

# The BRAZILIAN ECONOMY



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The crisis, which originated in the US, has spread around the world and will bring about a deterioration of public finances. In Brazil, the first casualty in this new scenario will be the primary surplus, which is likely to fall below the target of 3.8% of GDP. The real achievements of the fiscal policy of the Lula administration in 2008 are unfortunately too limited to create a solid base from which to address a much deteriorated situation in 2009. It was relatively easy to succeed last year as revenues grew along with healthy economic growth. Seen in perspective, though, that progress was less impressive than was desirable. Today, in 2009, the risk of failure has increased enormously.

#### Interview

Walter Russel Mead, one of the leading interpreters of United States foreign policy, claims that, since the end of the Cold War, the USA have been much less apprehensive about Latin American security. There is far less U.S. security concern about Latin America, so the U.S. is much less pressed to influence political developments in Latin America except for very specific issues, such as drug trafficking and terrorist connections. In this context, according to Mead, Brazil has a crucial role to play: Brazil can serve as a center for development and political stability in Latin America. "If Brazil cannot effectively lead Latin America, no one can," he stresses.

##### External crisis and public spending reform – Raul Velloso

The global crisis will bring about an accelerated and expressive reversal of the global financial bonanza in 2002–2008 that produced such positive effects on the Brazilian economy in recent years. At present, the major effect of the crisis is the severe scarcity of foreign currency as a consequence of the halt in foreign capital flows and the plunge in commodity exports due to the significant drop in their international prices. The global crisis will likely bring about a slowdown in GDP growth and a drop in the primary surplus, with serious consequences for the solvency of the Brazilian public sector.

##### Homework in turbulent times – Paulo Skaf

Brazil's highest priority in 2009 is to ensure GDP growth in a scenario of global slowdown. The measures announced by the government are welcome and timely, especially flexibility regarding bank reserve requirements, tax reductions for the automotive industry, and increased public investment. Such measures, however, are bound to stumble upon structural problems that can hold back the country's response to the crisis. Among the structural problems, the most severe is the flawed culture of public spending. The budget is a bloated aggregate of expenditures resulting from several decades of mistakes, which remains a huge burden for taxpayers and is ineffective in such key areas as health, education, safety, and infrastructure modernization.



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Walter Mead, one of the leading interpreters of U.S. foreign policy, in an exclusive interview with *The Brazilian Economy* claims that, since the end of the Cold War, the USA have been much less apprehensive about Latin American security. Thus, because it has far less security concerns about Latin America, the U.S. is much less pressed to influence political developments in Latin America except for very specific issues, such as drug trafficking and terrorist connections. According to Mead, then, Brazil can serve as a center for development and political stability in Latin America: “If Brazil cannot effectively lead Latin America, no one can,” he stresses.

Almost 10 years after coming into force, the Fiscal Responsibility Law has led to significant fiscal improvement, including renegotiation of state debt and an extensive financial restructuring program; on the other hand, the main characteristic of the fiscal adjustment has been an increase in tax revenues. Expenditure control has clearly been unable to bring about efficient management of the public finances, considering that the increasing primary surpluses have relied critically on a steady increase in the tax burden.

In this current crisis the best alternative for Brazil would be to cut the public deficit and substantially reduce interest rates — in other words, to combine a tight fiscal policy with an expansionary monetary policy. In the real world, however, the best policy does not always gather support from society. Politics is the art of the possible.

If Brazilian society wishes to resort to fiscal policy, what would be the best alternative? The government in our opinion should take the opportunity to increase investment in housing for the poor and in urban infrastructure. By doing so, government would both create jobs and eliminate a major social problem.

Instead, the government decided to award R\$ 100 billion to the National Bank for Economic and Social Development (BNDES). 

# In 2009, renewed attention to fiscal policy

In many countries these days, fiscal policy dominates the public debate, particularly government spending. Public financial management is a source of permanent tension and dispute between the actors in a society. Badly done, it is prone to generating imbalances, with far from negligible effects on economic development.

In Brazil, society is called upon to transfer to the State roughly one third of GDP — far above the average of other emerging market countries. The real achievements of the fiscal policy of the Lula administration in 2008 are unfortunately too limited to create a solid base from which to address a much deteriorated situation in 2009. It was relatively easy to succeed last year as revenues grew along with healthy economic growth, and Brazil registered modest progress in building a primary surplus and a more balanced expenditure profile. Seen in perspective, though, that progress was less impressive than was desirable. Today, in 2009, the risk of failure has increased enormously.

The fiscal policy of Lula's administration has been the subject of continuous controversy, particularly the steady increase in public spending in the last few years. The government's fiscal performance has been distinguished by a combination of ever-increasing spending with persistent primary surpluses (cash surplus less interest). The nominal budget balance, in turn, has posted deficits, though these are apparently under control. This picture of a fiscal policy with both positive and negative aspects is the background against which a structural public policy challenge emerges: how to increase public investment while keeping spending under control, so that the growing tax burden does not erode Brazil's production capacity.

## **Improvements in Fiscal Policy**

The profile of public spending changed significantly in 2008. Last year registered the lowest increase in spending in Lula's administration, measured in GDP terms — although the in-

crease in certain items remains worryingly high. The most positive factor was the continued and vigorous growth of investments. Actually, since 2006 the government has recovered its investment capacity, which has increased by 29 percent yearly: In 2008 the government invested R\$29.5 billion (US\$13 billion), up from R\$22.9 billion (US\$10 billion) in 2007. In addition, in 2008 — for the first time in the Lula administration — in absolute terms the investment account (R\$6.65 billion) grew more than social expenditures (R\$6.04 billion). It helped that fiscal performance was boosted by an increase in tax revenues, which to a large extent reflected the positive performance of the economy.

Among the recurrent criticisms of Brazil's fiscal policy is the poor quality of public finance adjustments to obtain the primary result, which has been mostly based on bringing in more tax revenue rather than containing spending. Nonetheless, despite the undeniable increase in spending by 4 percent of GDP, recurring primary surpluses are a Lula administration achievement that must be acknowledged. Even with increased tax collection, the surplus performance could have been worse, in that spending could have risen to more than offset the increase of revenues. There is no indication that the government would be irresponsible enough to have increased spending if the tax revenue outlook had been less favorable.

Also, it is important to look into how the government spent the resources obtained from society (obviously, that does pre-empt the debate on the costs to growth and individual well-being of the high tax burden to which Brazilians are subject). Most of the increase was unequivocally aimed at expanding social

and investment spending as a proportion of total expenditure, and the costs of running public administration took up a slightly lower share of GNP when costs associated with the civil servant wage bill and health and education are excluded. Over the last five years social expenditures registered the highest proportional increase, from 0.88% of GDP to 1.65% between 2003 and 2008, an increase of 0.77 percentage points. Investments took second place, with an increase in their share of GDP in the five-year period of 0.63 percentage point, i.e., an increase from 0.40% to 1.03%.

Other expenditures showing a proportional increase were those related to pensions, which increased by 0.6 percentage point during the Lula administration, from 8.21% to 8.82% of GDP between 2003 and 2008. This increase reflects both a policy of raising civil servant salaries and more frequent adjustments of the minimum salary, which is the reference for about two-thirds of all retirement and pension payments to workers from the private sector. However, in 2008 spending in this category retracted by 0.12 percentage point of GDP as a result of restraints on payments of health benefits. Those gains will not be repeated in the future. At the other extreme is spending for running the public administration (excluding that related to education and health and civil servant wages). This expenditure, which represented 2.1% of GDP in

*In the light of the occurrences post-September 2008 (hard to predict, admittedly) last year's fiscal policy should have been much more strict*

2003 and 2.2% of GDP in 2007, was reduced to 2.0% of GDP in 2008.

### **Countercyclical Fiscal Policy on the Wrong Foot**

Given the incomplete, though welcome, advances achieved by Lula's fiscal policy, the global crisis that hit Brazil by the end of last year was particularly unfortunate. Had the crisis spared Brazil, and provided the country maintained the previous production growth trend and stabilized public spending, 2009 would have been the best fiscal time in the last few years. This scenario would have brought about an increase in public savings and made it possible to sharply reduce the debt/GDP ratio or reduce the tax burden on society.

As growth has started to wane since last September, the future of the public finances

stimulus packages similar to those launched by several developed countries and some emerging market countries.

There are, in the Brazilian case, obvious limits to government's capacity to provide fiscal stimulus to economic activity (except for monetary policy). Surpassing those limits will mean potential problems in the future, which may have serious consequences for the economy. One has just to remember that in the not too distant past the creation of substantial public liabilities resulted from high default rates in subsidized interest loans granted by public financial institutions. A concern in the present circumstances is, therefore, the excessive role of financial intermediation played by public institutions in a time when general economic conditions tend to be unfavorable to a return on their loans and investments.

The 2009 trend is of a deterioration of the public finances, both in terms of primary results and expenditure composition. The first casualty in this new scenario will be the primary surplus. Even though it may still be too early to predict — in light of the many variables which still remain to be defined — the primary sur-

plus will most likely be around 2.5% to 3.5% of GDP, below the administration's target of 3.8% of GDP. Because of that, the Brazilian Sovereign Fund (FSB), passed by Congress, should be, at a minimum, 1% of GDP to ensure a satisfactory countercyclical effect without undermining the public finances. Thus, the R\$14.2 billion reserve created by the Fund, which represents roughly 0.5% of GDP, is insufficient. Admittedly, the creation of an

*Stimulus policies to production should have a temporary character. If permanent, on one hand, their efficacy may be compromised; on the other hand, public expenditures may become crystallized.*

in this new economic reality became shrouded in extreme uncertainty. The Lula administration has tried to show society that it is capable of conducting a countercyclical fiscal policy to offset the impact of the global economic downturn. However, the fact remains that, in spite of Lula's fiscal gains and the promising improvements in 2008, the structural weaknesses of the Brazilian public accounts have not been sufficiently remedied to allow

FSB reserve corresponding to 1% of GDP, approximately R\$29 billion (US\$13 billion), would only have been feasible if the primary surplus in 2008 had been 0.5% higher in GDP terms than the actual result.

The second casualty resulting from the smaller primary surplus is the public debt-to-GDP ratio. Following the last few years of positive development resulting from the fiscal efforts and the sharp decline in 2008 resulting from the devaluation of the Real, debt is projected to remain stable at around 36% of GDP or to increase slightly in 2009. That will, of course, depend on the behavior of interest rates during the year, as well as the exchange rates.


The recent announcement of R\$37 billion (US\$16 billion) contingency reserve for the 2009 budget underlines the administration's concern over the uncertainty of the next few months. In this context, which calls for renewed caution, the recent sharp increase in the salaries of civil servants seems to be a mistake and is inconsistent with the present state of the economy. These salary increases should be conditioned on actual tax revenues in the future.

Increases in civil servants spending, albeit below the forecast — R\$131.5 billion in 2008, slightly under the R\$133 billion in the budget — correspond, nonetheless, to a sharp increase of 12.5% for the year. This was the second largest increase for the active and retired civil servants since 2003, second only to 2006, when a 14.5% increase was posted. The civil servants spending-to-GDP ratio was 4.59%, below the 4.86% in 2002.

In 2008, the federal administration was able to meet its programs and projects because of strong GDP growth, which is estimated at around 5%. This performance made life easier

for the Lula administration, as it allowed for increased spending without offsetting the primary surplus. However, the global economic crisis has drastically changed the rules of the game, and the challenges in 2009 are suddenly much more complex. In the light of the occurrences post-September 2008 (hard to predict, admittedly), last year's fiscal policy should have been much more strict. What is required now is to start from a much higher level of spending, which is difficult to compress, and attempt to maintain the social programs and necessary investment without further increasing the tax burden on the society. Indeed, this juggling exercise will have to be carried out despite much lower growth, which should not exceed 2%.

In the present circumstances, a counter-cyclical fiscal policy, based on the Treasury's expenditures and particularly on public investment, is perfectly justified — and most economists agree on that point. On the other hand, one should not lose sight of the fact that if fiscal results deteriorate too much they may have an opposite effect and trigger uncertainty over the quality of the public administration. That could bring about severe imbalances which, more than once in the past, have driven the country into a critical situation.

In this context, we need to be aware that stimulus policies to production should have a temporary character. If permanent, on the one hand, their efficacy may be compromised; on the other hand, public expenditures may become crystallized in future budgets. The issue becomes even more sensitive when, at the start of a new year, there is no expectation that the primary surplus target will be met, nor that the ratio between public debt and GDN will continue to decline. 

# If Brazil cannot effectively lead Latin America, no one can



## Walter Russell Mead

Henry A. Kissinger Senior Fellow for U.S. Foreign Policy Council on Foreign Relations

**Pinheiro Ronci**, from New York

Walter Russell Mead is one of the leading scholars of American foreign policy. Mead argues that the Anglo-American system of values based on individual freedom and capitalism was extremely successful in organizing a global financial and economic system that generates a huge amount of wealth and power. This system ultimately gave the U.S. a hegemonic central position in the world. According to Mead, the competition between great powers is a constant, but the system most of the time constrains competition. For him, there is a clear lesson: by joining the world system, a country can achieve much better results in terms of international power, security, and the prosperity of its people. He believes that Brazil can serve as a center for development and political stability in Latin America.

**The Brazilian Economy — How does the Anglo-American system organize international relations?**

Walter Russell Mead — The Anglo-American system sets the background for geopolitical and economic systems around the world. This has been true since the British defeated the French in a series of wars in the early 19<sup>th</sup> century. That does not mean that economic or geopolitical competition among powers has disappeared; it means that the global system most of the time constrains that competition. From time to time individual powers or groups of powers challenge the foundations of the system, as did, for example, Napoleon's France in the 1800s, Germany and Japan in the 1930s and 1940s, and the Soviet Union until 1989. Challenges, however, are rare. Since the collapse of the Soviet grand challenge, many people have been unhappy with the current world system, but so far that unhappiness has not coalesced into a single power striving to overturn the system.

**Struggles for honor, status, and influence in the world seem to be key features of international relations.**

The world is always changing, but the competition among great powers is a constant. It is also true that, while China and India are both seeking to increase their power in the world, at least at this moment they are doing it primarily within the Anglo-American

system. They are trying to exploit the economic opportunities that already exist in the system, and as they do so, they become more identified with the system. In the same way, after World War II Germany and Japan tried to gain influence within the Anglo-American system rather than try to overthrow it. They have been extremely successful and today have a great voice in world affairs, and at same time the German and Japanese peoples enjoy a very high standard of living. They are now pillars of the international system rather than opponents trying to knock it down.

**However, Germany and Japan had to go through a horrific war before they adopted the Anglo-American system.**

Let's hope people can learn from the lessons of the past. To me, there is one clear lesson: by joining the system and becoming part of it you can achieve far greater results, whether measured in terms of international power, state security, or the prosperity of your people. You actually do much better by cooperating rather than resisting.

**Some have announced that the current economic crisis is the end of the Anglo-American system.**

History is instructive here: Since the British rise to power begin in the late 17<sup>th</sup> century, there has been one financial crisis after another, many of them extremely severe, with very widespread consequences. Yet the Anglo-American world system has continued to grow. It is possible that the current crisis could mean the end of the American world system, but it seems far more likely that it does not.

Should we bet on American creativity and flexibility to pull themselves out of this crisis?

The recent presidential election in America in a sense illustrated that. It is very interesting to look at what both McCain and Obama were saying during the campaign. Both candidates were proposing a vision of a different and better future. Obviously people preferred President Obama's vision. In the U.S. we really do not have what Europeans often mean by conservatism, the type that does not want to change anything. In the U.S., our "conservatives" are actually economic revolutionaries who want unrestricted free markets. On the other hand, U.S. liberals tend to be economically conservative but in some ways social radicals: promoting gay marriage or active state intervention to reduce inequalities. Because neither of these political groups is a conservative social group, the U.S. remains a very future-oriented and flexible society. In a situation where change is the dominant social and economic reality, this may give American society continuing advantages, because all countries will have to adjust to accelerating waves of change.

**The American system was very successful in raising hundreds of millions of people out of poverty around the world. However, when it is applied to developing countries it creates social and economic dislocations.**

We have to look at capitalism as both a political and a cultural problem. For one thing, the world capitalist system was not designed by Latin Americans to meet their needs. It was designed primarily by Anglo-Americans, and it has proceeded at a pace that was

*The Anglo-American system sets the background for geopolitical and economic systems around the world. This has been true since the British defeated the French in the wars of the early 19<sup>th</sup> century*

agreeable to Anglo-American cultural instincts. A country like Brazil confronts a world system that is not always sympathetic, and it does not move at the pace Brazilians would like it to move. It does not have the priorities Brazilians would have put in place in a world system. At the same time, Brazilians and other Latin Americans share a different world view. Carlos Véliz argues that, coming out of the Baroque heritage in the Ibero-Luzitanian world, there was a desire in Latin America to create a unified world system of thought, polity, and culture, in which everything proceeded in a very logical and straightforward way from first principles. This mindset is poorly adapted to what capitalism is and does.

**The real world is messy and unpredictable.**

Exactly. There are exceptions to every rule, and one has to allow a new industry to come in and disrupt all the producers and all ways of life. But this is not enough. You have to have a passion for innovation and change. A story I tell in my book *God and Gold* illustrates the point: When the telephone was first invented, it was almost ignored until Don Pedro II, the emperor of Brazil, was visiting the centennial exposition at Philadelphia and saw it. He picked it up, listened, and said “Good God, it talks!” There were so many reporters following the emperor that this was great publicity for the telephone. You could argue that Brazil “discovered” the telephone, but Brazilians did nothing with it; the companies that brought telephone services to Brazil

*For Brazil a good relationship with the U.S. is not only a positive factor in terms of Brazil’s own international objectives, it sends a signal to other countries in the region about the nature and limit of Brazilian ambitions, and that can facilitate the rise of a Latin American identity and effective regional institutions*

were Anglo-American. To be at the cutting edge of the capitalist system — generating new ideas and applications — you have to have a passion for the new, and the surprising, and the disturbing. Historically, that is something many Latin American peoples lack.

**Latin American countries tend to have periods of liberal market-oriented reforms alternating with populist policies.**

Latin America has a very tragic history: a history of swings between corrupt and authoritarian oligarchs, who are not equal to the task of leading a modern society, and corrupt and incompetent populists, who are not capable of harnessing social energies to the necessary tasks of modernization. Brazil is emerging as an exception. If we take a long view — and I am not making a comment on any particular Brazilian government — we

have seen both on the left and the right in Brazil the growing importance of strong and more transparent institutions and a sense that the market must be allowed to exist. Brazilian politics is beginning to look more like the debates in Europe and in the U.S. Thirty years back, neither left nor right were democratic in their hearts.

President Lula has performed a historic role in Brazil. That does not mean that everything his government does is wise and good, any more than that is true of any government. But as an outsider who admires Brazil, I have been very heartened to see this long-term development in Brazil toward a national politi-

cal approach that is both modern and more stable. If Brazil stays on this path, I think it will enjoy increasing success, even though there will be a rough path at times.

**The political developments in Brazil contrast with the tragic path Argentina took.**

Argentineans had all the material riches you need for prosperity and greatness, and yet Argentina today is neither rich nor powerful. Every society has to find its own way to be effective in a capitalist world and yet remain true to its own core values and identity.

**As the Japanese did.**

Exactly. The Japanese are as Japanese as they have ever been, but they have learned since the 19<sup>th</sup> century how to manage the capitalist system for their own benefit. In contrast, the Chinese in the 19<sup>th</sup> century had no ability to manage the capitalist system, it was just too hard for them, and they went through terrible suffering. China's "Long March" to modernity is not over. Nevertheless, the Chinese are far more effective today in using the energies capitalism unleashes to make China successful while still remaining essentially Chinese.

This is the task that Latin America faces. The example of China should be inspiring: countries can find a way to maintain their identity, adapt to capitalism, and grow enormously in power and wealth

in the international system. It is possible. Latin America can do it; others have.

**In Latin America as in other parts of the world, people see the U.S. as a threat but at the same time they admire U.S. values, culture, and the dynamic economy. Some argue the U.S. should restrain its power.**

U.S. foreign policy has a mixed record. I think the sentiment one finds around the world is

best illustrated by the slogan: "Yankees go home — and take me with you." Indeed, it is a problem for the world that one country has such a disproportionate amount of power. On the other hand, would international anarchy and chaos be better than the current situation? I wonder whether Europeans could have reunited and rebuilt after the World War II without the American umbrella protecting them, not only from the Soviet Union but also from any renewed German ambitions. I do not think anarchy would necessarily be an improvement on American power. Americans provide security for everybody, and I am not sure that there are that many countries that could provide security for everybody much better than America does. Although, certainly, America is by no means perfect at this job.

**How could Americans cooperate better with other nations?**

Again, Europe is the place

*Another important point is that the future of the 21<sup>st</sup> century will be likely decided in Asia, and the Pacific will be the ocean of the 21st century as the Atlantic was the ocean of the 20th. The U.S. today enjoys better relations with China, India, and Japan than it did in 2001. Promoting the emergence of an Asian international system that is naturally balanced may be one of the great triumphs of American statesmanship*

where American foreign policy has been most successful. After fighting two horrible wars, America was able to conceive its objectives regarding Europe in a way that meshed with what Europeans wanted. The result was almost three generations of peace and the creation of the European Union. In Latin America there is the possibility for a different U.S. approach. Historically, until World War II, U.S. interest was limited to the Caribbean and the Isthmus of Panama. British, French, and German influence in Argentina, Brazil, and Chile was far greater than American influence. During World War

*I wonder whether Europeans could have reunited and rebuilt after World War II without the American umbrella protecting them, not only from the Soviet Union but also from any renewed German ambitions*

II, there was a new U.S. security concern, particularly because of German penetration in Argentina and Chile. And during the Cold War the U.S. was very apprehensive that the Soviet Union could gain a foothold in Latin America through ideological subversion. So the U.S. became intimately concerned with the social and political evolution of Latin America. U.S. security concerns became mixed up with Latin America's ability to succeed in the international capitalist system.

In general, the U.S. foreign policy record in Latin America was mixed. Security concerns led the U.S. to a succession of rather poor choices. I think sometimes all the alternatives were poor. From the point of view of the U.S., there were left-wing populists

who sympathized with the Soviet Union and would ruin their countries' economies, and corrupt right-wing dictators who were brutal and also not good for the economy, but at least they would not go over to America's enemy. Americans found themselves often choosing the lesser of two evils.

Since the end of the Cold War, two important developments have happened: there is far less U.S. security concern about Latin America, so the U.S. is much less pressed to influence political developments in Latin America except for very specific issues, such as drug trafficking and terrorist connections. At the same time, a number of emerging countries — Chile, Brazil, and Mexico — are modernizing. There is a lot more optimism about Latin America's potential to modernize. These developments offer the opportunity for a different and better relationship between the U.S. and Latin America. Here Brazil has a critical role to play. Brazil could serve as a center of development and political stability in Latin America.

**Brazil has been very shy about leading other Latin American countries. Chávez has taken the lead, with regrettable consequences.**

In fact Brazil does have a moderating impact, by example and by also not joining Chávez. It makes sense for Brazil to deepen the dialogue with its neighbors. Obviously, Brazil is so large and its economy so big that suspicions could grow very quickly if neighbors thought Brazil is trying to arrogate leadership. Brazil in some ways should think of itself as Germany after World War II, moving very carefully and with great deliberation and calm to try to reassure its neighbors as it builds deeper forms of cooperation. Brazil is capable of that kind of regional leadership. Again, I would suggest that this works best when U.S.-Brazilian relations are very clear.

In the same way, Germany understood that in order to play a constructive role in Europe, it needed to work with Washington to reassure its neighbors. For Brazil a good relationship with the U.S. is not only a positive factor in terms of Brazil's own objectives internationally, but it sends a signal to other countries in the region about the nature and limit of Brazilian ambitions that can facilitate the rise of a Latin American identity and effective regional institutions. If Brazil cannot effectively lead Latin America, no one can.

**The Bush administration was defined by the conduct of the Iraq war. What is the current situation in Iraq?**

I just returned from Baghdad and I am in a very cautious way optimistic about Iraq's future. It was fascinating to me that everyone I met with — opposition as well as people involved in the current government — talked about politics and elections. They had the belief that electoral success or failure would affect their strength. People are beginning to understand that the way to handle their differences is through institutions instead of adjudicating their conflicts through violence, and these institutions do have legitimacy among Iraqis. Many of the Sunnis are now convinced that only a constitution can save them from the fate of being a minority surrounded by a hostile majority. Iraq's pluralistic society seems to be shifting from expressing itself in hostile and violent action in the streets to hostile and violent action in parliament. There is a lot of corruption.

Oil is more a curse than a blessing in terms of development. Oil revenue allows the government to buy off some of the opposition, which may be better than killing them, but it does suggest that some negative practices are being built into the foundation of Iraq civil society. I do not think Iraq will emerge as a perfect example of democracy. However,

if at the end of the day Iraq could look like Turkey's ugly stepsister wearing a veil, that actually would be good for the U.S., good for Iraq's neighbors, and far better for Iraq's people. If you define success this way, I think Iraq is heading in that direction. Whether the war was justified or whether the tactics used were correct is another question.

**What could we expect from the Obama administration?**

It still very early, but having listened to the inaugural address and knowing some of the people going into the administration, I think we are going to see some very dramatic steps to show that change is taking place, including the closing of the Guantanamo Bay prison.

Let me point out that there was a major break in U.S. foreign policy in the second Bush term. In the second term, the Bush administration stopped lighting new fires and focused on dealing less stridently with some of the fires they had started in the first term. Obama is going to continue that transition away from the first Bush term toward what people regard as a more traditional American policy.

Another important point is that the future of the 21st century will be likely decided in Asia, and the Pacific ocean will be the ocean of the 21st century as the Atlantic was the ocean of the 20<sup>th</sup>. The U.S. today enjoys better relations with China, India, and Japan than it did in 2001. Promoting the emergence of an Asian international system that is naturally balanced may be one of the great triumphs of American statesmanship. Historians may view that as the most important accomplishment of the Bush administration, and it is very likely that the Obama administration will continue to move to a deeper relationship with Asia. ■

# External crisis and public spending reform

## Raul Velloso

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Brazil was one of the countries that benefited most from the global financial bonanza in 2002–2008. Globally, this favorable period was brought about by excessive monetary expansion in developed countries and disproportionate expansion of the real estate market in the US and other countries, combined with excessive leverage (the ratio between borrowed funds and equity), particularly in developed countries with weak financial supervision.

In the wake of this bonanza, the Brazilian economy was the recipient of an unprecedented volume of foreign resources, and the global boom led to a rapid rise in the price of our export commodities. In this context, even as the Central Bank purchased an enormous volume of dollars (foreign reserves), it was possible to significantly increase our imports, particularly capital goods, while the exchange rate and interest

rates fell markedly. As a consequence, domestic investment expanded rapidly, leading to considerably higher growth of the Brazilian economy.

## Tax revenues bonanza

In the public sector this prosperous period brought in substantial tax revenues that, despite continuing high growth of current expenditure, since the end of the 1980s made it possible to increase primary surpluses (cash surplus less interest). Against a background of significant increases in international reserves, higher growth of the economy, increased primary surpluses, and falling interest rates, net foreign public debt (gross debt less international reserves) declined continually, to the point where in June 2006 it vanished. It has since consistently shown increasing large negative values. In other words, in relation to the rest of the world, the Brazilian public sector went from being a debtor to being a net creditor. In spite of the crisis, this situation continues to this day. This transformation brought about a drop in the country's risk assessment and an increase in the inflow of foreign resources, at least until the current crisis emerged.

It was also possible to substantially increase the Federal government's investment in transportation, despite the

well-known sluggishness of the public administration. Granted, because of the excessively depressed comparison base in 2003, this increase has barely allowed investments to surpass the average of 1990–2006. In fact, in 2007 expenditures accounted for 0.22% of GDP, compared to the average of only 0.19% registered in 1990–2006. It is worth noting that, according to estimates of the Ministry of Transport, at the end of the 1970s investment in transportation was nine times higher as a share of GDP than today.

To sum up, even though the share of current government expenditure in the country's aggregate expenditure continued to be as high as before, it was possible to reduce the public debt-to-GDP ratio and substantially improve the solvency of the public sector because of ample tax revenues.

### **Foreign currency scarcity**

The global crisis will bring about an accelerated and expressive reversal of the conditions that produced such positive effects on the Brazilian economy in recent years. At present, the major effect of the crisis, now hitting the country with full force, is the severe scarcity of foreign currency as a consequence of the halt in foreign capital flows. This will be worsened by the plunge in commodities exports due to the significant drop in their international prices.

It is estimated that the “deleveraging” process that is on course particularly in the United States will lead to a US\$7.7 trillion drop in the volume of loans in the U.S. financial system—the equivalent of 52% of U.S. GDP. These estimates assume the average leverage of the system will drop from 12 to 8. The extent of the debt rollover in the American financial system would, under these circumstances, decline to 66% of total repayments, which would result in a substantial financial tightening on debtors without parallel in recent history.

Obviously, foreign deleveraging would also hit in full Brazilian debtors owing to the international financial system. Currently the extent of rollover of the private sector's foreign debt is estimated to be only 20% of the total repayments.

In view of the decline of commodity exports and the

The domestic financial markets seem to indicate that the rate of growth of GDP will fall to approximately 2.5% in 2009

higher deficit in the capital account of the balance of payments, the trend points to a sharp exchange rate devaluation (already the case), new inflationary pressures, a possible hike in the central bank policy rate, and finally a severe drop in economic activity. These adverse effects may be aggravated in the coming months, which makes forecasting the economy and fiscal variables enormously risky.

As far as the Federal budget is concerned, on the one hand, the issue is a severe drop in the growth of tax revenues, which would lead to a significant fall in Brazil's high primary fiscal surplus, if the excessive increase in primary current expenditures continues. On the other hand, there is the risk of a significant increase in the cost of public debt.

The drop in the growth of tax revenues would come about as the GDP growth rate slows down, as well as

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recent government decisions to give up taxes as a response to the crisis.

The major increase expected this year in Federal primary current expenditures will be in two areas, social security and the civil service, which correspond to almost 70% of the total. A case in point is the impact of the new minimum wage for 2009, which accounts for almost 40% of social security expenditure. According to the draft budget, the minimum wage will be raised by R\$50 (US\$25), or 12% of the current wage, well above the expected yearly inflation over the 12 months before the minimum wage adjustment. In addition, the adjustment of civil service salaries and new hiring already approved by the federal government are expected to produce a significant impact on the government's wage bill in 2009.

### The fall

The government and the Congress continue to express optimism about the future of the economy. However, the expectations expressed on December 12 by the domestic financial markets seem to indicate that the rate of growth of GDP in 2008 (close to 6.5% a year up to the third quarter) will fall to approximately 2.5% in 2009. Indeed, since mid-October 2008 all the GDP growth forecasts produced by domestic financial markets, as published in the Central Bank Bulletin, have been declining.

Furthermore, due to pressures from certain constituencies to obtain government assistance, new measures have been taken to give up taxes that will result in a loss of tax revenues of approximately R\$8.4 billion (US\$4 billion) in 2009.

A drop in the primary surplus combined with a hike in the cost of debt and reduced GDP growth means that the solvency of the Brazilian public sector has deteriorated—a problem that has recently not been among our serious concerns.

These factors should prompt the government to introduce a comprehensive program of adjustment for the public finances, without which it will be very difficult to cope with the severe crisis already affecting the world and the Brazilian economy. In addition to public sector solvency risks, there is a need for the administration to lead the unavoidable process of cutting domestic spending by means of reducing non-financial current spending in order to reduce the current account deficit of the balance of payments and inflationary pressures, which are likely to worsen.

In this context, it would absolutely be prudent to once again open up debate on spending reforms, which are completely absent from the list of priorities of the Federal government, including reforms of the social security system and public administration. The government should, in summary, make efforts to pass its own draft supplementary legislation to limit the maximum increase of the civil service payroll to the INPC price index plus 1.5%, which at the moment enjoys no support in the Congress. ■

# Homework in turbulent times

**Paulo Skaf**

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Brazil's highest priority in 2009 is to ensure GDP growth in a scenario of global slowdown. The measures announced by the government are welcome and timely, especially flexibility regarding bank reserve requirements, tax reductions for the automotive industry, and increased public investment. Such measures, however, are not sufficient. They are bound to stumble upon structural problems that can hold back the country's response to the crisis.

Among specific issues the most pressing is that related to ensuring that the resources injected into the financial system by reducing bank reserve requirements reach the real economy. Without this practical consequence, the measure is not only fruitless but also superfluous — fortunately, Brazilian banks are not in need of rescue. If this money were not aimed at financing production and consumption, the best thing to do would be to return it to the Central Bank to increase public investment.

One measure that is an important complement to increased credit by using bank reserve requirements is immediate reduction of interest rates. All countries have been slashing interest rates, favoring the promotion of their economies despite an eventual upsurge of inflation. Brazil, however, continues to swim against the current by maintaining the highest real interest rates in the world,

despite the fact that most recent projections suggest that inflation will recede in 2009.

Among the structural problems, the most severe is the flawed culture of public spending. As the budget for the current year approved by the Congress shows, the costs of the federal government are incompatible with what is expected from a modern public administration. The budget is a bloated aggregate of expenditures resulting from several decades of mistakes in the management of public entities, which remains a huge burden for taxpayers and is abysmally ineffective in such key areas as health, education, safety, and infrastructure modernization.

In times of plenty such distortions may pass unnoticed; in periods of crisis they reemerge stronger than ever and limit the State's power of response. Obviously, the

measures announced by the government to avoid economic recession would have been more consistent in terms of money resources had those resources not been committed beforehand to maintaining a heavy, anachronistic public administration structure.

Had the costing structure of the Federal government, as well as those of the states and municipalities, been more rational, there would have been a better chance to rescue the economy, both by increasing public investment and by introducing a broader tax reduction plan than the one announced. Both directly (by investing in infrastructure projects and updating public services) and indirectly (by cutting taxes and allowing businesses to invest more in production), the administration would serve the country better than by adopting a budget that is permeated with

expenditures that in the present economic situation are superfluous.

The high level of state spending, one must not forget, is also one of the reasons for high interest rates, which reflect the generous yield paid on the government securities with which the administration rolls over its enormous debt, which is currently almost as high as GDP. This is all the more serious in a context of a crisis. In times like these, society and the productive sector find it even more difficult to bear a tax burden as high as that of Brazil. Thus, the government starting yet another new year without having completed fiscal reform leaves a bitter taste, which is further aggravated by the recession in developed countries. It is frustrating to see that not even the draft proposed by the Executive branch, which itself is far from meeting the nation's expectations as far as tax cuts are concerned, has made it through the Congress.

More than ever, as this crisis exposes the country's weak points, the Brazilian government needs to seek solutions to the globalized financial hurricane. We did not do our homework when the skies were clear. We must now see to it in the midst of turbulence. ■

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