Tax and tariff rates would have to increase by some 8.4 in 1986 and a further 5.4 per cent in 1987. The Plan estimates this to be a fair deal, in view of the erosion of both the tax and the tariff rates particularly alter 1980. Rather than an increase of the tax intake, the objective of the 'fiscal effort' would be a redressing of the public sector losses in the last few years.

New foreign money would obviously reduce the size of this domestic fiscal effort. While allowing less stringent import controls to prevail. It could also contribute to bring domestic interest rates down, if used to reduce government indebtedness in domestic financial markets. However, these alternatives are only contemplated as background exercises for the Plan.

4. Perspectives

The Brazilian political calendar in the next few years is marked by a series of important direct elections. In November 1985, the mayors of al1 state capitals will be chosen. In November 1986, a Constitutional Assembly will be installed. In principle, a Presidential election will be held in November 1988. After years of political repression, more than twenty political parties are competing in these elections, including two communist parties[6].

Labor unions were repressed for more than twenty years. In their rebirth, a younger and more assertive leadership, while extending their influence from their traditional industrial enclaves towards the services and the public sector is increasingly dominating them. Wage demands include sizable front-end increases to compensate workers for years of alleged wage repression.

Agrarian reform was in the letter of the 1aw during the completely military regime, but it was never implemented. The commitment of the new civilian regime to this reform is marked by the creation of a new Ministry exclusively for this purpose.

[6] The precise date of the Presidential election will be determined by the Constitutional Assembly.

It is a new ball game for the richer classes in Brazil. In 1964, faced with apparently similar challenges they chose to support a conservative military coup. However, after 1974, they helped to promote a progressive opening-up of the military regime, and eventually strongly supported the shift-over to civilian rule, which occurred early this year. Landowners are obviously frightened, but urban entrepreneurs up to now are only contused. They realize that rapid social changes are needed. However, they are afraid of the new political realities and their possible radical consequences.

Democracy is a fragile construct in Brasil. Current economic problems considerably complicate the task of strengthening its foundations. In the short-run, the big challenges are the inflation and the public sector deficit. After a two-day national strike in early September, the unions in the banking sector won a sizable wage increase plus a disguised reduction of the wage readjustment interval from 6 to 3 months. Now the government will have a very hard time resisting the generalization of quarterly wage readjustments in the country. A new and higher inflationary plateau should result. The wage demands are also causing a very sizeable increase in the government wage bill, partially because of a series of concessions in the last few months of General Figueiredo’s administration. The conjunction of the practice of very high real interest rates with nearly frozen public sector prices in the first four months of the new administration al so contributed to the financial problems of the government.

Complications do not stop there. The ‘fiscal effort’ contemplated in the Plan is being strongly resisted by the private sector leadership which insist in additional government spending cuts to control the deficit. On the other side of the fence, the state bureaucracy is strongly lobbying against the secondary role reserved for them in the Development Plan, and insisting in the definition of a new block of public sector investments as a means of putting the economy back in the growth track.

Nonetheless, there is some hope in the horizon. All social groups seem convinced that military rule only led to authoritarianism and corruption. Today, contrary to what happened in 1964, dealing with the military is a problem not a solution for the Brazilian elite. Hence, there is a strong generalized commitment to democracy. Shor-term economic problems are serious, but the economy is fundamentally healthy. The industrial strength of the country is a reality; Brazilian agriculture has proven its price responsiveness repeatedly; the open spaces of the Amazon and of the West are only starting to be conquered. Growth is not a problem for the Brazilian economy. Even under current constraints, the country’s GDP should expand by nearly 6 per cent this year, and urban open unemployment has been falling for over a year.

The social question is harder to deal. Hundreds of years of social unbalance were temporarily repressed by the military regime. Dealing with the country’s social problems without radicalization will require stretching to its limits the historical capacity of Brazilians to negotiate in an orderly and peaceful way. Strong political leadership will be required.