TEXTO PARA DISCUSSÃO

Nº 238

BRASIL: MEDIUM-TERM DEVELOPMENT ISSUES

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revised version

January 1990

prepared for the
WIDER Seminar on Medium and Long Run Strategic Issues
to be held in Stockholm in April, 1990

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Abstract

This paper addresses the issue of the nature of a feasible growth path for the Brazilian economy for the nineties as well as the main obstacles in the way of the necessary policies. Drawing heavily on previous articles by both authors, the paper summarizes characteristics of feasible growth paths for the Brazilian economy, analyzes macro policy problems and presents some sectoral implications. Finally, the political economy of adjustment to a new growth path is examined.

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Resumo

Este trabalho examina as implicações de trajetórias factíveis de crescimento para a economia brasileira para os anos noventa, bem como alguns obstáculos que se interpõem no caminho das políticas necessárias para a retomada do crescimento. A partir de argumentos analíticos desenvolvidos em trabalho anterior dos autores, as características das trajetórias factíveis são analisadas, bem como as políticas macroeconômicas. Implicações setoriais e a economia política do ajustamento da economia à nova trajetória são examinadas.

Outline

0. Introduction

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Introduction

On November 15th, 1989, Brazilians commemorated the first centennial of the country's republican system, established 67 years after its independence. Were it not for the fact that at the same day more than 80 million voters have started the election of a new president, in the first democratic presidential election since 1960, there would be hardly an occasion to celebrate. The Brazilian economy has been facing in the end of the eighties the longest crisis of its development process. In spite of successful re-democratization, economic stagnation, high inflation and a critical level of uncertainty has led to a very low rate of investment and to a self-fulfilling pessimism concerning economic prospects. The present state of disarray in economic relations, as well as the deep unbalances which have helped to brew the present crisis, leave no option to the new president but to launch a frontal attack on the country's main sources of disequilibria, if there is any hope for a successful recovery for the economy's growth proneness.

From 1940 to 1980, Brazil sustained an average annual growth rate above 7%. This performance was achieved in spite of serious economic and political difficulties which were often faced by the country during those four decades. Expansion was not only fast, but remarkably steady. Only in six of the forty years the growth rate was below 4%: 1942,

1947, 1956 and 1963-65. And in only one year (1942) there was a fall in aggregate output. Real GDP increased by a factor of fifteen in forty years, meaning an increase of five times in per capita output, since population has practically trebled in the same period. In 1988 dollars, per capita income grew from US$ 490 to US$ 2,450 during these forty years.

These facts allow a proper perspective of the extent and consequences of the slowing down of economic growth in the eighties.[1] In the 1981-89 period the average annual growth rate of the GDP fell to approximately 2.3%. In five of the nine years expansion was below 4 percent, and in two of them (1981 and 1983) there were significant falls in GDP. As the average population growth rate was slightly above 2.2% yearly during the period, there was practically no growth in per capita GDP, that remains around US$ 2500. In fact, the evolution of per capita output was highly unstable. Only in 1987 it reached again the 1980 level, after an accumulated 13,1% fall in the 1981-83 recession.

Had the historical trend of the previous forty years prevailed throughout the eighties, the value of Brazilian GDP at the century's end would correspond to around US$ 1 trillion, or an equivalent to one fourth the size of the US economy today, and a level of per capita income equivalent to the poorest countries of the European Community today.

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1 The analysis below is based on Werneck [1988].

One cannot argue that growth could have been maintained notwithstanding all the difficulties -- the external ones in particular -- faced by the Brazilian economy in the early eighties. But from a long run perspective, this period may be seen as a costly interruption in the growth project of the Brazilian economy. An interruption that will have cost an estimated 40% of the per capita income before it is over. For a poor country which has not been able to solve its inhabitants' most elementary needs such as food, health, education and housing, the social dimensions of this lost decade are even more dramatic than the idea of richness forgone.

This paper addresses the issue of the nature of a feasible growth path for the Brazilian economy for the next five to ten years and the main obstacles in the way of the necessary policies. It is divided into three main sections, following this introduction. The first one covers general background issues. The second one analyzes macro policy problems and some sectoral implications. The third section examines the political economy of adjustment to a new growth path.

Drawing heavily on previous articles by both authors, the paper summarizes findings and opinions which have as a rule been developed or, at least, more extensively expressed,

elsewhere. It also advances some ideas to be further explored in additional work, trying to call attention to unsettled issues for future research.

1.1 The state and the public sector in the Brazilian crisis

It is useful to have a broad perspective on what happened to the public sector from the early seventies to the mid-eighties, a period during which the Brazilian economy has been submitted to a series of important external shocks. That helps to perceive the overall adjustment patterns followed by the public sector in response to the external difficulties and domestic pressures faced by the Brazilian economy along the period.[2]

During the growth-cum-debt period of the seventies, the public sector adjustment was characterized by two different trends that were obviously inconsistent in the long run. On one hand, the huge import-substituting and export promoting program, that constituted the core of the long-run strategy of adjustment of the Brazilian economy to the oil shocks, imposed on the public sector a sizable and central part in the required investment effort. On the other hand,

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2 See Werneck [1987b] for a detailed analysis of the public sector behavior in the period.

despite those enhanced commitments, public sector's share in aggregate income shrank significantly along the seventies. That latter trend stemmed from the falling gross tax burden, the rising transfer and subsidies to the private sector, and the decreasing real prices and tariffs charged for the goods and services produced by public enterprises.

Though untenable in the long-run, the coexistence of those two trends played important roles in the designed adjustment strategy. That strategy meant a maximization of the economy's annual growth rate, although it implied growth well above the rate consistent with an equilibrium in the balance of payment's current account in the medium run. Public sector's increasing borrowing requirements constituted a secure way to assure the steady flow of foreign loans that was required to finance the external accounts deficit. The maintenance of the high investment self-financing capacity that public enterprises displayed in the early seventies, would mean having to rely more extensively on the nervous and risk averting private sector's investment behavior, to accomplish the increasingly difficult foreign capital flow targets.

In other words, the implicit logic of the adopted economic policy was the following. As public enterprises had such an easy access to badly needed foreign loans to finance their investments, there seemed to be no problem in reducing

their self-financing capacity. Actually, it would induce them to resort to debt in order to carry on the investment plans. There was therefore room to let their real prices and tariffs to be somewhat eroded, what would be particularly convenient since it would avoid unnecessary pressures on the worrisome evolution of inflation.[3]

The reduction in the net tax burden and in public enterprises' real prices and tariffs allowed the burden of the adjustment to fall upon the public sector, and to delay therefore the required adjustment on the part of the private sector. But within the public sector the response to the shrinking share in aggregate income was the virtual disappearance of the important role the public sector had been playing as a saver. As there was no offsetting enhancement of private savings, the adjustment meant substituting foreign savings for domestic savings without any fall in consumption.[4]

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3 In fact, in the mid-seventies public enterprises were forbidden to resort to new equity capital from minority private shareholders and forced to limit their borrowing in the domestic financial markets, in order to induce them to resort to foreign loans. There is no room in the Brazilian case to ascribe the explosive behaviour of the foreign debt to a liberalization of borrowing restrictions imposed on public enterprises and agencies, that would have lead to unwanted indebtedness from the point of view of the central government. Strict control on foreign exchange and external credit operations were maintained throughout the period under analysis in this paper. Foreign borrowing targets were explicitly established by government and their accomplishment carefully surveyed month after month by the Central Bank.

4 See Werneck [1986] for a more complete analysis of this point.

As interest payments on the, predominantly public, foreign debt soared in the wake of higher international interest rates after 1979, there was still no effort to recover the public sector's share in aggregate income in order to accommodate the mounting expenditures. Avoiding a rise in taxes and fearing the inflationary impact of a correction in public enterprises' real prices and tariffs, the government simply resorted to increasing foreign and domestic indebtedness.

With the further acceleration of inflation following the inconsistent macroeconomic policies of 1979-80, the government decided to adopt a stricter monetary policy in 1981, without any support either from a consistent fiscal policy or from an IMF program.[5] The resulting rise in domestic public debt and the pressure on interest rates in the domestic financial markets contributed to increase the transfers of resources from the public to the private sector over the eighties. Furthermore, when the external debt crisis came in 1982 there was an effort to bail out private sector's borrowers through arrangements that permitted the abortion of foreign exchange risks by the Central Bank, aggravating public sector's financial strains.

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[5] See Carneiro [1987] for a description of stabilization and adjustment programmes of the early eighties.

The concentration of the adjustment burden on the public sector, revealed by its shrinking share in aggregate income, and the consequent disappearance of its savings capacity poses important questions on the ability of the Brazilian economy to sustain again the high average historical growth rate it was able to maintain from 1940 to 1980. That would involve a significant enhancement of the present low domestic saving effort, what could hardly be obtained without re-establishing the importance of public sector's savings.[6]

1.2 The behavior of the economy in a medium term perspective; initial conditions in early 1990

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[6] The design of a policy that could effectively generate the required enhancement of the domestic savings effort in Brazil involves some important trade-offs that are analysed in Werneck [1987a], through simulations based on two simple consistency models. Those simulations outline what would be the required increase in the private sector's saving effort in different scenarios, that involve distinct sets of hypotheses on the evolution of income distribution and of variables that determine the public-sector's savings capacity. The results stress the lack of realism of savings policies that do not restore the importance of public sector's savings, which used to represent - in the mid seventies - one third of total domestic savings in Brazil. The need to restore the importance of public sector savings becomes particularly clear when one considers scenarios involving even a modest -- and highly probable -- redistribution of income in favour of labour in the near future, and takes into account the consequent impact on the private savings ratio.

In the five years of the Sarney government, five different anti-inflation policies -- including three frustrated heterodox trials -- exhausted government's credibility in the final months of the present administration. Lack of confidence in the official indexation mechanism opens space for a profound uncertainty concerning future policies. Volatile speculative markets reflect uncertainty with respect to the continuity of the financial rules. Since December 1989 the monthly inflation rate has topped 50%. The exchange rate in the parallel market has been above twice its value in the official market.

The trade surplus reached more than US$ 16 billion in 1989, but the monthly surpluses have been following in the wake of a sizable valorization of the exchange rate, which is expected to be significantly devalued as soon as the new federal administration takes office in March. However, uncertainty with respect to the developments concerning the external debt negotiation, as well as the possibilities of either an internal moratorium on the government's domestic debt or a sudden de-indexation of the economy, are the main reasons behind the demand for dollars as a safe financial asset. The menace of open hyperinflation is the main determinant of both financial asset-holders' portfolio behavior and government short run policy.

The present administration's announced intention has been to follow an inflation control strategy, without

resorting to either further heterodox measures or even any sharp policy discontinuity that could resemble a shock. Given the practical impossibility of a fiscal shock before March, the uselessness of a credit crunch when firms are flooded with liquidity and the ineffectiveness of a monetary shock without matching policies to curtail government's borrowing requirements, the announcement means in practical terms that an attempt will be made to keep nominal interest rate paid to overnight holders of government debt three to four percentage points above the monthly rate of inflation.

It is hoped that this should be enough to exorcise the ghosts of an internal moratorium which was feared might spark hyperinflation. This is not, however, the only thing that could initiate an unbound acceleration in the monthly rate of inflation. Other possibilities include: a speculative move in the parallel exchange market started by a sudden deterioration of the country's external position, the menace of a new price freeze with the elimination of indexation, the government's own instability leading, for example, to a resignation of the economic staff.

The precarious nature of the present situation derives not only from the above mentioned factors, but also from the fact that the high rate of inflation which resulted from the last policy shock in January 1989 is untenable in the medium run: it is too high to be "stabilized" and it necessarily

entails tremendous shifts in relative prices and ensuing income transfers. The perception that some important prices are "lagging" behind, and therefore will be soon raised above past inflation, as well as widespread speculative demand behavior, help to maintain a general climate of defensive price increases and aggravate the picture of an inevitable hyperinflation.

The government had been able to show some marginally favorable fiscal policy data in the third quarter of 1989. And this helped to temporarily revert expectations of an imminent explosion of the monthly rate, but needless to say, was far from sufficient to remove hyperinflation from the horizon in the Brazilian economy. Nevertheless, figures from fiscal deficits suggest that the budget has again increased its pressure over the Central Bank in the last months.

The fast acceleration of inflation has fuelled widespread anticipation of consumption and stock piling, notwithstanding government's attempts at keeping real interest rates high. As a result GDP expansion in 1989 was more than 4%, according to early estimates. The very high recent level of activity is evidenced by the fact that unemployment figures are the lowest ever recorded. The upsurge in economic activity and stock piling has led to a strong increase in imports, which partly explains the recent fall in the monthly trade surplus figures.

The agreement concerning external debt payments signed last year came to a standstill in the last months due to the failure of the banks and the multilateral institutions to fulfill its commitments to refinance part of the interest bill for the current year. The reason was the deterioration of the domestic situation, especially the fiscal deficit, relatively to what had been estimated by the Fund mission in 1988. In view of the failure of the "Summer Plan" -- a combination of a freeze, de-indexation and high nominal interest rates -- the government could not pass legislation conducive to a smaller deficit and, on top of it, had to face the increasing burden of the interest bill on the domestic public debt.

In view of the difficulties to reach a satisfactory agreement with the IMF, that would be essential for the normalization of the relations with private banks, it is estimated that in March as much as US$ 7 billion in debt service will not have been paid, since the government will hold on to its goal of leaving reasonably comfortable foreign reserves, as its contribution to the next government's negotiating position. As reserves are expected to also reach approximately US$ 7 billion in March, they would have been completely depleted if debt service were not suspended.

1.3 Medium-term prospects and problems

Less than two months before the new president takes office it is still not possible to draw a clear picture for the medium term prospects. In view of the high and paralyzing inflation, the new administration will have to start with a very drastic stabilization plan. The most desirable path would use rhetoric of fiscal reform, associated with inflation control, to refurbish the public budget and increase governments' savings in order to open room for a sustained growth path. Details of different types of fiscal adjustment are discussed in section 2 below.

There are two equally likely deviations from such path: the first one could result either from populist premature re-heating of demand or from sheer impossibility to negotiate a thorough reform with Congress. In this scenario, a return to generalized indexation with a high monthly rate of inflation could mean a continuation of the stop-an-go policies which prevailed before the Cruzado first attempt, with low economic growth. The second one, either in view of the difficulties to increase public savings or out of ideological option would try to implement liberalizing reforms aimed at reducing the role of the state lowering import tariffs. After a possibly long stabilization crisis, the effective growth possibilities would depend drastically on the cooperation of bankers and multilateral institutions

in the first moves, as well as on the willingness of foreign investors to finance a possibly long period of high current account deficits.

2. Macroeconomic Issues

2.1 External, savings and fiscal constraints

This section summarizes and comments the main conclusions of Carneiro and Werneck [1990]. The model used in that paper was aimed at assessing the importance of public investment under the assumptions of complementarity of public and private investment, as well as of sensitivity of private investment to capacity utilization. It is supposed that the issue of a sustainable level of capacity utilization is likely to rank high in the next years after the failures of the three heterodox attempts at stopping inflation in Brazil. If this is true, short run changes in capacity utilization which may derive from the need to keep prices and mark-ups under control are bound to have lasting influence on the country's level of investment.

The link between short and long-run is thus supposed to be a crucial one in the present juncture: the long run effects of short run macro policies are transmitted in the form of the level of capacity utilization which is judged to be sustainable in the long run, as a result of inflation control policies.

In the basic scenario, the public sector borrowing requirement and the current account deficit in the balance of payments were both made equal to zero, in order to provide a benchmark for simulations. The former represents no increase in the domestic public debt after years of uncertainty on the willingness of the private sector to hold more public debt. Making the latter equal to zero represents independence from external sources of savings in the aftermath of the external debt crisis.

Under this basic scenario the saving and the foreign exchange constraints jointly determine a maximum feasible growth rate -- approximately 3.1%, well below the historical 7% average annual rate observed in the period 1940-80. In such a scenario the possibility of keeping a higher current deficit in the balance of payments would have little effect on long term growth. A steady flow of foreign finance of US$ 3.5 billion per year in the first year and 1% of GDP thereafter would turn the foreign exchange constraint non binding. The resulting shift in the saving constraint could allow a maximum growth rate of 3.5%, but only at the cost of keeping the capacity utilization rate very close to 100%. That could mean, in practice, a more overheated economy than might be advisable from the viewpoint of inflation control, illustrating the connection between short run limitations to long run performance.

Growth rates higher than 3.5% would only become feasible through policies that improve the fiscal and saving constraints. If a current account deficit of 1% of GDP is feasible, growth would be limited by savings for levels of capacity utilization above 90%. Higher fiscal deficits under these conditions would not increase growth possibilities. This means that policies are required to improve jointly the saving and fiscal constraints. A strong fiscal adjustment may be an important instrument to shift upward in a significant way these two constraints.

One interesting result of the exercise was that the pattern of fiscal adjustment is of great importance, since the adjustment is needed, not so much as a way to open room in the fiscal budget for more public investment, but also to turn the global saving constraint less severe. Two additional experiments were made to illustrate the issue. With no external finance, an increase in public savings by 3% of GDP allows that similar growth rates to that of the basic scenario be attained with lower capacity utilization. But it has been found out that there is little point in increasing public savings if the overall investment cannot respond, for example, because private savings are not forthcoming. In such an experiment, the fiscal adjustment turns out to be an overkill, since the fiscal constraint became non-binding and practically no additional growth is possible, for lack of savings.

There is thus no point in increasing the investment financing capacity of the public sector if the overall investment financing capacity of the economy remains binding. The overkill may be eliminated if the fiscal adjustment is combined with the assumption of an offsetting negative PSBR. This could be achieved, for example, by an increase in the net tax rate not matched by a simultaneous equivalent rise in public expenditure, so as to allow the public sector to finance part of private investment, thereby increasing the economy's total investment capacity. In this case, the adjustment acts basically upon the saving constraint, avoiding an impact on the fiscal one that would be unavailing from the viewpoint of faster growth.

To make relatively high growth rates possible, and to avoid the need of maintaining high, potentially unstable, levels of capacity utilization, one must combine a vigorous fiscal adjustment with high net financial transfers from the public to the private sector, and a move to a more favorable external constraint. A scenario that was considered involved a fiscal adjustment of 6.8% of GDP and a fiscal surplus (-d) of 6.5% of GDP (in order to supplement private voluntary savings). Most of the fiscal adjustment (6%) would stem from an increase in fiscal effort. The remainder would be generated by a 40% cutback in interest payments on the public-sector's foreign debt, that would also contribute to

turn the external constraint significantly less adverse. In this scenario a growth rate of approximately 5% could be attainable.

2.2 Other constraints: sectoral implications

Even after macroeconomic policies have been correctly directed towards the removal of growth constraints, there remain several issues pertaining the sectoral breakdown of economic growth. Without going into detail, at least two important issues may be mentioned: the first one is the role of agriculture and the implications for "new dynamic sectors", which hinges in a special way on the role of the state in the next phase of economic growth. The second one relates to the possibilities and consequences of further deepening of capital goods import substitution which was started in the late seventies.

Agriculture has never been given a leading role in the post war industrialization experience. The average growth rate of the rural sector has kept around 4% in every phase of the past forty years. Deviations from trend growth were essentially explained by the years of unfavorable climatic developments such as droughts or floods.

In the seventies, substantial resources were committed to agricultural research and experimentation designed

essentially to develop and adapt new varieties to specific regional conditions. As result of a continuous effort, in the eighties a substantial increase in agricultural output has been achieved especially through the expansion of the agricultural frontiers in the direction of the cerrado area, which occupies about one third of the Brazilian territory, but considered to be land of bad quality until the sixties.

As a fortunate combination of this expansion of the agricultural frontier, as well as the progress made in adapting new varieties to the soil and climatic conditions of the new lands, with a cycle of favorable weather, the grain crop has grown above its trend rate for the past four years, with successive records of production both in export and in crops for the domestic markets. Specialists tend to point to a new era of agricultural growth and underline the role played by domestic price policies as well as by favorable stimulus from the international market.

Two important implications from the new developments in the agricultural sector may be derived for the assessment of growth constraints for the coming years. The first one has to do with the pressure for improvement in the transportation and storage facilities brought about by the simple fact that the new production areas may be located three to four thousand kilometers from the nearest port. A necessary condition to maintain competitive prices at the port is of

course a total refurbishing of the transportation network connecting the new production areas to the export outlets.

The second issue relates to the sectoral implications of the agricultural boom. There are issues pertaining to the natural inducement to the manufacturing sectors, such as the transportation equipment, agricultural machinery and storage and refrigerating equipment, for example, and the issues belonging to the new migration flows toward the new areas, as well as to middle-sized prosperous new towns with their demands for the comforts of modern life, in clear contrast with the concentrating nature of the two recent industrialization experiences of the fifties and the seventies. In fact, it is hard to see import substitution playing again the role it has played in the two previous experiences. Yet, the identification of the new dynamic sectors is important for the assessment of the relevance of the external constraint.

As seen in Carneiro and Werneck [1990], the impact of additional investment on the demand for imported capital goods is also likely to be an important parameter to be considered in the evaluation of the external constraint to the economic growth of the Brazilian economy in the nineties. In the model used for the exercises, the share of imported capital goods in total investment was made to depend on the investment ratio. The higher the investment ratio, the higher

the marginal importance of capital goods imports in total investment. A parameter (gammal) was defined to measure the response of the share of imported capital goods to total investment.

It was remarked that this response depends on the investment pattern that will prevail in the nineties and may reflect the effect of import-substitution policies in the capital-goods industry. The degree of success of the last round of such policies implemented in the second half of the seventies are hard to evaluate at this point, due to the fall in the rate of investment following the stabilization crisis in 1982-83. In the first half of the seventies, typical figures for the share of imports in total machinery and equipment outlays were above 20%, and this figure declines to 13,2% in 1980 and to only 9% in 1982. As a fraction of total fixed investment, imported capital goods declined from 10% in 1973 to 5.4% in 1980 and to 3.4% in 1982.

In the model used for the growth exercises, (gammal) was taken as 0.15, meaning that an increase of 1% of GDP in the rate of investment leads to an increase in the imports of capital goods of 0.15% of GDP. Between 1973 and 1975, the observed value for (gammal) was 0.125 and between 1980 and 1982 the figure was 0.14.

It is likely that the effectiveness of the external constraint to economic growth will change substantially with

the expected role to be played by imported capital goods in total investment. But on the other hand, further import substitution in the capital goods industry may lead to an increase in the value of the incremental capital-output ratio -- and that would be detrimental to growth. Although the latter effect was not considered in the simulations exercises, new data on investment in the past years suggest that a substantial increase in the relative price of capital goods -- as reflected in the difference between the rate of investment figures at constant and current prices -- may be indicating a declining productivity of investment.

The sensitivity of the growth exercise results to the parameter (gamma1) has been tested in the mentioned paper. When (gamma1) is supposed to be equal to 0.15, an increase in the feasible current account deficit equivalent to 1% of the GDP would raise by 1.9 percentage points the maximum feasible growth rate, from the viewpoint of the foreign exchange constraint. If, instead, (gamma1) is supposed to be equal to 0.1, the same increase in the feasible current account deficit would raise by 2.9% the externally- constrained growth rate.

Nevertheless, those results probably constitute an illusive justification for deepening import substitution of capital goods. It has to be born in mind that a decline in the dependence from imported capital goods may also lead to a

lower productivity of investment -- in the form of a higher incremental capital-output ratio -- an effect which the model does not capture, but that may be quite substantial.

2.3 Possibilities for the state to control economic change

Given the aggregate constraints, as well as the sectoral unfolding of the challenges of a new growth strategy for the Brazilian economy, a natural question which has been raised in the recent years is to what extent the public sector will be able to perform a role similar to its historical record in this new growth strategy.

The weakening of the state's power of initiative in Brazil has two identifiable and interdependent reasons: the public sector financial crisis and loss of political grip on economic strategic issues. For lack of sound financial basis, as well as convincing long term projects, the Brazilian state has lost along the eighties a good deal of the legitimacy of its power of intervention in economic matters. In the past, free market ideas have not been popular in the country even at the early times of the military government, in spite of the official liberal rhetoric. However, they have recently become widespread among politicians and present even in the self-spoken leftist intellectuals' program in the late eighties, after the failure of the New Republic transient regime to produce a credible growth strategy.

The difficulties of the 1985-89 period tend to project into the nineties since the public sector financial crisis and the hyperinflationary menace undermine the credibility of any plan based on official sources of finance without a convincing fiscal reform. From the viewpoint of growth strategy, the fiscal reform is a way to dismantle the plethora of fiscal exemptions, tax expenditures, cheap inputs and special credit facilities which had been enhanced after the first oil shock, as part of the effort to mobilize private investors towards the top priority sectors of the II National Development Plan.

An estimated 3 to 4% of GDP in government expenditures or forgone revenue has been transferred each year to the private sector during the eighties. If a reform of the tax system manages to give this share of income back to the federal government, a substantial increase in government savings will be available to support a new investment effort.

In the previous growth experience, government financial capability was used to cement the solidarity between state enterprises, representing the modern face of the government, and a host of new entrepreneurs which accepted the challenge to invest in capital and intermediate-goods producing sectors, as part of the effort at import substitution and export expansion. The system implied the

choice of selected capitalists which were eligible to receive substantial transfers from the Treasury. In return, the level of direct bureaucratic controls over imports, prices and exports permits has probably never been so high and widespread in the Brazilian economy.

More recently, the result of the obsolescence of incentives coupled with the bankruptcy of the state gives rise to an ever increasing claim for less state intervention and more reliance on market forces, with scarcely any support to the view that there is considerable less room for the state in the next stage of economic growth.

A competing view with the apparently dominant stance that less government intervention is essential for the new growth experience of the nineties may be offered by arguing that: [1] after the present state of high uncertainty, the role of the state in warranting the feasibility of the new growth path is bound to be crucial; [2] as in other moments of Brazilian economic history, the infrastructure sectors [transport, energy, communications, water supply, etc.] are once again those which will have to be given special attention, since the past five years have witnessed a visible deterioration of public utilities in the country. This is in strong contrast with what constitutes a new main stream view, which tend to see the issues of deregulation, privatization and import liberalization as the key issues for the new development strategy.

The pace and the limits of privatization in Brazil will be shaped by strict economic constraints, which are bound to impose difficulties quite different from those that stem from vested interests and political opposition. Privatization represents a structural change that has to be justified in terms of long run policy objectives.[7] The central long-run problem of the Brazilian economy today is the resumption of economic growth. The effective advancement of privatization in Brazil will be determined by the extent to which it may foster or hinder the resumption and maintenance of rapid economic growth.

It is certainly true that, as part of a more general effort to reform and modernize the public sector and to enhance economic efficiency, privatization may have a significant contribution to make to the resumption of economic growth.[8] But the Brazilian economy will not be able to maintain again the high average annual growth rate of the past without a sizable increase in its present investment ratio. And this poses important questions about the economy's ability to finance the required additional investment effort and about whether privatization may make that financement easier or more difficult.

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7 For a deeper analysis of the privatization issue in Brazil see Werneck [1989a].

8 See Bacha and Werneck [1988] for a brief discussion on the urgent need for a drastic public sector reform in Brazil.

The case for privatization in Brazil has been partly made in terms of the positive effects it could have on investment financing, particularly in those sectors that have been controlled by public enterprises. It has been argued that, given the serious financial difficulties that have been faced by the public sector, the transfer of capital-intensive public enterprises to the financially unconstrained private sector would be the natural way to increase the much needed investment in those enterprises, and to raise aggregate investment. The problem with this kind of argument is that it lacks macroeconomic consistency. There is an aggregate savings constraint to be faced. Shifting the investment responsibility from the public to the private sector will not lead to a higher sustainable overall investment ratio, unless aggregate savings are increased accordingly.

Discussion on the financial absorptive capacity of the private sector in privatization programs has usually centered on stocks, as opposed to flows, on whether the private sector would be able to buy the transferred assets and pay what they are worth. There is no doubt about the relevance of such discussion, but it is at least as important to discuss also the privatized enterprises' financial ability to maintain the required investment effort in the sectors they operate. In very capital intensive sectors, such as electricity, telecommunications and railroads, even the largest Brazilian

groups would face serious difficulties in maintaining the required investment effort. Of course, the expansion could be extensively financed by the state, as has been done in the past in many sectors, but in this case the privatization argument would naturally become much less forceful. Furthermore, the large-scale chanelling of required public funds into private enterprises may also pose difficulties, already observed in the past, if giveaways are to be avoided and the private character of the enterprise preserved.[9]

Actually, the need to avoid giveaways of public funds and assets may prove to be a strong impediment to the asset transfers in the first place. Significant giveaways were possible in the seventies, under the military government. But obvious distributional equity considerations would tend to make them much more difficult in the very different political circumstances of today. But if giveaways are to be avoided, even top public officials directly involved in the Brazilian privatization program acknowledge that it would be difficult to sell the control of most of the largest public enterprises.

The ability of the private sector to absorb the assets to be transferred, as well as to maintain the required

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9 Such difficulties were faced during the seventies in many sectors. Very often there was either resort to large giveaways of public funds or the firms fell under state control. See Werneck [1987b] and Najberg [1989].

investment effort in the privatized sectors, will in some measure depend on the role allowed to foreign investors. Speculation about this raises difficult questions as to the relative power of the nationalist coalition within Congress.

3. Political Economy

3.1 Difficulties of the recovery of historical rates

The long transition of the eighties has led to a growing sentiment of discredit on the growth possibilities for the Brazilian economy. Its less radical aspect is translated in the form of a belief that the historical rate of 7% is no longer attainable on a sustainable basis, and therefore that one should settle for a lower feasible rate. This may be turned into a gloomier prospect if one believes that absorption of the new additions to the work force (still expanding at approximately 3.5% yearly, despite the sharp fall in population growth) will require, at the previous rates of job creation, an economic growth close to the historical rate during the next decade.[10]

There seems to be no evidence that recovery of the historical rate of economic growth has become unfeasible. But there are several important obstacles to such recovery. The first one is the political difficulty in gathering support to

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[10] Of course such estimates reflect the past growth experience. Very little is known on the pattern of job creation of the recent growth in services and the new agriculture regions and their supporting sectors.

condition is that the visible deterioration of public services has evidenced the inefficiency of the public sector in some specific sectors, creating opposition to increases in the net tax rate.[12] Another aspect is a widespread corporatist action in some segments of the public establishment, which helps to generate political obstacles to any increase in transfer of command over resources to the government. Finally, years of half-hearted budget control measures have not managed to control public deficit, but to undermine the funding of several important functions of the public sector from education to health services, as well as to deteriorate the credibility of budgeting techniques and expenditure control practices. Systematic underestimation of inflation has been turned into a device to increase centralized control over effective disbursements, as actual disbursements have to be negotiated every quarter when allocated expenditures become obsolete due to inflation. Such practices contribute to further demoralize attempts at budget control and fiscal adjustment efforts.

3.3 Difficulties of an effective anti-inflation policy

Two types of challenges have to be faced by an effective anti-inflation policy. The first one relates to the above mentioned costs involved in stabilization after the repeated frustration associated with the stabilization attempts of the past five years. The second one is due to the long tradition of inflation, which has contributed to

establish a view (dominant among politicians as well as specialized analysts, who contribute to form the public opinion) that inflation is "part of the culture", a "necessary lubricant" to structural changes or even "beneficial to development". This view seems to be so embedded in some people's mind that the natural consequence is to see as ridiculous any program to bring inflation down to European, say, levels. Politicians and practical men tend to have very modest goals regarding inflation. Therefore, it is very difficult to form a political coalition to support anti-inflation policy.

On top of these, the fact that heterodox promises of putting an end to inflation with small social cost in terms of recession had led to great frustration in Brazil should have unfavorable effect upon economic agents' expectations following the announcement of any new policy shock. Costs of stabilization are perceived now to be inevitably higher than four years ago.[13]

3.4 Political stability and medium-term growth

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12 See Bacha and Werneck [1988].

13 This point is further developed in Carneiro [1989].

What will happen if growth and stability are not attained reasonably soon? It has been a whole long decade of very slow growth and macroeconomic disarray. There is room to believe that if the new President, elected in late 1989, fails in his attempt to put the country back on the road to sustainable and fairly rapid growth, a scenario of much higher political and social tension will probably become unavoidable. After all, the labor force is still growing very fast -- and that is expected to last till at least the end of the century -- despite the recent surprisingly sharp fall in population growth. Latent social unrest in the country's large metropolitan areas is evidenced by the rise in the importance of informal jobs and criminality during the decade, in the wake of a general decay in the quality of urban services due to the financial crisis of the public sector, in all spheres of government. If demand for labor does not start to grow steadily in the beginning of the next decade, and if urban life quality -- and the supply of basic services as elementary school, health care, police protection and mass transport -- cannot be improved in a significant way, there may be extensive grounds for social and political unrest.

If that is accepted, the relevant question is how this unrest will feed back in the political sphere. One possible, more optimistic scenario, would foresee the growing concern

with the building up of social unrest turning it less difficult to build up a majority coalition that could implement the needed adjustment measures. For example, reducing the pervading fierce resistance to any loss that could stem from an effective fiscal adjustment. Another, more pessimistic scenario would mean that democratic rule has failed to generate political support for reasonable economic policies in Brazil.

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