Chapter 2

A New “Order and Progress” in the Brazilian Economy

SAORI KAWAI

Introduction: Is a Giant Awakening?

“A giant by thine own nature, thou art a beautiful, strong and intrepid colossus.” As proclaimed in its national anthem, Brazil holds rich natural resources, a huge amount of cultivable land, a very diverse ecology and a multiethnic society with more than 200 million people. Nevertheless, Brazil was unable to enjoy all this potential because of the economic instability that it suffered for decades. The “Country of the Future” was for a long time a metaphor to describe the potential of the country.

In 2010, Brazil attained 7.6% of GDP growth[1] in stark comparison to most developed countries, which were suffering difficulties recovering from the global financial crisis. The rapid response of the Brazilian economy, which used to be vulnerable to the world economy’s fluctuations, impressed those both at home and overseas. Brazil which ranked 10th in the world GDP in 2005 climbed to 7th in 2010, overtaking Italy, Canada and Spain. The achievements of the Brazilian economy were widely welcomed because of the country’s character. Compared to other major emerging economies, Brazil is characterized as a stable multiethnic society that is not hegemonic and participates peacefully on the global scene.

The words “Order and Progress” in this chapter’s title are an exact translation of the words on the flag of Brazil. During the 1980s, a period of economic difficulty, Brazilians commented ironically that “Order and Progress” only existed on their flag. In the economic sense, “order” can be interpreted as economic stability and “progress” as economic growth, both of which seem to have been achieved in the 2000s. What has made “Order and Progress” a reality? What was the turning point for the Brazilian economy? These are the questions that this chapter tries to answer.

High growth of the 2000s in the Brazilian economy has been propelled by the

[1] Brazilian Institute of Geography and Statistics (IBGE) released the new series of the System of National Accounts (SCN 2010) on March 11, 2015. http://cod.ibge.gov.br/41XGO In this chapter, we adopted the updated numbers, which were available at the moment of writing for the years between 2000 and 2010, otherwise, the existing series were used.

Ryohei Konta ed., *The Post-New Brazil*. Spot Survey 35. Chiba: IDE-JETRO, 2015.

twin-engine of commodity exports and domestic demand. The former was caused by the rise in commodity prices in response to remarkable demand from emerging economies such as China. In this sense, the Brazilian economy has benefited from globalization. The funds gained from the commodity exports were used for the repayment of its external debt and the strengthening of its foreign reserves. The country's risk fell and stimulated private capital inflows into Brazil. The inflow of abundant capital ignited an expansion in domestic demand and created jobs. Job growth created more demand in the domestic market. Worth mentioning is the leading role of the virtuous cycle had played by the people who used to be dependent on state support. Since 2003, more than 20 million people have escaped poverty and joined the middle class, which has become a driving force in a vigorous consumer market [Neri 2011, 34]. The emergence of the so-called new middle class has made significant contributions not only economically but also to the maturity of the democracy and the stability of the social environment. It has also led Brazil to be cited as a pioneer of this kind of development, in other words, a role model for the world.

The next section, discusses the very famous problem of the Brazilian economy: inflation. Section 2 describes mechanisms behind its economic development in 2000s. The third section, discusses in detail, several challenges faced by the country in medium to long term.

1. Macroeconomic Policy: The Fight against Inflation

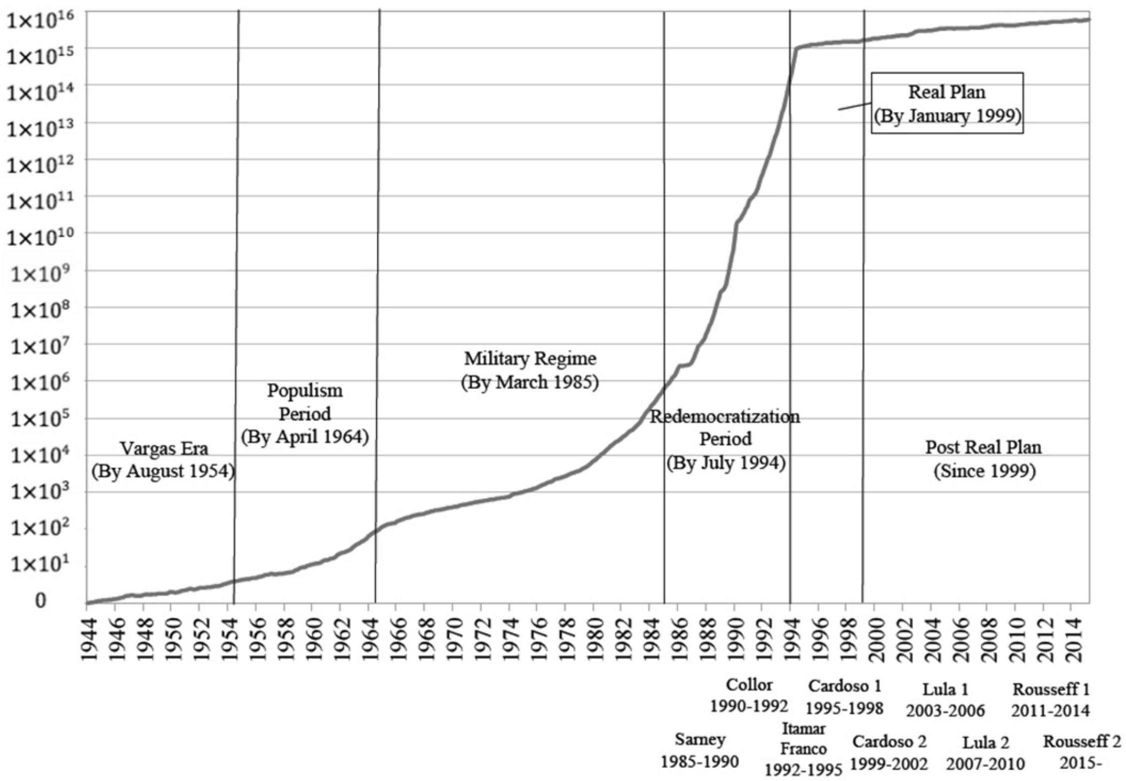
1.1. Historical Background

Brazil's economy has a long history of fighting inflation. Persistent and harmful inflation had been the biggest economic challenge for the country over the decades. Finally in 1994, the Real Plan was introduced and inflation has been contained to a single-digit level. However, the fear of awakening the sleeping dragon of inflation produced disciplined macroeconomic policies to avoid high inflation disrupting the economy again. This section, explains the history of the inflation problem to understand the present situation.

As shown in Figure 1, the evolution of inflation rate was remarkable until 1994, especially after the period of military rule, which ended in 1985. A quick overview of the experiences in successive periods are given. During the Getúlio Vargas administration from 1951 to 1954, the average annual inflation rate was 13%. Since

1956, the government commanded by President Jucscelino Kubitschek (JK) adopted an industrialization program named the Target Plan (*Plano de Metas*) with the slogan "fifty years in five years." Under this plan, introduction of imports substituting industrialization of durable goods, the transfer of the capital city from Rio de Janeiro to a newly constructed Brasília and infrastructure development such as highway construction were implemented. These initiatives resulted in a high economic growth during the period of populism, after the JK administration ended in January 1961. Nevertheless, these economic policies caused an overheating demand and a worsening of the fiscal balance, eventually provoking a rise in inflation (at an annual average of 31%). The deficit on the current account continued and the economy became dependent on foreign capital inflows. The high inflation brought instability to society and became a trigger for a coup d'état that established an authoritarian government in 1964. At that time, Brazil had experienced the demise of a regime caused by economic disorder.

Figure 1. Evolution of Inflation



Source: Brazilian Central Bank.
Note: Annual inflation rates are logarithmically transformed from the price index of 1994 as 1, to be able to cover the hyperinflation period in the end of 1980s and in the beginning of 1990s. A slope of each point shows the inflation rate at that time, and a slope between any two adjacent points shows the average inflation rate during the period.

In the beginning, the military government adopted austere economic policies (PAEG). Inflation rate was lower than the previous period (an average of 23% annually from 1964 to 1973), and the current-account was balanced. After macroeconomic conditions improved, there was a shift in economic policy from austere to expansionary. From 1969 to 1973, the military government made huge public investments to induce rapid economic growth, and the average growth rate reached over 10% a year. During this period, the so-called Economic Miracle happened. However, after the first oil shock in 1973, fuel prices rose sharply and reignited inflation (62% a year from 1974 to 1985). In order to stimulate economic growth, the military government adopted another development plan (PND II) that expanded public investment in state owned companies especially in heavy chemicals and electric power. As a consequence, the fiscal condition deteriorated and the economy became dependent on foreign debt to finance its development.

As the macroeconomic fundamentals worsened, price adjustment mechanisms introduced under PAEG took effect. For example, indexation was used to adjust prices by means of a price index to maintain purchasing power. According to this system, prices (such as wages, interest rates, and exchange rate) and contracted expenses (such as housing rent and public utility charges) changed with inflation rate. Binding these prices to inflation meant that there was no change in real terms, so the effects of inflation could be neutral from the monetary and real economy. This might have been sustainable theoretically if all variables slid with the current inflation rate, but indexation was calculated based on the inflation rate of the previous year. Thus, the mechanism created inertia, and the inflation of the first period was carried over to the inflation of the next.

The inertia of inflation became a principal factor behind the acceleration of the inflation rate from then on. As the inflation rate rose sharply and uncertainty grew, people expected inflation to be higher in the future. For example, companies might raise the price of their products according to the inflation rate of the former period. It was possible for Brazilian companies to do so because the country was economically isolated from international competition as a result of high tariff rates. Also, workers demanded wage increases in line with the inflation rate of the former period in order to safeguard their purchasing power. In addition, the government raised public utility charges higher than the inflation rate of the previous period to prevent services from becoming unprofitable. As a result, companies shifted the cost increase to consumers and tried to raise their prices. This created a game of chicken that would last until someone dropped out of the spiral of continually rising prices. The inflation rate thus continued to rise uncontrollably.

At this time, there were intense debates regarding inflation between mainstream economists and structuralists, in other words, an orthodox versus heterodox controversy. The former argued that inflation was caused mainly by the unbridled issuance of money to finance the fiscal deficit. Their prescription was to improve fiscal balance and to assure strict control of the money supply. The International Monetary Fund (IMF) adopted this stance and required fiscal retrenchment from Brazil's government as a condition of its support in the repayment of the country's foreign debt. In contrast, the latter advocated that tightening fiscal policies could only lead to recession and inflation would continue to accelerate if prices continued to spiral out of control, as described above.

In fact, the macroeconomic policies of the early 1980's, which were based on IMF's requirements, failed to control inflation and were substituted with heterodox policies. In 1986, the Cruzado Plan was implemented when the government introduced a pricing freeze. The aim of the plan was to end the game of chicken by abandoning the price indexation. It was also difficult for the populist and fragile government that followed re-democratization to overcome recession and social costs that orthodox policies might generate. The coexistence of a democratic environment (instituted in 1985) with high economic inequality created a political bottleneck that blocked the advance of solutions to structural problems in the Brazilian economy [Mendes 2014].

The Cruzado Plan at first controlled inflation but the effect did not last long. As detailed in Fishlow [2011], the government relied excessively on seigniorage for its financing and the monetary base doubled in a few months. The excess in aggregate demand and the decline of supply caused by price control demoralized producers. The demand-supply gap brought a surge in imports and exhausted the foreign reserves. Despite initial success, the Cruzado Plan failed within a year and indexation began to reappear. From the end of the 1980s to the beginning of the 1990s, inflation increasingly threatened the economy and the annual inflation rate reached 226% on average. The country experienced a so-called hyperinflation. Failures in the fight against inflation and low level of economic growth characterized the decade of the 1980s and became the "lost decade" for the Brazilian economy.

1.2. Real Plan: Stopping the Reckless Train

In 1994, a new economic stability policy was planned under the then Minister of Finance, Fernando Henrique Cardoso. The Real Plan was designed by several eminent Brazilian economists, such as Persio Arida, André Lara Resende, Edmar Bacha, Gustavo Franco, and Pedro Malan etc. The plan was consisted of three phases.

First, a virtual currency (URV) was introduced in February 1994 in order to recover confidence in a currency that had been ruined by hyperinflation. The URV was linked to the US Dollar and maintained at a rate of 1URV=1USD. For conversion, an exchange values between the URV and the real currency (*Cruzeiro Real*) were announced. Price tags were written in both terms, URV and *Cruzeiro Real*, and the latter continued to be used in the markets. As the exchange rate was almost synchronized with prices, despite the continuing inflation in *Cruzeiro Real* terms, in URV terms the price rises were contained at almost zero inflation. The introduction of the URV was actually a rewriting of prices in dollar terms, but the adoption of the virtual currency smoothed the currency transition process [Nishijima & Tonooka 2002]. Second, after March 1994, part of the budget was retained by the federal government and gathered in an Emergency Social Fund to be controlled by the Ministry of Finance instead of being distributed to each ministry. This was intended to recover fiscal discipline. Third, after the URV had successfully penetrated the economy in July 1994, the virtual currency was replaced by the new real currency the "*Real* (BRL)," and the government maintained a fixed exchange rate of 1BRL=1USD as an anchor to guarantee price stability.

1.3. The Currency Crisis in 1999 and the Post Real Plan

After decades of fighting inflation, the Real Plan finally succeeded in stabilizing prices. However, there were several problems regarding sustainability of the plan. First, under the fixed exchange regime, the new currency *Real* appreciated about 30% and reduced the competitiveness of Brazil's industrial sector. Despite the nominal exchange rate being adjusted little by little, the inflation rate accelerated beyond that level and sharp increases in imports caused a current account deficit.

Second, under the fixed exchange rate, the Brazilian economy lost the independence of its monetary policy. Known as a trilemma in international economics, a fixed exchange rate, free capital movement, and an independent monetary policy cannot be followed simultaneously. More specifically, it is not possible to use monetary policy for economic adjustment, and the country had to adopt an interest rate that guaranteed a foreign currency balance to maintain a fixed exchange rate. The economic situation at that time was characterized by dependence on foreign debt, a current account deficit and high country risk. This brought the annual interest rate reaching 60% immediate after the implementation of the Real Plan. It then took two and a half years to lower the interest rate by 20%, and no better than that could be achieved. Maintaining the high interest rate caused stagnant economic growth.

At the end of the 1990s, there was a succession of crises such as the Asian financial crisis in 1997, the Russian Ruble crisis in 1998, and speculative capital flows against over-valued currencies in emerging countries. Rapid and large capital outflows in response to changes in the international economy caused a spike in interest rates and Brazil's economy faced significant instability. At the end of 1998 and the beginning of 1999, the Brazilian government could not prop up the currency because of a foreign currency shortage, and it had to abandon the Real Plan.

The transition to a new economic policy regime did not take long and a macroeconomic trinity, including monetary policy with inflation targeting, a floating exchange rate, and a fiscal surplus established by the Law of Fiscal Responsibility was adopted. This trinity became the new macroeconomic basis after 1999 and continues in effect to the present. After the Real Plan, the policy change introducing this macroeconomic trinity marked a major turning point for the Brazilian economy.

Shifting to a floating exchange rate recovered Brazil's independence in monetary policy. Instead of an exchange rate anchor with a fixed exchange regime under the Real Plan, the government adopted inflation targeting as their anchor for the new trinity. Inflation targeting matches the economy to annual targets set by the government. Brazil's central bank estimates the long-run behavior of aggregate demand using a front-line statistical model, and, if excess demand and inflation exceed this annual target, the authority reduces the money supply and raises the interest rate to decelerate the economy. Otherwise, in those instances where short demand and inflation is lower than the target, monetary policy can be adjusted to increase the money supply and the interest rate can be reduced in order to accelerate the economy. The central bank holds meetings of its Monetary Policy Committee (Copom) eight times a year. The committee announces a target rate for the central bank's benchmark overnight rate, the Special System for Settlement and Custody (Selic), to indicate the direction of monetary policy. Since 2005, the annual inflation target has been set at 4.5% and the central bank has conducted monetary policies to fix the inflation rate to the target with a margin of error of plus or minus 2% points. We can see in Copom's minutes, which are published on the Internet a few days after the committee meets, the economic perspective of the members of the committee and the bases for the determination of the Selic. In addition, the central bank publishes a weekly market survey with projections of key macroeconomic variables, such as inflation, GDP growth, and the current-account and trade balances. Projections for these variables are collected from the principle financial institutions in the country. After the introduction of an inflation targeting policy, the central bank has tried to foster transparency on monetary policy and this has helped to produce broader economic stability in a sustainable way.

For the last component of the macroeconomic trinity, a primary fiscal balance is used as an important variable to monitor Brazil's fiscal situation. The primary balance is government net borrowing, and it excludes interest payments from expenditure. The higher the primary surplus, the more credible the government's ability to meet debt payments becomes. In Brazil, the Law of Fiscal Responsibility is imposed in all spheres of the government to oblige them to achieve fiscal balance. They are therefore not allowed to borrow without authorization. Every year, targets for a fiscal primary surplus are set by the government to reduce or at least stabilize the public debt.

The international economic environment that favored Brazil also helped in the transition to the new macroeconomic bases of the post Real Plan. Developed countries had been growing, at least on the surface, until the international financial crisis triggered by the sub-prime loan crisis in the US happened. China and other emerging economies had accelerated its growth and boosted commodity prices in the international market. Brazil's export sector, which was strongly favored by the commodity boom, expanded rapidly, and the current account surplus rose as a consequence.

Regarding inflation, one of the most significant macroeconomic variables for Brazil's economy, the situation has been changing. During the Real Plan, the annual inflation rate was 11% a year on average and since 1999, in the period of the post Real Plan, the rate stabilized at around 9%. As we see in Figure 1, considering the country's economic history, the control of inflation since the adoption of the Real Plan is worth mentioning. It is an exceptional success for a country to obtain the control of prices since World War II.

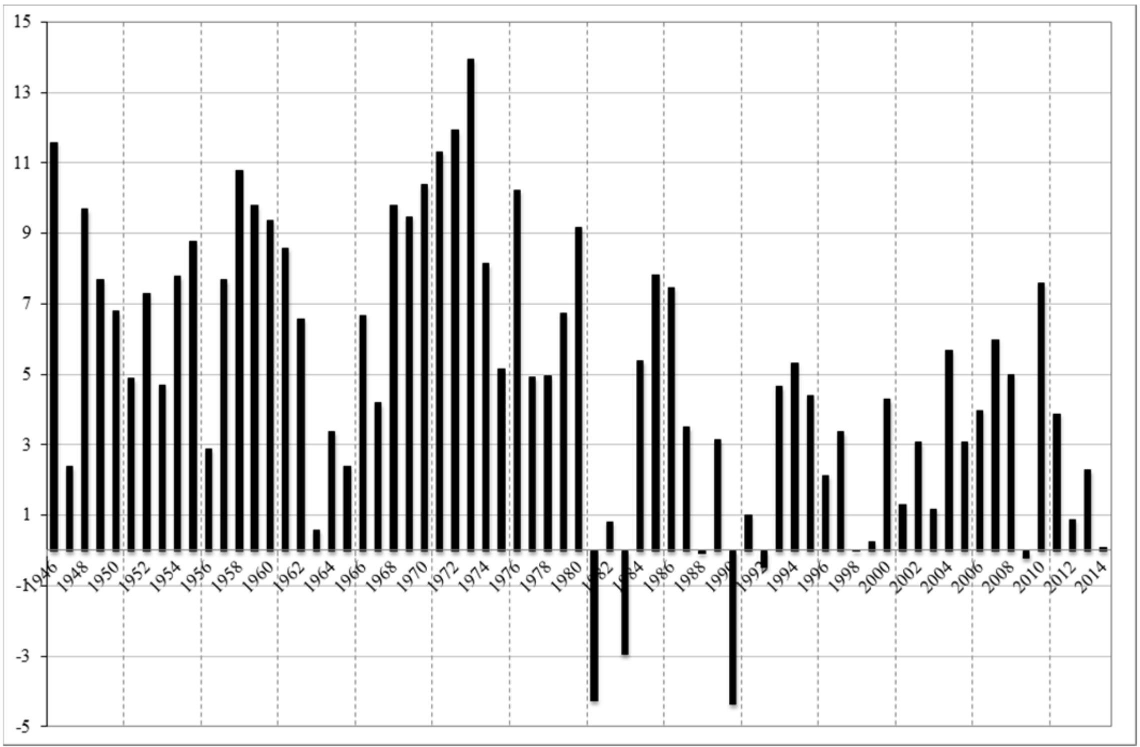
2. Economic Growth

2.1. Crises, Economic Stability and Institutional Improvement

Figure 2 shows the real GDP growth rate of the Brazilian economy in the decades after WWII.

In the initial period of industrialization under President Getúlio Vargas (1930-45, 51-54), the average annual growth rate reached 6.4%. This was succeeded by a period of populist government when the Target Plan was introduced and public investment for infrastructure expanded. During this period, the annual growth rate recorded 6.9% on average. Under the military regime (1964-85), including the period of the "Brazilian Economic Miracle," average annual growth rate jumped to 8%. However, a period of high inflation began with the oil shock in 1973, and the growth rate declined to 4.2% in the latter half of military rule. The rate fell to 2.4% a year after re-democratization in 1985 and the country suffered hyperinflation.

Figure 2. Annual Real GDP Growth Rate (%)



Source: Ipeadata and IBGE (http://cod.ibge.gov.br/41XGO, http://cod.ibge.gov.br/1Y1Q8, http://cod.ibge.gov.br/2A1LG, http://cod.ibge.gov.br/450KH).

During the last years of the military regime and the transition to civilian control, the Brazilian economy became very unstable and even experienced negative growth for several years. The country faced a volatile economic situation during these periods. Thus, economic growth after the introduction of the Real Plan seems to have been lower than the previous period but fluctuations were greatly reduced.

It is worth mentioning that Brazil's economy has significantly improved in the sense of economic stability, despite the difficult situation imposed by the series of crises after 1994. Externally, there was the Mexican peso crisis in 1994, the Asian financial crisis in 1997, and the Russian financial crisis in 1998. As Brazil's enormous current account deficit was financed by foreign capital, these crises and speculative capital movements had exposed the economy's vulnerability. Domestically, there were banking crises and the above-mentioned 1998-1999 crisis obliged the country to abandon the fixed exchange rate and adopt a floating system. As a consequence of the Real Plan, banks experienced deadlock with the disappearance of inflation and high interest rates. Private and public banks, which were used to perform in inflationary times, had to adjust their business model to the new situation, and Brazil's banking system needed reconfiguration. Between 1995 and 1998, there occurred a clear downsizing, an increase in the efficiency of the banking system and less participation of the public banks. This helped to clean out financial distortions [Baer 2008].

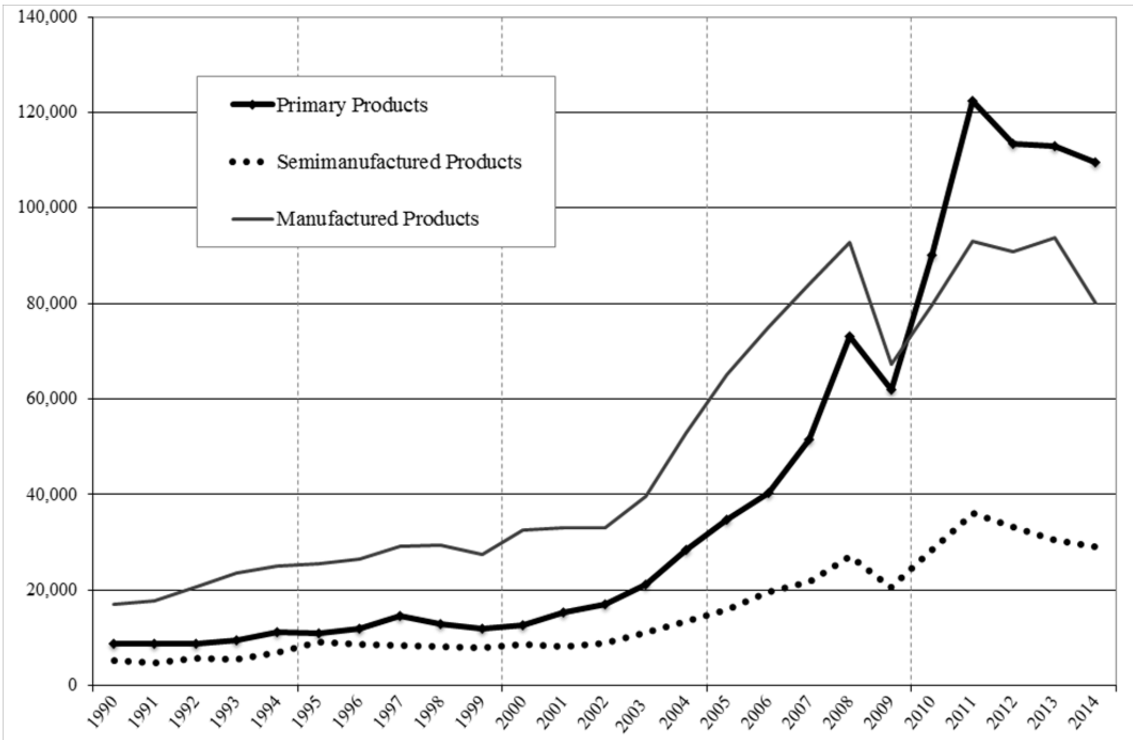
In 2001, the second government of President Fernando Henrique Cardoso suffered a serious power crisis, which caused rolling blackouts for almost half a year. Brazil's energy matrix is heavily dependent on hydroelectricity (at that time, around 85% of energy matrix were hydropower generation), and the lack of rainfall of that year caused a shortage of electrical power. The crisis strongly affected the economy, not only in the electricity sector but also in industry, commerce and above all, people's lives. Power consumption fell more than 20% and significantly reduced economic growth. Alongside these crises, there was a series of institutional improvements that helped the future development of the country.

In October 2002, both domestic and international financial market felt nervous about the victory of the candidate from the Worker's Party (PT), Luiz Inácio "Lula" da Silva. Investors worried about irresponsible macroeconomic policies and the erosion of established property rights that might come with Lula's government in 2003. However the newly elected government announced immediately that it would follow its predecessor's commitment to Brazil's principal macroeconomic policies. Besides political ideology, Lula and his economic team's rapid response and pragmatic management of the economy showed the importance of expectation control in achieving economic stability.

2.2. Commodity Boom and Domestic Demand

As mentioned at the beginning of this chapter, the strong growth of the Brazilian economy in 2000s has been propelled by the twin-engine of commodity exports and domestic demand. The remarkable expansion of the export sector can be seen in the average increase of 14% a year from 2002 to 2012, compared to 3% from 1997 to 2002. Brazil exports commodities (such as iron ore, soybean and sugar), machinery, and industrial materials. Figure 3 shows that these three categories had almost the same share in Brazil's exports at the beginning of the 2000s. However, the situation drastically changed after the mid-2000s with an outstanding expansion in commodity exports. A major reason for this change was the demand for natural resources urged by China's high growth. Until 2000, China's purchase share of Brazil's exports was less than 2%. In 2011 and 2012, it jumped to 17% and China became one of the country's biggest export destinations, comparable to the EU and the United States.

Figure 3. Export by Goods Category (Million USD)



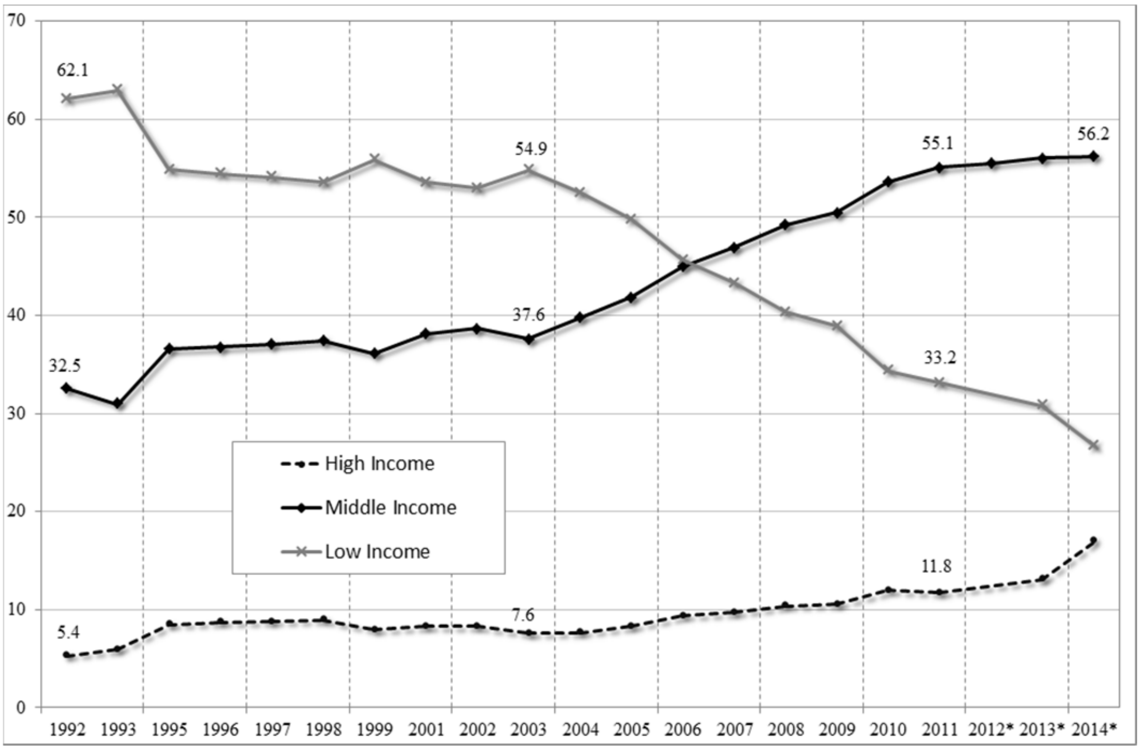
Source: Ministry of Development, Industry and Foreign Trade.

Brazil's government used its trade surplus to reduce foreign debt and increase foreign reserves. As a consequence, Brazil, which was a heavily indebted country in the 1980s, is now a net creditor. According to JP Morgan's EMBI+, the country risk, which was above 500 points in 2004 declined to 150 points in January 2013 and this reduced the cost of capital for the government and Brazil's companies. However, a downturn in growth forecasts and an increasing fear of inflation led to a downward adjustment in economic prospects, and the country risk went back up to 240 points in July 2013.

As previously mentioned, the interest rate in Brazil is still one of the highest in the world and the range of its reduction is low. Nevertheless, an aggressive interest rate cut implemented by the central bank moved some financial resources from the bond market to the private loan market. According to the central bank's database, the balance of private loans as a percentage of GDP, which was 25% in 2002, jumped to 50% in 2012, and, for the individual consumer loans increased from six to 16%.

Broad access to the credit market significantly stimulated domestic demand and triggered a consumption boom. The "new middle class," who moved from low-income groups to be a part of the middle class, played a central role in this boom. Figure 4 shows the change in composition of society by income groups. According to this figure, 54.85% of the population was in low-income group（monthly household income below R$1200, at 2011 BRL） and 37.56% in middle-income group (between R$1200 to R$5174) in 2003. These percentages inverted in 2009 and the share of low-income group declined to 33.19% while the middle-income group expanded to 55.05%. Considering the estimated total population for each year, the low-income population shrunk by 32 million people from 2003 to 2011. By contrast, the middle-income group increased by 39 million people. It is worth pointing out that this massive poverty reduction was attained even in the period when the Brazilian economy was suffering from the negative effects of the international crises.

Figure 4. Share of Income Groups (%)



Source: Neri [2011], SAE[2014].
Note: Estimates for 2012 to 2014.

There is another reason why special attention has been paid to the "new middle class." These people, who have just come out of poverty, have now become new consumers, and aggregately helped expand the domestic market and became one of the engines propelling Brazil's economic growth. Greater participation in the formal labor market and income increases, combined with broader access to consumer credit, have allowed them to purchase a variety of goods and services, such as mobile phones with Internet connections, the latest flat TV models, and cable TV services, as well as taking out loans to buy vehicles. It has become more common for children from these families to study in private schools and go to English conversation schools. Moreover, consumption of restaurant meals, domestic and international trips, use of nail salons increased and eventually boosted the service sector, especially in the food and tourism industries. Labor market conditions have also been favorable. According to the labor statistics of the Ministry of Labor and Employment, about 1.5 million formal jobs were created on average per year between 2003 and 2012.

Considering all of these factors, the situation can be described as follows. The commodity boom brought export growth and increased demand for goods and services in the domestic market. Addressing these demands, a significant increase in formal employment occurred. Steady income opportunities stimulated the use of credit and expanded domestic consumption further. Financial institutions broadened their operations from the bond market to the consumer loan sector in response to the stronger creditworthiness of individuals. The expansion of the consumer market stimulated production and increased the demand for workers. This virtuous cycle has supported strong economic growth since the 2000s.

With the Brazilian economy enjoying the wind behind them, reaction to the international financial crisis in 2008 and 2009 was rapid and effective. Until the Real Plan, any downturn in the international economic environment had led the country to raise its interest rate to avoid capital flows out of the country or to pursue fiscal austerity and reduce demand to adjust Brazil's balance of trade. Although these policies could aggravate the situation, the government had no choice but to adopt them. Brazil's economy used to be highly vulnerable to external shocks. By the end of the 2000s, the situation had changed. Sufficient foreign reserves and less external debt allowed the country to act proactively in the face of external degradation. The government took fiscal action, reduced taxes for durable goods such as vehicles, and chose monetary easing to help increase domestic demand. The implementation of this counter-cyclical policy showed the new strength of the Brazilian economy.

In November 2009, *The Economist* published a famous article titled "Brazil takes off," with a suggestive illustration of Christ the Redeemer, the symbolic statue of Rio de Janeiro, being launched as a rocket. As mentioned in Mendes [2014], auspicious growth and consumption data, poverty reduction and the accelerated expansion of the middle class created the idea that the country was entering a new era, and many optimistic publications predicting a positive economic and political future for the country were published. In fact, the authors of these books gave a positive assessment of the increase in economic stability through the Real Plan and post Real Plan periods. Under the favorable international economic environment, Brazil's strong potential as a commodity exporter and expansion of the domestic market, which was mainly led by the new-middle class resulted in the higher economic growth during the last decades. Along with factors above, the expansion of formal employment, poverty and inequality reduction had happened. Many people believed that, finally the dormant giant was awake and the future was there for the taking.

3. The Post New Brazil

3.1. Parade a Float

Quick recovery from the deceleration caused by the international financial crisis and significant economic growth in the end of 2000s helped the political heir of President Lula win the election in 2010. The country of football was awarded to hold the 2014 Soccer World Cup, followed by the right to stage the Olympic and Paralympic games in Rio de Janeiro in 2016. Annual GDP growth rate recorded 7.6% in 2010, consumer confidence index and industrial production maintained high levels in the beginning of President Rousseff’s government, which started in January 2011.

Similar to the first government of President Lula, Rousseff’s first administration took over economic policies executed in the preceding period. However, there were obvious differences between them, in terms of what succeeded and the context in which the Brazilian economy was situated.

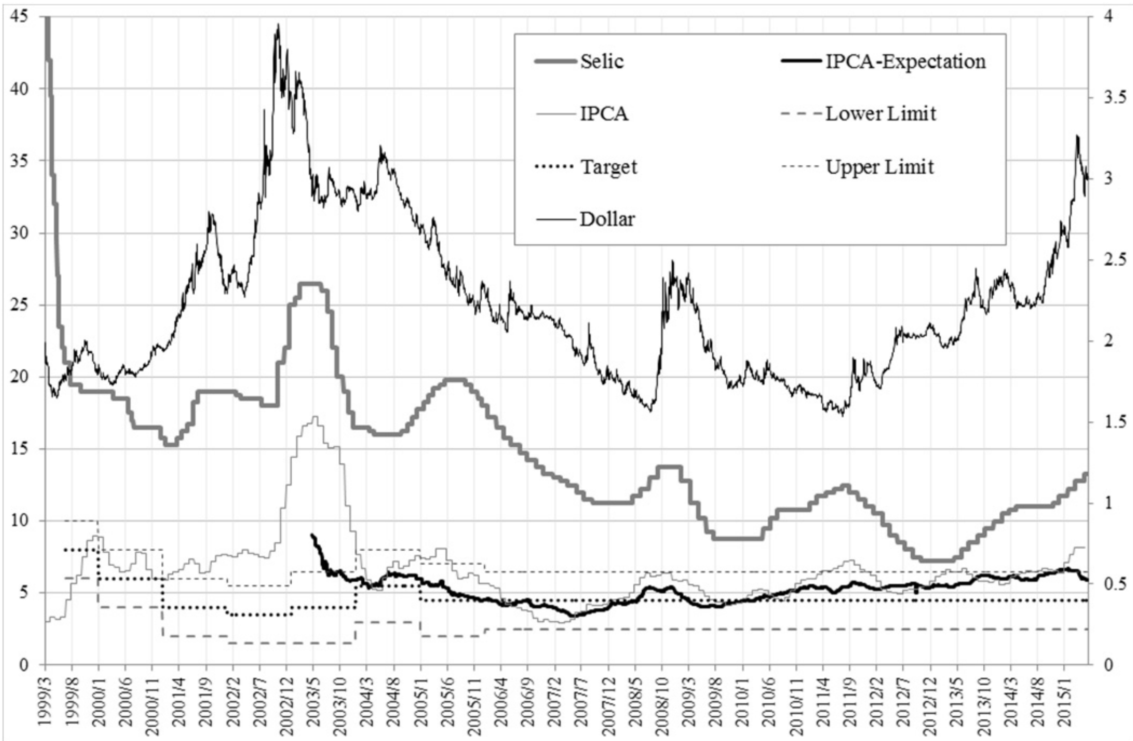
The former had shown clearly that macroeconomic stability was one of the most important priorities for the government to promote economic growth. As mentioned in section 1.3.,“order” was pursued by economic authorities with a firm commitment to the macroeconomic trinity introduced in 1999. Inflation targeting monetary policy conducted by the Central Bank under Henrique Meirelles’s command successfully controlled inflation expectations to its target and currency appreciation also helped contain inflation by the pass-through effect. Brazilian exports started to grow rapidly in 2000s, corresponding to the expansion of demand for commodity goods by emerging economies, especially China. With a favorable wind, domestic consumption also accelerated as described in a previous section.

On the other hand, Rousseff’s first government inherited economic policies conducted during the second administration of President Lula. Since the world economy suffered an economic downturn precipitated by the Lehman Brothers bankruptcy in 2008, economic management trended towards expansionary policies. Economic policies to boost domestic consumption started in President Lula’s government were enhanced especially during the period of the international financial crisis. As previously noted, various measures were adopted, such as expansion of credit access and reduction of taxes on durable goods. Rousseff’s government continued these policies and also scaled-up social policies started in the Cardoso government and consolidated in Lula’s government. The government announced infrastructure development programs, a housing policy for lower income groups, and industrial policies for several selected sectors. In general, the presence of the government in the Brazilian economy increased.

Under the leadership of President Rousseff, the economic authorities changed its direction of economic management policies. Regarding macroeconomic policies, the Central Bank constantly operated foreign currency swaps in the exchange market. The government controlled utility charges and administrative prices to contain inflation, repeatedly changed the fiscal target, and reinterpreted fiscal variables. For various sectors, the Brazilian Development Bank (BNDES) expanded its role to invest not only in the traditional industrial sector and infrastructure but also in commerce and services. Moreover, small enterprises and the Northeast region gained shares of the bank's loan percentage compared to others [Puga & Borça 2011]. Industrial policies, discussed in the following chapter, focused on preserving employment in several selected sectors rather than improving productivity or promoting innovation. Furthermore, the government introduced protectionist policies especially for the manufacturing sector, and persisted with its relationship with the Southern Common Market (Mercosul). During the last decade, Mercosul became an even more limited regional common market with a hard stance of member countries, contrary to the trends for advancements in economic integration in the world.

These government interventions in the economy are categorized as short-term economic policies, which consequently distorted the market and provoked a loss in confidence of the economic management team. This kind of policy shift could also been seen in the monetary stance of the Brazilian Central Bank. Considering the time lag of a policy to take effect, the Central Bank would conduct inflation targeting monetary policy to control not just the inflation rate itself but also the market's inflation expectations. As shown in Figure 5, monetary policy for Selic rate management seemed different from the past. It is worth mentioning that during Rousseff's first administration, inflation expectations never converged to the target established at 4.5% annually, and despite the up trend of market expectations, Copom made a sudden change in its interest rate policy direction in August 2011. Regarding the time lag of monetary policy effects, the falling trend of the official price index (IPCA) since October 2011, was not caused by the accompanying effect of inflation, but caused rather by the preceding restraint period. From back then, the Selic rate itself become a number to propose rather than and actual instrument of monetary policy for the government. President Rousseff frequently announced the low rate of interest as a policy priority for her administration, along with the maintenance of a competitive exchange rate and reduction of taxes to pursue economic growth. Accordingly, monetary authorities lost its rigor in the inflation targeting monetary policy under political pressure.

Figure 5. Inflation Targeting and Exchange Rate



Source: Brazilian Central Bank.

Note: Real (BRL) on a vertical axis of right-hand-side, opposite left in percentage. IPCA-Expectation corresponds the expectation of the financial institutions for the twelve-month accumulated IPCA, which is released on Focus reports.

Accompanying the deceleration of the international economy, the Brazilian export sector experienced modest growth but rapidly lost its trade balance around 2012. In 2014, a trade deficit was recorded for the first time since 2000. Losing one of the engines that sustained economic growth during the 2000s, the government relied more heavily on the other engine, domestic consumption, to shore up economic growth. Public banks continued to provide consumer finance for acquisition of durable goods, and a reduction in the industrial production tax assisted the trend.

One of the most controversial measures adopted in 2012, was the reduction in energy prices. The government forced electric power companies to reduce their prices solely from political motivation. As we all know, the dissolution of long-term contracts is not acceptable in the economy and this measure led the electric power companies to be too underfunded to invest in maintenance or expand production. Furthermore, it aggravated the economy because the worst drought on record occurred during the end of 2014 and the beginning of 2015. The country is again at risk to experience rolling blackouts, which exhausted growth potential at 30% in 2001 and led to change government in the election of 2002. Learning a lesson from the power shortage experience of 2001, the country diversified its energy mix, reducing dependence on hydro to 70%. However, it cannot respond to the rapidly growing power needs accelerated with an expansion of the use of home electronics and artificial price control of electricity. One must not leave the country's fortune in the hands of natural phenomenon.

A similar measure was introduced for fuel prices. Petrobras, a semi-public Brazilian multinational energy company, had been selling fuel cheaper than its import price, which adversely influenced the company's financial situation. As previously mentioned, these interventionist measures not only distorted the market in the long term, but also created further inflation pressures evoked by the implementation of demand-side policies without strengthening the supply side. In addition, a series of fiscal expansionist policies adopted by President Rousseff's administration caused deterioration of the fiscal situation. Financial deterioration drove the government, especially the Ministry of Finance to other controversial measures, namely creative accounting (*contabilidade criativa*). Various window dressing and methods of manipulation of accounts involving the national treasury and public enterprises have been adopted and conclusively messed up public finance.

Increase of governmental intervention of the economy happened for several reasons. One reason why the Rousseff's administration needed to intervene was based less on an ideological viewpoint, but rather a necessity to show economic results to obtain votes for her reelection in 2014. During the whole election campaign, the President and PT, which she belongs to, paraded a float decorated with ostentatious and suspicious economic achievements of her first administration. The float that adorned her during the election campaign in 2014 was built on a solid strategy designed by the party's election committee. For this strategy, the targets were readjusted to align with what her government had done, and the adoption of different measures to evaluate the policy outcomes of her administration were encouraged. A small percentage of society perceived and criticized the mismanagement of economic policies; however, the float was powerful enough to convince the majority of the population and guaranteed Rousseff's reelection.

3.2. Old Problems Re-emerge

After the final ballot was cast on October 28, 2014, the economic situation suddenly altered its appearance especially for those who believed in Rousseff’s election campaign. The Brazilian economy experienced a minimal rate of growth under Rousseff’s first government (2011-2013 [2]) at 2.09% compared to former administrations. Average annual growth rate for the four years of Cardoso’s first government (1995-1998) was 2.49%, Cardoso’s second (1999-2002) was 2.24%, Lula’s first (2003-2007) was 3.50%, and Lula’s second (2008-2010) was 4.60%. Inflation rate, officially measured by the IPCA, remained far above the official target of 4.5% and very close to the upper limit of the allowable range. Decrease in income inequality decelerated, the Gini coefficient remained around 0.50, and the number of people in extreme poverty increased for the first time in ten years from 10.08 million in 2012 to 10.45 million in 2013. Administrative prices, such as electric power, fuel price and urban public transportation fees, which were artificially controlled by the government, rose and directly hit the living expenses of the people. The fiscal situation deteriorated for various reasons mentioned above, and the fiscal deficit reached R$32.5 billion in 2014, the worst in 14 years since the current methodology was introduced. Even the unemployment rate, the most reliable and controlled by the government, began to rise at the end of 2014 according to the IBGE[3].

In fact, this is exactly how other parts of the population perceived the economy during President Rousseff’s first administration and was alerted to its policy failures. Indicators and statistics show that the Brazilian economy is situated in a slump and the macroeconomic trinity that sustained economic stability and economic growth since the end of the 1990s was ruined under Roussff’s first administration.

The government kept pointing to the international crisis for the poor economic performance of its country. However, one can disagree presenting two points. First, other major countries in Latin America such as Colombia, Peru and Mexico experienced higher economic growth with lower inflation rates in 2014 compared to Brazil. It is

---

[2] Calculation is made only for the first three years of the administration because the data for 2014 is not yet available at the time of submission of this paper. Regarding market expectation surveyed by the Central Bank (as of December 26, 2014), GDP growth rate for 2014 is expected to be around 0.14%, so that the average rate for the whole period of the first administration of President Rousseff will be downwardly modified with the announcement of the official data.

[3] PNAD Continua released on March 12, 2015, indicated increase in unemployment rate of 6.8% for November 2014 to January 2015, compared to the 6.5% for October to December 2014 and 6.4% for the same period of the previous year.

worth mentioning that, even in this region traditionally sensitive to world economic slowdowns, economies are in a growth trend. With economic statistics released by OECD for 38 countries, similar result can be found for the principal economies in the world. There was no critical slump in the world economy that Brazil's economic authorities in power persist there was. Second, the Brazilian economy is one of the least open in the region when comparing exports plus imports as a share of GDP. World bank statistics show this openness to trade ratio of Mexico (0.69), Colombia (0.39), Argentina (0.41), Peru (0.53), Venezuela (0.50) and Chile (0.72) to be much bigger than that of Brazil (0.25) for 2011. This means that Brazil would suffer less impact from external economic destabilization.

Therefore, not all but most reasons for the Brazilian economic contraction can be found among domestic economic and political conditions. As discussed in the previous section, one of the reasons can be inefficiency and distortion of the economy caused by government intervention. Intervention ruined the economic stabilization efforts pursued by former administrations and the current situation is reawakening the sleeping dragon named inflation. The battle against inflation is hardly won after years of efforts as described in Section 1. Frequent ups and downs in interest rates in a short period of time and regulation changes clouded business investment decisions affecting companies over a long period of time. In general, the government and economic authorities ungracefully lost the confidence of economic agents in their economic policies during Rousseff's first administration. This also could be one of the explanations for the current economic difficulties.

Soon after the election won by the closest margin in the history of Brazil, President Rousseff appointed a highly experienced economist, Joaquim Levy as the Minister of Finance to reconstruct the fiscal system. From the very beginning of the administration, which started in January 2015, Minister Levy announced a wide range of fiscal tightening policies to cut expenditures and to increase revenues with the aim to improve fiscal balance. Among the proposed measures, there are adjustments related to labor regulation. Because of this, the government already faces counter pressure from labor unions and related groups, which were traditional supporters of President Rousseff's workers party. Minister Levy travels both domestically and abroad to directly persuade congress and the private sector of the necessity of austerity programs to restore confidence in Brazil's economic management and future development with the return to growth.

The Central Bank, commanded by Alexandre Tombine, the same President from Rousseff’s first administration, is expected to apply monetary policies targeting inflation more strictly to converge inflation expectations to the center of the target. As mentioned in the first section of this chapter, inflation targeting is the anchor for the current framework of the macroeconomic trinity. The market misleading policy intensions and uncertainty of the independence of monetary authorities can cause the economy to stray without its anchor. It is important for the central bank to demonstrate that price stability is the first priority of the monetary authority and its commitment to pursue it [Mishkin 2004].

An additional difficulty for Brazil’s economy in the Post-New Brazil period is the rapid depreciation of the Real that started in mid-2011. It had intensely declined more than 20% in the first 80 days of Rousseff’s second administration and ended the high level experienced more than ten years ago in the beginning of Lula’s first administration. The Real became more unstable with drastic changes in the external economic situation; such as international financial crisis started in September 2008, the European debt crisis suffered since 2010, and in May 2013 the indication of a possible scale down of Fed easing brought financial outflows. Depreciation and instability of the currency increases inflationary pressure through the pass-through effect, and along with high interest rates, it restrains companies’ long-term investment. These negative effects might bring back the old problems in addition to business slowdown. The loss of credibility of Brazilian economic management is so severe that we can confirm this with the increase in the country risk measured by the Emerging Markets Bond Index (EMBI) to over 300 in the beginning of 2015. In the short-term, the economy first needs to achieve macroeconomic stability, even in the face of an economic recession. The process will be accompanied by pain, especially for the lower income groups situated in more vulnerable conditions and suffering more with higher inflation. Unfortunately, there is no quick solution.

Public dissatisfaction with the government continues to increase and there are no signs of slowing down. As shown in a massive demonstration held by millions of people on March 15, 2015, the poor condition of the economy was one of the most strongly criticized issue. High inflation rates and low growth were criticized, along with the corruption scandal of Petrobras, which involved lots of politicians of parties in power. The President’s popularity dropped drastically to almost single-digits in the third month of her government. Without public support, the President’s governability will be weakened further in conducting economic policies to ameliorate the current situation. After the parade, more people began to notice that the float was not bright enough to hide the bumpy road. Also apparent, was the disharmony of the band, inadequate interpretation of the theme, a malfunctioning engine, and hefty fees to be charged during the following years. At the very beginning of Rousseff's second administration, the economy faces stiff challenges; macroeconomic stability for the short-term and economic reforms to the fiscal system, labor markets, pension system, infrastructure development, educational system, etc. for the medium- to long-term. These are nothing new, but the same problems and challenges discussed in literature such as Nishijima [1993], Baer [2008] and Mendes [2014]. These works emphasize economic inequality and social conflict among groups, which complicate policy implementation. The dormant giant who was almost awake with the achievement of new "order and progress" in the economy, seems to be asleep again under a potent anesthesia that reduced economic stability and economic growth. As a consequence, the challenges facing the critical situation of the economy are much harder to resolve.

Concluding Remarks

This chapter, gave a brief overview of the Brazilian economy by focusing on Brazil's major and persistent problem: inflation. It then reviewed how this problem was challenged and finally resolved with the Real Plan in 1994. Next, the transition in economic policy in order to stabilize the economy in a sustainable manner was described. Economic stability, pursued through a trinity of macroeconomic policies, is the fundamental base for the period of economic expansion that has been promoted by the twin engine of a commodity boom and robust domestic consumption. Facing the international financial crisis in 2008, the government changed its economic policy to further stimulate the domestic market and resist this difficult period. This policy helped recover quickly from the crisis, and Brazil became one of the countries that was least affected by deceleration in developed economies.

On the other hand, there was a series of maladjustments in dealing with structural problems during President Lula's second term. Behind the remarkable economic growth at the end of 2000s, the awareness of these measured dimmed. The adoption of gloss-over policies with short-run objectives was accelerated in President Rousseff's first term and together with greater intervention from the government, reduced efficiency and distorted the economy. Economic agents' confidence in various areas has also been forfeited. The period of experimental management of the economy showed the following. Despite the institutional improvements attained since the mid-1990s, the discredited government failed to implement any kind of economic policy and left room for a resurgence of solved problems, such as inflation. This brought on a situation that was far from achieving the government's imperative of economic growth.

For the second term of President Dilma Rousseff, macroeconomic discipline needs to be restored first. Implementing monetary policy targeting inflation accompanied by fiscal administration, could converge the inflation rate to its targets. Authorities are expected to assure transparency and accountability to implement the necessary measures to stabilize the economy and revive the confidence of economic agents both nationally and internationally.

In the mid- to long-term, a wide variety of reforms to help economic growth should be undertaken. One of the most important issues is growth in productivity. Improvements in education are crucial in this regard; the country especially needs to ensure educational quality. Infrastructure development is also critical for boosting productivity.

Despite the potential of high returns on investment, underinvestment and low level of capital accumulation has continued for more than three decades in Brazil. Absence of infrastructure quality can be easily seen with chronic traffic congestion in metropolises, frequent delays and cancellation of flights, accumulation of goods waiting for export at ports, and a vulnerable electricity supply system. Under the fiscal constraint of low levels of domestic savings, encouraging participation of the private sector could help the situation. With the aim of infrastructure development, consistent regulations and abatement of legal and practical complications are necessary for the efficient execution of projects.

In Brazil's economy, the possible third engine has not yet been ignited. For example, the country has not been able to fully enjoy the benefits of the domestic market potential of more than 200 million people. As mentioned above, more than half are the newly ascended middle class, with a hearty appetite for consumption and investment. Because of the low levels of infrastructure development and cumbersome bureaucracy with a complicated tax system, the domestic market is not yet well integrated. As a result, potential widespread consumers have not yet been captured and not yet matched with business opportunities. Human and capital investment can be more effectively utilized if the economy becomes more nationally integrated. Moreover, it would be applicable in a wider regional setting, too. Latin America is a market with enormous potential, especially for the Brazilian industries that traditionally exported manufactured goods to the region. In fact, depreciation of the Real in recent years has already encouraged exports of manufactured goods to the region. Both infrastructure development and enrichment of institutional integration within the region are necessary to fully enjoy the regional market potential.

Also, encouraging technological development of several sectors might accelerate innovation. For example, agroindustry-related technology such as agricultural machinery and petroleum-related technology especially for the development of deep sea (Pre-Salt) areas are Brazil's viable sectors. The first focus should be improvements in the business environment, including institutional development and reduction in bureaucratic red tape. It also could be applicable to other sectors because assuring a business environment that effectively functions reduces each company's costs and makes their activities more competitive. In this sense, institutional development to improve the environment is one of the most important roles for the government.

As argued in Mendes [2014), in Brazil, the moments of acute economic crisis have been windows of opportunity for unpalatable reforms whose benefits have been enjoyed by some social groups. Institutional improvements that form the basis of Brazil's economy today have mainly been derived from lessons learnt from past failures, which have forced the economy to adjust at the moment of crisis. This means that the economic difficulties faced by the second four-year term of President Rousseff could turn out to be the catalyst for embarking on structural reforms. It is important for the government to formulate economic policies with a concrete vision to increase efficiency, reduce distortions, improve economic growth and reduce inequality in the long term.

Bibliography

Baer, Werner 2008. *The Brazilian Economy: Growth and Development.* Sixth Edition, Lynne Rienner Publishers.

Fishlow, Albert 2011. *Starting Over: Brazil since 1985*. Washington, D.C.: Brookings Institution Press.

Mendes, Marcos 2014. *Inequality, Democracy and Growth in Brazil: A Country at the Crossroads of Economic Development*. First Edition, Elsevier.

Mishkin, Frederic S. 2004. "Can Inflation Targeting Work in Emerging Market Countries?" *NBER Working Paper Series*, 10646.

Neri, Marcelo C. 2011. *Os emergentes dos emergentes: reflexões globais e ações locais* *para a nova classe média brasileira*. Rio de Janeiro: Centro de Politicas Sociais, FGV.

Nishijima, Shoji 1993. *Gendai Raten Amerika keizairon* [*Theory of Modern Latin American Economy*]. Kobe Daigaku Kenkyu Sousho.

Nishijima, Shoji and Eduardo K. Tonooka 2002. *90 nendai Burajiru no makuro keizai no kenkyu* [*A Study on Macro-Economy of Brazil in 1990s*], Research Institute for Economics & Business Administration, Kobe University.

Puga, Fernando and Gilberto Borça Jr. 2011. "O papel anticíclico do BNDES e sua contribuição para conter a demanda agregada," *Visão do Desenvolvimento*, No. 96.

SAE (Secretaria de Assuntos Estratégicos) 2014. *Assuntos estratégicos: social e renda: a classe média brasileira*, No.1, Brasília: SAE.