



Brazil's Presidential Election: Background on Economic Issues

BY MARK WEISBROT AND LUIS SANDOVAL

Introduction

Brazil's presidential election of October 1st is not considered to be close, with incumbent president Lula da Silva of the Workers' Party (PT) holding a 21-point lead, or 50-29 over his closest competitor, Geraldo Alckmin of the Brazilian Party of Social Democracy (PSDB).¹ Lula's re-election would undoubtedly be even easier if not for the competition from the left by Heloisa Helena de Moraes Carvalho of the Socialism and Freedom Party (PSOL), a former PT member of congress who was expelled from the party in December 2003 because of her opposition to the PT's Social Security reform. She is currently polling at about 9 percent, and most of her support is presumed to be from people who would otherwise vote for Lula. It is therefore possible that Lula will fail to get the requisite 50 percent of votes in the first round on October 1st, although most observers currently see a first round victory. But even if there is a second round, he is expected to win by a comfortable margin.

Nonetheless there are important economic issues relevant to the election, even if they are not the subject of campaign debate that could affect the outcome. Rather, if Lula is, as expected, re-elected to a second four-year term, there are questions as to what economic policies, if any, might be different than in the first term. This paper will look at some of these key economic policy issues.

The Long-Term Growth Slowdown

Figure 1 illustrates the most pressing long-term economic problem facing Brazil: the lack of economic growth over the past 25 years. From 1980-2000, GDP per capita in Brazil grew by a cumulative total of 8 percent, and has grown by just 3.5 percent

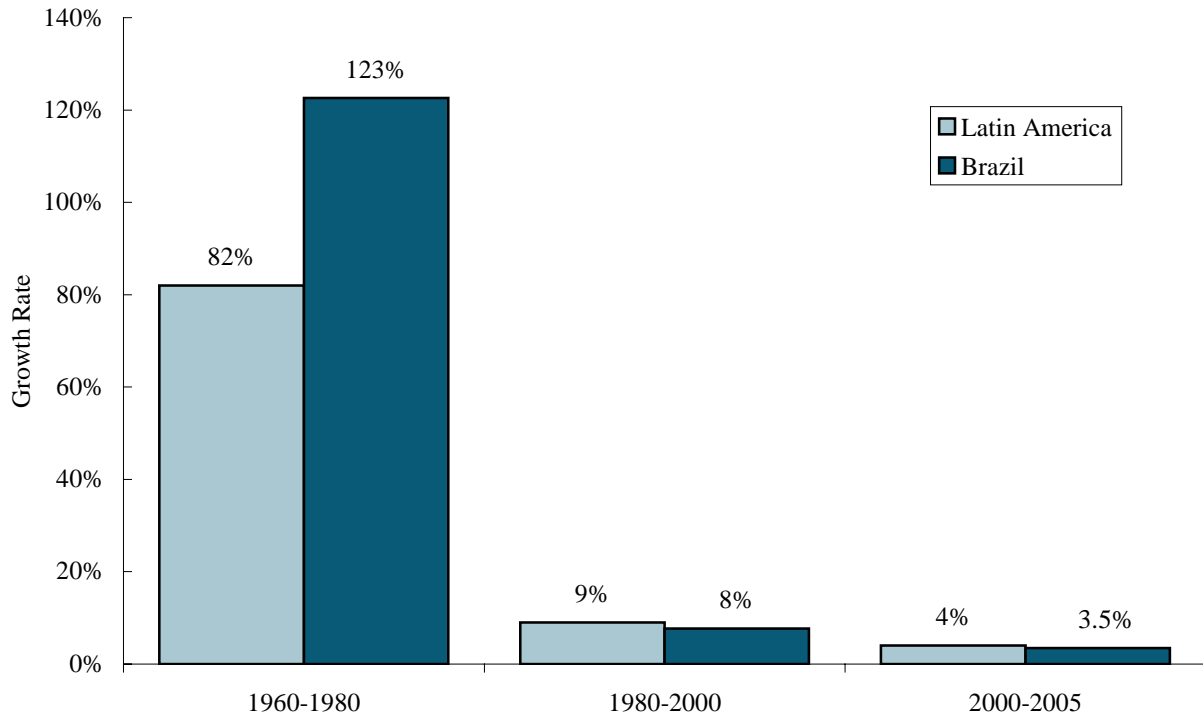
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¹ See, for example, "Lula Gains, Reaches 50% in Brazil," September 18, 2006, Angus-Reid Global Scan: <http://www.angus-reid.com/polls/index.cfm/fuseaction/viewItem/itemID/13179>.

for 2000-2005, for a total of 11 percent over the last quarter century. For comparison, the Brazilian economy grew by 123 percent per capita in just the twenty years from 1960-1980.

FIGURE 1
Total Growth in Real Per-Capital GDP



Sources: Angus Maddison, WEO 4/06, and author's calculations.

This mirrors the problem that has plagued the Latin American region as a whole over the past two and a half decades. As can be seen from Figure 1, the region's GDP per capita growth was similar to Brazil's over the past 25 years – about 13 percent – as compared to 82 percent from 1960-1980. The last 25 years in Latin America have seen the worst economic growth in more than a century. The growth collapse in Brazil was even more pronounced than for the region, because the economy's growth rate was considerably above the regional average prior to 1980.

The magnitude and consequences of this enormous, long-term growth failure are well known among economists but not so much among the larger public. If Brazil had simply continued to grow at its pre-1980 rate, the country would have European living standards today. Instead, in 2004, some 52.5 million people were living below the official poverty line of about \$1.50 per day.

Brazil's pre-1980 growth rate was very good but by no means the best among developing countries. For example, South Korea grew nearly twice as fast and Taiwan about 2.5 times the rate of Brazil during this period (1960-1980). Brazil's pre-1980 growth rate is therefore a reasonable benchmark by which to compare the country's economic growth of the last 25 years.

Table 1 shows selected economic indicators for Brazil since 2000. The current government took office in January of 2003. During these four years, GDP per capita has grown by 1.4 percent annually. This is similar to the 1.6 annual per capita growth rate for the Cardoso years (1995-2002), and is about one third of the growth rate prior to 1980.

With so little economic growth, it is very difficult to accomplish much in the way of poverty reduction. When the economy is growing rapidly, it is at least possible to direct some of the increased income to the poor. When it is hardly growing or not growing at all, poverty alleviation becomes much more politically difficult to the extent that it can only be accomplished by taking income away from the upper and especially the middle classes. Brazil also has an income distribution that is one of the most unequal in the world: the ratio of the income of the top 10 percent to the bottom 10 percent is 68 to 1.² (For comparison, the United States, after suffering one of the largest upward redistributions of income in its history over the last 30 years, the ratio is 15.9 to 1). But this inequality has probably not worsened significantly over the last 25 years. The real cause of the existing poverty is the collapse of economic growth. Restoring healthy economic growth is thus the most important problem facing policy-makers in Brazil.

Monetary and Exchange Rate Policy

Figure 2 shows the central bank's short-term (overnight) lending rate, called the Selic rate in Brazil, since 2000. The inflation rate (consumer price index) is also plotted on the same graph, with the difference between the two approximating the real interest rate. When Lula first pulled ahead in the polls during his 2002 presidential bid, there was a crisis in the financial markets, and the central bank raised interest rates from an already-high 18 percent in October of 2002 to 26 percent when Lula took office in January of 2003.

The Selic rate remained at 26 percent for about 6 months, was then brought down to 16 percent by January of 2004. The authorities continued to lower rates slightly for the first half of the year but then began raising them again in August of 2004, to 19.75 percent in June 2005. In response to weak economic growth in 2006, the central bank has lowered rates to the current 14.25 percent.

Nonetheless these are still extremely high interest rates. Brazil's inflation is now expected to come in at 3.2 percent for the year, lower than in the United States. This means that the real short-term (policy) interest rate in Brazil is more than 11 percent, among the highest in the world. In the United States, for example, after a long series of rate hikes, short-term interest rates stand at 5.25 percent. With inflation at 3.5-4.0 percent, the real interest rate is less than 2.0 percent.

²United Nations Development Programme, Human Development Report 2005 Statistics, available online at: <http://hdr.undp.org/statistics/>.

TABLE 1
Brazil: Selected Economic Indicators

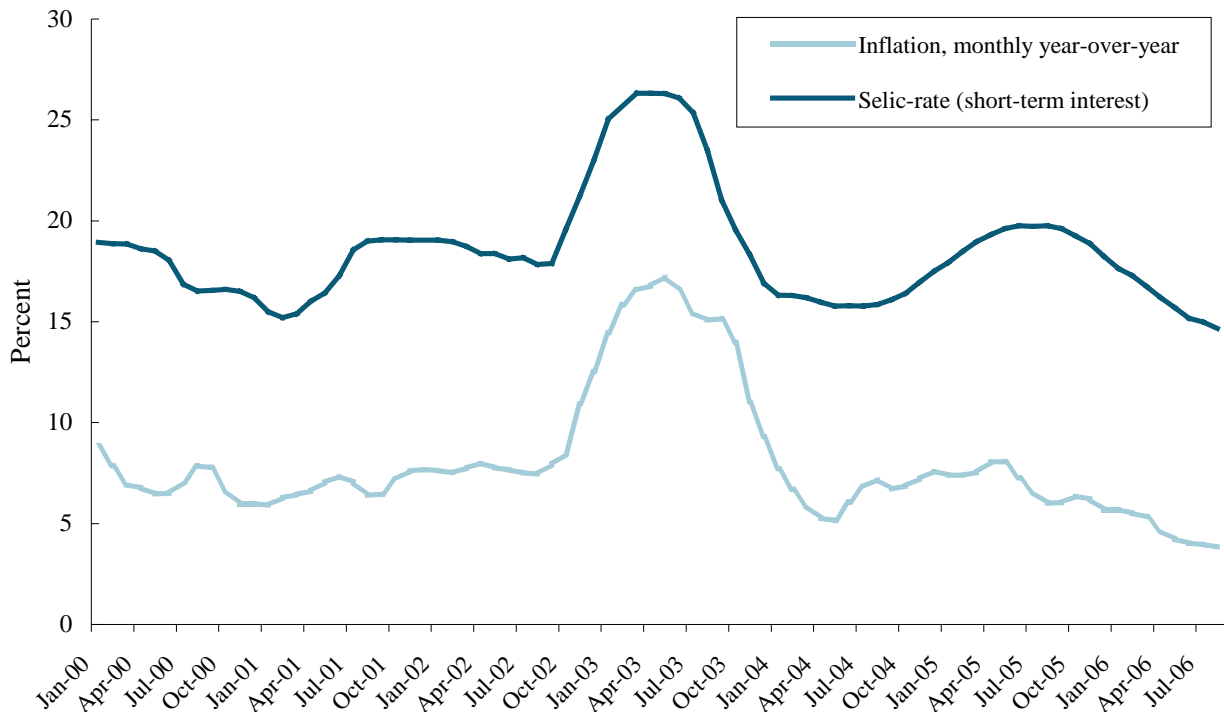
	2000	2001	2002	2003	2004	2005	2006 Most Recent Data	2006 Projections
Real GDP (annual % change)	4.4	1.3	1.9	0.5	4.9	2.3	1.2 ¹	3.6 ^a
Net exports, contributions to GDP growth (%)	-0.3	1.1	2.8	1.6	1.1	0.8	-1.5 ²	0.0 ^b
Real GDP per capita (annual % change)	2.8	-0.2	0.4	-0.9	3.4	0.8	...	2.2 ^a
<i>US\$ millions</i>								
Current account balance	-24,224.5	-23,214.5	-7,636.6	4,177.3	11,679.1	14,192.7	1,306.0 ²	5,808.0 ^a
Exports of goods and services	64,211.2	67,407.1	71,154.2	82,988.3	108,854.0	133,558.2	34,000.4 ²	...
Imports of goods and services	-73,319.3	-72,469.2	-61,620.4	-64,725.7	-80,657.8	-98,662.3	-26,715.4 ²	...
Trade balance	-9,108.1	-5,062.1	9,533.8	18,262.6	28,196.2	34,895.8	7,285.0 ²	...
<i>% of GDP</i>								
Current account balance	-4.0	-4.6	-1.7	0.8	1.9	1.8	0.6 ²	0.6 ^a
Exports of goods and services	10.7	13.2	15.5	16.4	18.0	16.8	15.6 ²	...
Imports of goods and services	-12.2	-14.2	-13.4	-12.8	-13.4	-12.4	-12.3 ²	...
Trade balance	-1.5	-1.0	2.1	3.6	4.7	4.4	3.3 ²	...
Total Net Public Debt (%GDP)	48.8	52.6	55.5	57.2	51.7	51.6	51.7 ²	...
Net External Public Debt (%GDP)	9.6	10.4	14.3	11.7	7.5	2.6	1.5 ²	...
Net Domestic Public Debt (%GDP)	39.1	42.2	41.2	45.5	44.2	49.0	50.2 ²	...
Additional Items								
Inflation, consumer prices (annual % change, end of period)	6.0	7.7	12.5	9.3	7.6	5.7	4.0 ²	...
Nominal Exchange Rate (R\$ per US\$, end of period)	1.8	2.4	2.9	3.1	2.9	2.4	2.2 ²	2.2 ^a
GDP current prices (US\$ millions)	602,207	509,797	459,379	506,784	603,994	796,284	217,683 ³	966,827 ^a
GDP per capita (PPP US\$)	7,315	7,478	7,642	7,727	8,202	8,561	...	8,917 ^a

Sources: IMF, World Economic Outlook, September 2006 (WEO 9/06); Banco Central do Brasil (BCB); Instituto de Pesquisa Econômica Aplicada - IPEA (www.ipea.gov.br).

Notes:

1. Second Quarter, year-over-year % change
2. Second Quarter
3. First Quarter
- a. WEO 9/06
- b. Brazil's Ministry of Finance

FIGURE 2
Inflation and Short-Term Interest Rates



Sources: Instituto Brasileiro de Geografia e Estatística (IBGE); Banco Central do Brasil (BCB).
 Note: The Selic-rate, set by the Central Bank, is annualized. The inflation rate is based on the Broad National Consumer Price Index (IPCA), calculated by the Brazilian Institute of Geography and Statistics (IBGE)

The effect of the high interest rates set by Brazil's central bank is to slow growth, although interest rates do not influence the economy the same way as they do in the United States. In the U.S., when the Fed raises interest rates, it slows the economy by raising the cost of borrowing for consumers and businesses. Home mortgages become more expensive, as does a large amount of consumer borrowing based on home equity. Credit card interest rates and business borrowing costs also go up. This tends to reduce consumer borrowing and spending, especially for big-ticket items such as homes and cars, and (with less certainty) business borrowing and investment.

In Brazil, consumer spending that is based on credit is a small fraction of that in the U.S., relative to the economy. And there is not much borrowing for business investment that is tied to these high rates – most long term borrowing for business investment is from the BNDES (Brazil's National Development Bank), which is owned by the government and provides about 20 percent of overall credit (about 6 percent of GDP). These loans are at much lower interest rates – currently about 7.5 percent – than the Selic rate. Most credit for agriculture is from the Banco do Brasil, in which the government has a majority share.

Therefore, in the short run,³ the main effect of these high interest rates is through the exchange rate. The high interest rates attract foreign capital and push up the value of the currency (the Brazilian *real*). This makes the country's exports more expensive and imports cheaper, undercutting production in export as well as import-competing industries, thus slowing the economy.

In this way the central bank's policy of *inflation targeting*, although it has been recently successful in bringing inflation down to low levels, can be very harmful to the economy's health. The central bank targets a specific level of inflation (this year was 4.5 percent), and raises the short-term rate as necessary in order to achieve this target, while allowing the currency to float. This effectively makes the exchange rate an instrument of domestic monetary policy, causing the currency to be more volatile, and at times overvalued, than would be best from the point of view of growth, employment, and development.

The Brazilian real, as measured by the Real Effective Exchange Rate, has appreciated by 53.8 percent since Lula took office in January of 2003. (See Figure 3). As would be expected, the contribution of net exports⁴ to growth has been steadily dropping. This is shown in Table 1. In 2002, net exports contributed 2.8 percentage points to GDP growth (which was only 1.9 percent in 2002); this has fallen to 0.8 percent in 2005 and is expected to come in at about zero for this year. The reduced contribution of net exports could be a positive development⁵, if growth rates were high and remained so; but as can be seen in Table 1, this is not the case when growth is sluggish and/or declining as it has been for 2005 and 2006.

The effects of exchange rate appreciation can also be seen in Table 1. Exports increased quite substantially from 10.7 percent of GDP in 2000 to 18 percent of GDP in 2004. They have since fallen off to 15.6 percent of GDP (2006, first quarter), which is at least partly due to the currency appreciation.

Some observers point to the country's trade surpluses as evidence that the exchange rate is not overvalued. Indeed, Brazil's trade balance soared from a deficit of 1.5 percent of GDP in 2000 to 4.7 percent of GDP in 2004 and remains at 3.3 percent today (See Table 1). But a large part of this surplus has been maintained, in spite of the large appreciation of the *real*, by increasing world demand and high prices for Brazil's natural-resource based products: for example iron, soybeans, and petroleum products. At the same time, the slow growth of the domestic economy has kept imports at a share of GDP constant since 2000 (See Table 1).

It seems likely that the maintenance of an overvalued currency will harm Brazil's growth prospects. The decline in exports since 2004, by 1.4 percentage points of GDP, has already contributed significantly to the slowing of the economy. It has hurt a number of labor intensive industries, including textiles, clothing, shoes, furniture, leather, and lumber – some of which are producing for domestic markets.⁶

³ Even in the U.S., a change in interest rates is believed to operate with a substantial lag. In this discussion here, we are including any time lags as part of the short run; the long run is over several years or more.

⁴ Exports minus imports.

⁵ For a given rate of growth, a higher level of net exports means that less is available for domestic consumption or investment.

⁶ Boletim de Comércio Exterior and Boletim Setorial (various issues), Fundação Centro de Estudos do Comércio Exterior (FUNCEX), <http://www.funcec.com.br>.

FIGURE 3
Real Effective Exchange Rate (REER), based on consumer prices
 (Index: units of foreign currency per R\$)



Source: BCB

Note: The REER used here is based on the consumer price index, IPCA (see notes to Figure 2)

But the effect of an inflation-targeting regime, which allows the currency to become overvalued, is just part of the problem associated with this monetary policy. Over the longer run, a policy of maintaining excessively high interest rates is much more destructive. It helps shape the economy into a slow-growth economy, with a much lower rate of capital formation. In the long run it severely limits business borrowing for investment, as well as the development of household mortgage lending and other credit. Credit is only about 32 percent of GDP in Brazil, a low level as compared with developing countries with similar income per capita.

When Brazil was a fast growing developing country, prior to 1980, there were other policies that played an important role its development. These included industrial policy and development planning that have mostly disappeared. Nonetheless, of all the policy changes that might restore growth to Brazil, a change in monetary policy seems to be the most important and urgent.

Employment, Wages, and Poverty

Table 2 shows data for employment and unemployment since 2001, for urban areas, which for Brazil contains about a third of the working age population.⁷ Comparing the current year (through July 2006) with 2002, the record is about what could be expected in a period of sluggish growth. Some 2.9 million net new jobs were created, as employment rose from 17.3 million in 2002 to 20.2 million in July 2006. However, the labor force also grew by slightly more than that, about 3.1 million over the same period. As a result, unemployment remained at about 10.7 percent in July 2006, as compared to 11.7 percent in 2002. In other words, the job creation was just about enough to keep up with new entrants to the labor force, but not enough to significantly reduce unemployment.

As can also be seen in Table 2, the average real wage also declined about 9 percent over during this period, from R\$1,134 to R\$1032 (about US\$482). This undoubtedly contributed substantially to bringing down inflation, but at the expense of people already earning very modest wages.

The government did enact some measures that benefited the poor. The minimum wage has been raised from R\$260 per month in 2004 to R\$350 (about US\$164) today. After adjusting for inflation, this is a 19 percent increase. This is still a terribly low wage (about one-third of the average wage) but the increase is significant for the millions of workers affected.

The government also created the “Bolsa Família” (Family Grant) program of cash transfers for poor families, consolidating four existing cash transfer programs under a new Ministry for Social Development. These grants are made to families with specific conditions attached, such as children attending school and utilizing health clinics and immunizations. The idea behind the program, besides reducing administrative costs and gaps in coverage through consolidation, is to reduce present poverty through cash transfers while at the same time investing in future poverty reduction, e.g. by increased school attendance.

As can be seen from Table 3, the number of families covered by the program has increased very rapidly, from 3.6 million in 2003 to a projected 11.2 million families (some 44 million people) this year. However, the amounts of money per family are relatively small: between US\$5 and US\$33 per family each month. The average payment is US\$24 per month, for a family of four.

As the World Bank's team leader for their Bolsa Família project⁸ notes, this average is about 6 percent of the minimum wage and about 19 percent of the World Bank's poverty line. Spending on the project has increased from about 0.2 percent to 0.5 percent of GDP.⁹

⁷ Comparable data for the rest of the country are not available.

⁸ The World Bank contributed a four year, \$572 million grant to this project – see World Bank (May 25, 2004), “Project Appraisal Document: Brazil Bolsa Família Project,” Report No. 28544-BR.

⁹ Lindert, Kathy (2006), “Brazil: Bolsa Família Program – Scaling-up Cash Transfers for the Poor,” in ‘Principles in Action: Sourcebook on Emerging Good Practices’, Managing for Development Results, March 2006, pp. 67-74. Available online at: <http://www.mfdr.org/sourcebook/6-1Brazil-BolsaFamilia.pdf>.

TABLE 2
Brazil: Employment

	2001	2002	2003	2004	2005	2006						
						January	February	March	April	May	June	July
Labor Market (Urban Areas)^a												
Unemployment Rate (%) ^b	11.3	11.7	12.3	11.5	9.8	9.3	10.1	10.4	10.4	10.2	10.4	10.7
Working Age Population (thousands) ^c	31,957.8	35,512.6	37,297.7	38,058.8	38,869.4	39,368.2	39,361.3	39,359.2	39,410.0	39,512.7	39,562.1	39,587.0
Labor Force	17,510.6	19,586.3	21,293.2	21,753.0	21,990.0	22,045.2	22,154.1	22,242.2	22,158.3	22,235.2	22,484.2	22,658.6
Employed (thousands)	15,533.4	17,302.5	18,669.3	19,259.5	19,830.1	20,006.3	19,921.6	19,928.7	19,861.6	19,974.5	20,144.5	20,228.9
Unemployed (thousands)	1,977.2	2,283.8	2,623.8	2,493.5	2,159.9	2,038.9	2,232.5	2,313.5	2,296.7	2,260.7	2,339.6	2,429.7
Average Real Wage (in R\$ of July 2006)	1,101.4	1,133.6	1,001.2	1,003.7	1,026.4	1,021.3	1,020.2	1,026.3	1,038.8	1,044.1	1,032.2	...

Sources:

IPEA; Departamento Intersindical de Estatística e Estudos Socioeconômicos-DIEESE (www.dieese.org.br)

Notes:

- Refers to the metropolitan areas of Recife, Salvador, Belo Horizonte, Rio de Janeiro, São Paulo and Porto Alegre
- Ratio between the unemployed and the Labor Force (or the Economically Active Population, which, in turn, is defined as the sum of the employed and the unemployed).
- Number of persons over 10 year old

TABLE 3
Brazil: Poverty and Social Programs

	2001	2002	2003	2004	2005	2006
Poverty^a						
Percent of people living in poverty	35.1	34.3	39.2	33.6	...	...
Percent of people living in extreme poverty	15.2	14.0	16.7	13.1	...	...
Bolsa Família Program						
Beneficiaries (millions of families)	...	...	3.6	6.5	8.7	11.2 ^b
Spending (US\$ billion) ^c	...	...	2.0	2.7	3.4	4.3 ^b
Spending (R\$ billion)	...	...	4.3	5.9	7.5	9.4 ^b
Average monthly payment per family (US\$) ^c	...	...	11.3	30.4	29.5	...

Sources:

Instituto de Pesquisa Econômica Aplicada -IPEA (www.ipea.gov.br); MDS/Balanco do Programas Sociais (www.mds.gov.br);

Notes:

- a. People living in poverty are here defined as those whose monthly income is no more than one half of the legal minimum wage and people living in extreme poverty are those whose monthly income is no more than one fourth of the legal minimum wage (IPEA). The monthly legal minimum wage in December 2004 was R\$260 and currently stands at R\$350 (or US\$159)
- b. Estimates
- c. At current exchange rates

Nonetheless, for the target families, whose per capita income is \$17 per month, or \$68 per family (“extreme poor”), or between \$68 and \$136 per month per family (“moderately poor”), this cash income can be quite significant.

The statistics on employment and poverty illustrate the limitations of trying to raise the living standards of the poor while facing slow growth and tight budget constraints. On the one hand, with so many poor people having so little cash income, it is possible to make a significant difference in millions of people’s lives with even a relatively small commitment of money (0.3 percent of GDP). On the other hand, under these constraints it is difficult or impossible pull people out of poverty on a large scale, or provide enough jobs to significantly reduce unemployment.

Future Prospects for the Economy

In addition to current monetary and exchange rate policies, there are other policies that may have constrained growth in Brazil, including fiscal policy. Last year the government ran a primary surplus¹⁰ of 4.8 percent of GDP, which was above its target of 4.25 percent. Interest on the public debt is now 7.9 percent of GDP, one of the highest in the hemisphere. A government commitment to running large primary surpluses, even in times when the economy is slowing and may need a more expansionary fiscal policy in order to avoid or recover from a recession, can be another impediment to restoring long-term growth. The high debt burden and tight fiscal policies also make it more difficult for the government to undertake public investments, for example in infrastructure or education, that might increase growth. It also constrains efforts to reduce poverty, and puts the government constantly on the edge of slowing the economy through spending cuts.

The primary surplus for 2006 is expected to come in at target of 4.25 percent, which may indicate a slight relaxation of fiscal policy. Perhaps more importantly, if the government continues to lower interest rates, this can have a potentially large impact on the public debt burden, since about 47 percent of the public debt is tied to the Selic rate. The government is now a net foreign creditor in foreign currency, which is a significant change from four years ago when 37 percent of the public debt was in foreign currency. This change insulates the public debt from the risk of currency depreciation – in the past, the public debt would rise significantly as the currency fell.

The net public debt now stands at 51.7 percent of GDP, down from 63.6 percent at its peak in 2002. This is one change that contrasts sharply with the previous administration, during which the public debt doubled, from 29.2 percent of GDP in 1994 to nearly 63.6 percent in 2002.

The finance ministry is projecting growth at 3.5–4.0 percent for this year - the IMF projects 3.6 percent, and year-on-year growth for the first half of the year has been only about 2.3 percent. The ministry expects growth of 4 to 5 percent for next year, and argues that future growth will be considerably higher than the past. According to this argument, inflation in previous years was running above target, and so monetary policy was contractionary and cut the economy's growth rate. This was the first year (2006) that inflation came in below target (3.0-3.2 percent vs. a target of 4.5 percent), and so monetary policy can be eased in the future.

To what degree this materializes, and whether the monetary authorities will allow Brazil to come close to the growth rates that it achieved in the past, remains to be seen. But there is little doubt that restoring reasonable economic growth, after an unprecedented 25-year economic failure, remains the country's foremost challenge.

¹⁰ The primary balance (in this case a surplus) is equal to government revenues minus expenditures other than interest payments on the public debt.