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THE BRAZILIAN ECONOMY FROM CARDOSO TO LULA
AN INTERIM VIEW

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This chapter on the Brazilian economy after 1994 is of a somewhat different nature compared to those on the economy in earlier periods. It is more speculative than its predecessors and based on a more restricted range of bibliographical material, as there is less consolidated research work on the period. It is to stress the obvious that the essay is inevitably marred to a certain degree by the lack of a sufficiently long time perspective. But it was thought that the benefits of providing a provisional account of the more recent economic developments in Brazil far outstripped the costs.

The Brazilian economic history from 1995 to 2004 was still dominated by efforts to stabilise the economy. The essay is structured around an analysis of the eventful macroeconomic policies followed during the period. Other aspects are also considered, but often only to allow a clearer picture of the evolution of macroeconomic policies and the constraints they had to face. At first, the main economic policy objective was to consolidate the results of the Real Plan and to make sure that the long high inflation experience was really over. But soon the need to put public accounts under control and to make a sizable external adjustment would become the main challenges to be faced. A major balance of payments crisis in early 1999 imposed much overdue drastic changes in economic policy. Further disturbances occurred in 2002, the last year of Cardoso's second term, as financial markets reflected fears that economic policy could be reversed with the likely victory of the opposition presidential candidate, Luiz Inácio Lula da Silva. But, somewhat surprisingly, the new government opted for policies that by and large represented a continuation of the orthodox economic policies of its predecessor.

In contrast with the previous fifteen years there was success, in spite of many difficulties. Advance in the stabilisation front required reforms and institutional building efforts that brought very important changes and a sound foundation for future economic expansion. But effective growth performance over the period continued to be mediocre: between 1994 and 2004 per capita GDP (gross domestic product) increased an average of only 0.9 percent yearly. Together with structural fiscal difficulties, low economic growth imposed strict constraints on policies seeking to alleviate the country's severe social imbalances.

1. CARRYING THE REAL PLAN THROUGH

During the four years of President Cardoso's first term of office there was a permanent division within the government concerning the nature of economic policies to be implemented. This struggle for ascendancy opposed policy makers in the Ministry of Finance and the Central Bank to the self-denominated *desenvolvimentistas*, mainly in the ministries of Planning and Telecommunications and in the BNDES – *Banco Nacional de Desenvolvimento Econômico e Social* [National Economic and Social Development Bank]. The first group, headed by Pedro Malan, the Minister of Finance, placed consolidation of inflation control at the top of the agenda, wanted to preserve the exchange rate as the monetary anchor of the economy, stressed the need for fiscal and monetary discipline and defended a less protectionist trade policy. Their opposers, headed by José Serra, first Minister of Planning and later Minister of Health, wanted to give immediate priority to economic growth and favoured a more devalued exchange rate, greater flexibility towards inflation control, laxer fiscal and monetary policies and a reversal of trade liberalization, mainly for the benefit of the influential automotive sector. Nurtured by the President's persistent ambivalence, this division would lead to a highly inconsistent macroeconomic policy, marked by irresolution and halfway compromising decisions, that would drag the economy to a serious crisis in the very end of Cardoso's first term, after the president had already been reelected. Only in the last quarter of 1998 – when the contagion of the Russian crisis unfurled and minds became concentrated – the president began to abandon its ambivalence and the government started to show effective commitment to the adoption of a more consistent economic policy.

The beginning of Cardoso's government in early 1995 was marked by the fallout of the Mexican crisis. While during most of the second half of 1994 the government had been finding ways to increase competition of imports as a way to keep inflationary pressures in selected sectors of the economy under control, after December 1994 the situation was radically changed as Brazil was hit by balance of payments difficulties, in the wake of the Mexican crisis. That would be only the first of a sequence of major

external shocks that the first Cardoso government would have to deal with amidst its efforts to consolidate the achievements of the Real Plan.

In the first half of 1995 the government announced an ambitious program of reforms that envisaged an overhaul of the public sector, including massive privatisation and reforms of the civil service and of the social security system. But fiscal discipline would have to wait for Cardoso's second term. The government followed a very lax fiscal policy in 1995 and was slow to react to the asymmetrical consequences of the sharp fall of inflation on public accounts. The well known positive effect of lower inflation on tax revenues was not as strong as could be normally expected because, after such a long high inflation experience, the tax system had been strongly sheltered from the worst effects of inflation. But high inflation had been helping to keep expenditures under control, eroding the real value of budgeted appropriations. Overall public sector primary surplus (the difference between total revenues and total non-interest expenditures) which had reached 5.6 percent of GDP in 1994 was brought down to around zero in 1995 and 1996, before being turned into a deficit of one percent of GDP in 1997.

The stabilization plan had initially envisaged a *real*-US dollar parity within a R\$/US\$ 0.93-1.00 band. But the *real* was allowed to appreciate to R\$0.85/US\$ and held around this level from mid-October 1994 to early March 1995, when the exchange rate policy had become a serious bone of contention within the economic team, deeply divided on how to react to the Mexican crisis. A mediated Solomonic solution led to a bungled attempt to widen the band. It was met with a speculative attack that brought about a sizable deterioration of the risk premium of Brazilian bonds over US treasuries, from 10 to 15 percentage points. A new band, with R\$/US\$ 0.88-0.93 bounds, was created and an inner band was used as a crawling peg with an unannounced devaluation of 0.6 percent monthly.

This exchange rate regime was to last until early 1999. Combined with an unflinchingly loose fiscal policy, it led to a persistent deterioration of the trade balance that would condemn the first Cardoso government to four years of very tight monetary policy, marked by extremely high real interest rates. Such an unsound macroeconomic policy would take a heavy toll. The current account deficit rose from

1.8 billion in 1994 to around US\$ 20 billion in 1995 and 1996 and to more than US\$ 30 billion in 1997 and 1998. The other side of the coin was, of course, the dramatic rise in the capital account surplus as a result of high interest rates and strong privatisation-related capital inflows.

In a major step to consolidate the low inflation regime, key legislation reducing price and wage indexation was approved by Congress in 1996, allowing the annual consumer inflation rate to fall to 9.6 percent, from 22.4 percent in 1995. Several banks faced problems with the fast transition to a low inflation environment. The Central Bank was forced to intervene and to create a special programme to institutionalize such efforts under the name of *Proer – Programa de Estímulo à Reestruturação e ao Fortalecimento do Sistema Financeiro Nacional* [Programme to foster restructuring and strengthening of the national financial system]. Provisions to cover *Proer*-related losses had reached almost R\$ 9 billion [around US\$ 3 billion] in 2002.

The situation of banks owned by the states became especially difficult. Important efforts were made to assure that the states would start to put their accounts in order. There was a comprehensive strengthening of federal control over the finances of subnational governments. Significant incentives were offered to induce states to renegotiate their debt. The most important state banks were privatized. But the idea of privatising the biggest state bank, *Banespa – Banco do Estado de São Paulo* [Bank of the State of São Paulo], that had been under intervention since the end of 1994, met such a strong resistance from the *desenvolvimentista* group that it was almost abandoned in late 1995. Over the following year, the ample access of state governors to federal funds provided by BNDES, in anticipation of privatisation proceeds of electricity-supply companies owned by the states, would open a loophole that significantly undermined initial efforts to impose a hard budget constraint to subnational governments.

In view of the dramatic deterioration of public accounts observed in 1995, it was expected that the government would be engaged in a serious fiscal adjustment effort during its second year in office. By that time, however, the idea of giving top priority to preparing the ground for a constitutional amendment that would allow the president to be re-elected had already gathered strength in Brasilia. With an eye in the October

municipal elections, the *desenvolvimentistas* were particularly forceful in the defense of that idea, stressing the need to avoid untimely fiscal adjustment measures that could alienate the president's support, not only in Congress but also among mayors and state governors. Quite on the contrary, the *desenvolvimentistas* pressed for a still more flexible fiscal stance.

Some would say that postponement of the fiscal adjustment was essential to pave the way for re-election of the president, viewed as the only form of making sure that politically complex reforms would continue to be implemented and stabilization preserved. Others suggest that there were elements of political overkill in the re-election campaign and that the president squandered significant political capital which could have been used to prop more comprehensive reforms, especially in the fiscal field.

2. HEADING FOR A CRISIS: 1997-1998

The year of 1997 started well for the government. The constitutional amendment allowing re-election of the president was approved, the risk premium on Brazilian external bonds fell to near 4 percentage points and foreign direct investment flows were breaking records. Annual consumer inflation expectations had been lowered to around 5 percent. The government seemed convinced that it had plenty of time for correcting the macroeconomic imbalances that were leading to the rapid deterioration of the external accounts and unsustainable public indebtedness. But the tug of war within the economic team was still going on. The *desenvolvimentistas* were pressing for a new exchange rate regime, lower interest rates, more public investment and faster economic growth. Their oppositors, in the Ministry of Finance and the Central Bank, feared that the inflationary shock and the destabilization process that might be entailed by a devaluation could put the achievements of the Real Plan in jeopardy. They argued that, with a tighter fiscal policy, the exchange rate regime could be sustained with much lower interest rates and faster economic growth. However, between the two offsetting forces, economic policy was still following the same old line of least resistance, marked by ambivalence, irresolution and procrastination. Neither there was any sign that the exchange rate regime was to be abandoned nor any

reasons to believe that a more austere fiscal policy was to be finally adopted. In fact, fiscal policy was still being loosened up. The *desenvolvimentistas* had just won the last episode of the power struggle, as the government decided that privatisation proceeds, that were supposed to be entirely channeled to redeem public debt, would be partly used to finance a public investment program.

In the third quarter of 1997, however, Brazil was hit by the shock waves of the Asian crisis. To no avail, the president tried to point out that Brazil was a whale, not a tiger. The crisis exposed the vulnerabilities of the economy. Between the end of September and the end of November foreign exchange reserves fell from US\$ 62 billion to US\$ 52 billion and the risk premium on Brazilian bonds rose from 4 to 7 percentage points. The benchmark interest rate, which had fallen to 19 percent in June, rose to more than 45 percent in November, when the government had to announce a hastily prepared fiscal package. But the gap between promises and deeds turned out to be wide. The government once again revealed a pronounced lack of commitment with the idea of a serious fiscal adjustment. As it became clear that the simple choreography of apparent mobilization with the adjustment had been enough to allow the country to overcome the worst part of the crisis, the proposed measures were either watered down or just not implemented. In April 1998, the situation seemed to have improved as strong capital inflows, stimulated by the sizable differential between domestic and international interest rates, allowed foreign exchange reserves to reach US\$ 75 billion. By that time, the nearing electoral campaign made the government conspicuously postpone any plans for dealing with the increasingly inconsistent macroeconomic policy to the following presidential term. This would prove to be an unwise move.

There was still another big external shock to be faced. In August, two months before the presidential election, the Brazilian economy would start to suffer the devastating contagion of the Russian crisis, just when the government had made clear how uncommitted to the required macroeconomic adjustment it really was. The failure to deliver minimally on the fiscal adjustment side was in open conflict with the sustainability of the strategy of sticking to the crawling-peg regime. A speculative attack against the overvalued currency in the mid of the electoral campaign led to a fast loss of reserves. By the end of the year the loss had reached US\$ 30 billion, in spite of a benchmark interest rate lifted to around 40 percent. The risk premium on

Brazilian external bonds went beyond the 14 percentage points mark. Net public debt, which had risen from 30 percent to 33.3 percent of GDP over the 1994-1997 period, had reached 41.7 percent by the end of the year.

The economy's growth performance had been declining since the 5.9 percent increase in GDP in 1994. Over the 1995-1997 period GDP increased on average 3.3 percent yearly, but in 1998 the economy stagnated. Fixed capital formation had improved slightly in 1994 to 20.8 percent of GDP but fell to an average 19.8 percent in 1995-1998.

As the crisis deepened, the government was caught in a very vulnerable position. Cardoso was forced to deliver a rather tough speech as presidential candidate stressing that a major fiscal adjustment would be implemented in the beginning of his new term of office. Contacts with the International Monetary Fund, that had started in September, were intensified after his re-election in the first electoral round in early October. A scandal triggered by wiretapping of privatisation deals, involving members of the economic team, left the government even more off balance, at an already trying moment. In December, a program involving a fiscal adjustment effort of about 4 percent of GDP was approved by the IMF. The preservation of the crawling-peg exchange rate regime was a central point of the program. The financing package totaled US\$ 43 billion: about US\$ 18 billion of IMF resources, US\$ 15 billion from the Bank for International Settlements and Japan, and US\$ 5 billion each from the World Bank and the Inter-American Development Bank.

In late December 1998 Congress approved a rather watered down social security reform, casting additional doubts on the sustainability of fiscal accounts. Few weeks later, in the beginning of 1999, as Cardoso's second term started, the announcement by the state of Minas Gerais of a moratorium on its foreign debt proved to be the last straw for the crawling-peg regime. Its abandonment, in mid-January, after the substitution of Gustavo Franco, the Central Bank governor, involved first an attempt to avoid uncontrolled devaluation by widening the exchange-rate fluctuation band to between R\$1.20/US\$ and R\$1.32/US\$. As the attempt proved unsuccessful, the run against the *real* gathered overwhelming strength with a loss of US\$ 14 billion of reserves in two days. The government was forced to accept a much bigger

devaluation. In late January the exchange rate had already jumped to almost than R\$2/US\$. A peak of R\$2.16/US\$ would be reached in early March.

Whatever the collective hindsight nowadays may be, both sides of the economic divide within the government and most analysts at the time believed that a significant devaluation of the *real* would mean a return to much higher inflation with foreseeable important political implications. Allegations by the opposition that the Cardoso administration postponed an overhaul of its economic policies because of the presidential elections in October 1998 are not groundless. But it is also true that the opposition's economic program was totally inconsequential and that a victory by the opposition would have meant, almost certainly, an even more serious economic crisis.

3. 1999 AND THE SHORT-LIVED VIRTUOUS CIRCLE

In the somewhat chaotic aftermath of the devaluation, in the beginning of 1999, the difficulties that had to be faced were much amplified by the alienation of the support from the G7 and the IMF and by the fact that, for a while, the Central Bank remained totally crippled. Both the G7 and the IMF were blaming the government for lack of commitment to the whole idea of preserving the crawling peg that had been a key justification for the December bail out package. The Finance minister and the rest of the economic team had survived the crisis. But amidst the financial turmoil, the government decided to make another change in the governorship of the Central Bank. Over a two-month period the Central Bank had to operate under three different governors.

The turning point, in early March, was a brand new board taking office in the Central Bank, led by still another governor, Arminio Fraga, a highly regarded economist with Wall Street experience. That opened the way for the announcement of a new stabilization plan to be implemented under the agreement that had been signed with the IMF three months earlier, just before devaluation. The program had three main objectives. First, to reestablish fiscal sustainability, in view of the sizable increase in public indebtedness caused by the impact of devaluation on the dollar-linked part of the debt. Second, to assure that the external accounts would be compatible with the

much narrower foreign-financing possibilities the country was having to cope with. And, third, to keep inflation under control, despite the strong inflationary shock that had been triggered by the devaluation.

The following months would witness a fast confidence-building process, in the wake of a powerful virtuous circle. It is hard to establish which factor had precedence in this process. But key roles were certainly played by the surprisingly low impact of the devaluation on inflation and the recognition that the government was being successful in its effort to make the politically demanding fiscal-adjustment effort feasible. The inflationary shock stemming from the devaluation proved to be much weaker than anticipated. And skepticism about the possibility of extracting from Congress the challenging fiscal-adjustment program that had been announced was greatly reduced.

Rising optimism on both inflation and fiscal adjustment led to a fast appreciation of the nominal exchange rate, as foreign capital inflows were restored. That, in turn, opened the way for a very fast fall in interest rates, as the Central Bank determinedly brought down the benchmark rate from 45 percent per year in early March to less than 20 percent in late July. Plummeting interest rates and a much less depreciated exchange rate brought about a drastic reassessment of the sustainability of fiscal accounts, allowing the worst misgivings about the public debt to be quickly dismissed. Expectations about the level of activity also changed radically. In March, the government had announced that the GDP could fall as much as 3.5 to 4 percent in 1999. But in the end of second quarter, the size of the expected fall was being quickly reduced to zero, in anticipation of a much less costly slow down that in the end would still allow the economy to show a positive growth rate of 0.8 percent in 1999. By that time, the Central Bank was sufficiently comfortable to announce that the newly-launched inflation-targeting policy would aim at a rate of 8 percent per year in 1999 and of 6 percent in 2000.

However, the fast overall improvement of economic indicators showed the dent of a serious disappointment. By late 1999, it was becoming clear that the response of the trade balance to the devaluation would take much more time than was being anticipated. The simple elimination of the US\$ 6 billion trade-balance deficit observed in 1998 was widely seen as an insufficient adjustment, by no means

comparable to the spectacular improvement that was expected when the devaluation was at its peak in early 1999. It is true that under the newly-adopted flexible exchange-rate regime, the initial overshooting was followed by a fast revaluation of the *real*. But even so, in early 2000 the US\$/R\$ exchange rate was still more than 30 percent below its nominal level before the devaluation. Taking into any account any reasonable domestic price deflator, that meant a very sizable real depreciation that in due time should bring about a much stronger adjustment in the trade balance than had been observed until then. However, lingering pessimism over the trade balance, fuelled by disappointment with the initial response of the trade accounts, would lead to a much overblown debate on whether the situation called for more interventionist trade and industrial policies. Though the economic team resisted such policies, they continued to be fiercely defended by the *desenvolvimentistas* till the very end of Cardoso's second term, and remained an important divide within the government.

Despite worries about the trade balance, in early 2000 external accounts were in much better shape than in late 1998. The Brazilian economy had left the turbulence behind. Fiscal targets accorded with the IMF had been achieved and inflation was under control. The economy seemed ready again for growth resumption. In fact, 2000 was to be by far the best year of Cardoso's second term. Annual consumer price inflation was kept at 6 percent, exactly as targeted by the Central Bank. The fiscal situation became much less worrisome. The strong fiscal adjustment observed since the Russian crisis allowed the public sector primary surplus to reach 3.3 percent of GDP in 2000, in sharp contrast to a deficit of almost one percent of GDP in 1997. It is true that it had been a low quality adjustment, that was strongly based on a sizable increase in highly distorting cumulative taxes, given the political difficulties involved in expenditure slicing. The gross tax burden increased from 29 percent of GDP in 1997 to 31.7 percent of in 1999. But misgivings about fiscal sustainability faded away as the adjustment seemed large enough to keep public-sector debt stabilized at around 50 percent of GDP, particularly when a newly approved Fiscal Responsibility Law ensured that expenditures would remain strictly limited to the available means at all government levels (federal, state, and local). But the highlight of success of the macroeconomic policy adopted since the devaluation, with full support from the International Monetary Fund, was that economic recovery was finally in sight. The GDP growth rate reached 4.4 percent in 2000.

By the end of 2000, the impact of the sizable exchange-rate devaluation on external accounts was still unimpressive and much more limited than anticipated. Exports responded sluggishly, hampered by falling export prices, imports were not reduced as expected, and the economy's current account deficit remained well above 4 percent of GDP. However, a record inflow of US\$ 31 billion of foreign direct investment in 2000, in the wake of important public-asset sales, was more than enough to cover the current account deficit of US\$ 25 billion. There was a widespread view that sound macroeconomic policy and the perspective of sustained economic growth might be able to ensure the inflow of foreign capital that would be required to keep the expanding economy's external-financing problems at bay. Despite lingering pessimism over the trade balance, the country seemed to have leeway to wait for the slow effects of the devaluation on the external accounts to be fully felt.

Seen from early 2001, therefore, Brazil's economic prospects looked quite promising. What was envisaged by the business community was a virtuous-circle scenario involving economic and political aspects. With the economy on a new low-inflation steady-growth path (expanding at 4 percent per year), the government coalition would be bound to win the late 2002 presidential election after three years of uninterrupted prosperity. Economic policy continuity would open the way for a longer period of sustained economic growth.

Such widespread optimism would need to be rapidly and extensively revised over the following months. As 2001 proceeded, the external environment quickly became much less favorable. Hopes that bad news about the slowdown of the United States economy after a decade-long expansion were not to be taken very seriously, as a fast recovery was the most probable outcome, would soon prove to be unfounded. In February, the economic situation in neighbouring Argentina (which was supposed to have just found some respite with the approval of another large IMF support program in the very end of 2000) started to deteriorate quickly, exposing Brazil to still another wave of contagion. As markets once again tried to discern what could be the effects on the Brazilian economy of a worst-case scenario in Argentina, when the world economic outlook was becoming gloomier, the exchange rate started what would

prove to be a new and long depreciation movement. In March, the Central Bank was forced to interrupt the steady slackening of monetary policy that had been started two years before. Interest rates had to be hiked again.

The growing uncertainty stemming from the rapidly worsening external environment was considerably aggravated by unconnected domestic troubles. Serious political strife within the complex government coalition in Congress started to raise doubts about the outcome of the 2002 presidential election, and to stir up fears that a newly-elected leftist government could impose some sort of debt default. In the municipal elections held only six months before, in late 2000, the national campaign of the Workers' Party (PT) had been centred on an informal plebiscite in which voters had been asked whether the public debt and the country's external debt should be paid back or not. The worries were amplified in April 2001 when it became suddenly clear that the country was amidst an alarming energy crisis, caused by mismanagement of an excess-demand situation in the largely hydropower-based electricity-supply industry. The need to impose urgent but highly unpopular electricity-rationing measures and to abort economic growth made the government seem even less capable of assuring a favourable result in the nearing presidential election, in a moment in which the main opposition candidate, Luiz Inácio Lula da Silva, from the Workers' Party (PT), was already leading the polls by a wide margin. The energy shortage looked as a final blow to hopes of keeping the economy expanding reasonably fast over the second half of the presidential term.

These domestic troubles, however, would prove to be less damaging than initially anticipated. First, political infighting in the government coalition in Congress lost momentum and receded to less internecine quarrels. Second, the response to the electricity rationing program proved to be surprisingly positive, particularly among residential consumers. Soon it became clear that with a slight degree of luck regarding the intensity of rainfall over the following season, the rationing measures could be substantially relaxed by early 2002. However, just when the country's short-run outlook was beginning to improve, Brazil was suddenly exposed to a whole new wave of difficulties triggered by the terrorist attacks of 11 September 2001.

Even before the attacks the economy seemed much weaker than eight months before. With the growing uncertainty, the exchange rate had gone through another 25 percent depreciation, bringing considerable additional strain on inflation control. Though the benchmark interest rate had been lifted to 19 percent (from 15.25 percent in mid-February), the Central Bank was starting to admit that it would be hard to keep the annual inflation rate below 6 percent. After industrial output plunged in the second quarter, as consumer sentiment and business confidence were badly hit by the string of bad news coming from both the external and the domestic fronts, forecasts for GDP growth rate in 2001 had been slashed from 4.5 percent to 2 percent or even less, anticipating the 1.3 percent growth rate that would be effectively observed. Much higher interest rates and the even more devalued currency had saddled the public-sector with a significantly heavier debt burden, stoking misgivings in financial markets about the sustainability of fiscal accounts. In August, concern over the destabilizing effects that a financial debacle in Argentina might have on the much weakened Brazilian economy led to a fast and successful negotiation of a new US\$ 15 billion support program with the IMF.

For Brazil, the economic uncertainty triggered by the terrorist attacks meant a sudden exacerbation of predicaments that the country were already facing. With the world economy in an unequivocal recession and international investors becoming extremely risk averse, the external financing problem became considerably more difficult. It is true that, for months, the country had been bracing itself to deal with increasing difficulties in that area. Of course, what was feared was nothing like what happened after September 11, but merely a critical deterioration of the economic situation in Argentina and the loss of confidence that could stem from widespread pessimism in financial markets about the outcome of the presidential election. The sudden external shock seemed to have brought about severe external financing difficulties even before those two feared problems have materialized.

4. UNDER THE SHADOW OF POLITICAL UNCERTAINTY

After showing some improvement in late 2001 and early 2002, the economic situation deteriorated dramatically in the following months. The year started under a relatively

calm climate. The economic consequences of 11 September had proved to be less adverse than had been feared after all. The country was leaving the energy crisis behind, as a favourable rain season was replenishing hydro-electric dams, political infighting within the government coalition seemed to have receded and the currency was strengthening. Financial markets were even starting to nurture the idea that, after all, one of the government-supported candidates could win the presidential election. In mid-March, however, such hopes suffered a major blow, in the wake of unsurmountable dissension in the government camp, after a Federal Police raid triggered a campaign-funding scandal that crippled the candidate that was being fanned by the conservative Liberal Front Party (PFL) and happened to be faring particularly well in the polls.

Over the second quarter of 2002, it became increasingly clear that the remaining government supported candidate, Senator José Serra, of Cardoso's Brazilian Social Democratic Party (PSDB), would not be able to beat Lula da Silva -- the front-runner candidate of the Workers' Party (PT). The Liberal Front Party (PFL), which comprised a sizable part of the broad political coalition that had been assembled around President Cardoso, had quit the government immediately after the scandal that brought down its candidate and was staunchly determined not to endorse Serra in any circumstance. Even in Serra's own party, full support was hard to get. An attempt to attract the endorsement of the notoriously fractious centre-right Brazilian Democratic Movement Party (PMDB) to Serra's ticket had a very limited success. Large segments of the catch-all PMDB decided to steer their own independent courses.

As doubts over the outcome of the presidential election quickly disappeared and the idea that Lula might win became more concrete, mounting fears about the newly-elected government's economic policy and a possible default gave rise to devastating destabilising forces driven by wild anticipatory movements in financial markets. The nominal exchange-rate, which was at less than R\$2.4/US\$ in early March reached the 3.4 mark in the end of July, after the currency had lost 30 percent of its value. At that point, international financial markets were demanding a staggering risk premium of 24 percentage points above the interest paid on US treasuries in order to hold Brazilian external-debt bonds.

Alarm over the rapid deterioration of the economic situation led the government's economic team to approach the leadership of the Workers' Party (PT) in order to negotiate initiatives that could help to control the turmoil in financial markets. Within the Workers' Party, an effort to soften the more radical planks of the party's economic platform was already under way. Moderate party leaders perceived that the mounting destabilisation process could bring severe strain to the newly-elected government and even put Lula's seemingly assured victory in jeopardy. In a statement in late June, presented as an open letter to the Brazilian people, Lula tried to assure that he was committed to a sound macroeconomic policy and that investors had nothing to fear. But financial markets were unconvinced.

Uncertainty over what could be the economic policy of the newly-elected government increased even more in July, as the government endorsed candidate dropped to the third place in the polls, overtaken by a large margin by Ciro Gomes, a centre-left contender, supported by the small Popular Socialist Party (PPS), previously seen as a mere also-ran. But financial markets saw little reason for calming down, as Gomes had been insisting on a vague plan that allegedly would convince investors to voluntarily swap short-term for long-term public-debt bonds.

In August, as the word panic started to be used all too often to describe the degree of unrest observed in financial markets, a major new development took place. Since at least June, the government had been trying to negotiate a new loan agreement with the International Monetary Fund. But many difficulties had to be faced. At first, the thought of extending credit to bail out still another large emerging market economy – just after Argentina and Turkey – met with strong resistance from the main industrial economies. But Brazil was not the only South American country facing financial destabilisation. Less than eight months after having been bailed out, Argentina was facing serious problems again, amidst a devastating banking crisis that had crossed the River Plate and was imposing serious financial distress to neighbouring Uruguay. Concern over the consequences for the world economy of the whole region being sucked into a huge economic crisis rapidly allowed resistances to be broken, giving way to more pragmatic stances in the industrial economies.

The idea that at least some of the troubled South American economies had to be duly assisted gathered strength in Washington during July. Though Argentina was considered to be a hopeless case, the small-scale bailing out of Uruguay seemed not only defensible but easy. But the Brazilian case looked more challenging. The mobilization of the required resources would be much more demanding and the idea of signing a loan agreement with an outgoing government, without any guarantee that it would be honoured by the newly-elected one, seemed untenable. But five years before, in 1997, a similar difficulty had been successfully faced in South Korea, when the terms of an urgent bail out package signed with an outgoing government had to be approved in a pre-election deal, all candidates pledging to honour them. During July the economic team had been trying to convince the leadership of the Workers' Party (PT) of the importance of creating the required conditions for making a similar deal possible before the election. But party leaders were clearly split on that issue.

The idea of controlling the worrying destabilization process entailed by the mounting turmoil in financial markets seemed undoubtedly urgent. Underlining Lula's commitment to a sound economic policy would also be helpful to bring swinging conservative middle-class voters to the candidate's camp. On the other hand, after so many years of unrelenting IMF bashing, a formal pledge to honour the main terms of an agreement with the International Monetary Fund was seen by the party's left-wingers as an unacceptable surrender. It was also feared that the deal could make Lula lose faithful radical-left voters. At the end, moderate views prevailed, as radicals were convinced that a mild support to a possible agreement would be very important to allow Lula to win the election.

In early August the IMF announced a new agreement with Brazil involving a US\$ 30 billion loan – the largest ever made by the institution – over a 15 month period. Only US\$ 6 billion were to be disbursed before the end of Cardoso's presidential term. But as the Fund raised constraints that the previous agreement imposed on the use of the country's foreign reserves, the Central Bank would also have another US\$ 10 billion available to face the financial nervousness about the outcome of the election and to try to keep external financing difficulties at bay. The remaining disbursements, amounting to a carrot of US\$ 24 billion offered to the newly-elected government, would be made during the first year of the following presidential term.

Though there was no previous explicit endorsement by the leading presidential candidates, two weeks later, after some natural hesitation, they pledged to honour the main measures that constituted the backbone of the agreement, in separate meetings with President Cardoso. The formality marked an extremely important rite of passage, particularly for Lula, as it gave him a freer hand in what had become a clear effort to drop the radical talk and quickly move towards the centre.

Financial markets showed some relief, but remained ready to cast doubts on the sincerity of Lula's change. The risk premium of Brazilian external-debt bonds, relative to interest paid on US Treasury securities, fell from 24 percentage points in late July to around 16 percentage points in early September. After a four-month long depreciation, the currency strengthened by 12 percent during August. But the respite did not last much. Though Serra had become again Lula's main contender, as Ciro Gomes slipped fast in the polls, it became strikingly clear over September that Lula would win the first round of the presidential election in early October, and be in a very favourable position to beat Serra in the run-off election, endorsed by the remaining opposition candidates. With the growing unrest in financial markets, the currency lost more than 20 percent of its value in September. By the end of the month, just before election day, the exchange rate had reached R\$3.9/US\$ and the risk premium on Brazilian external bonds was back to 24 percentage points.

Lula was elected president, as expected. But even before the run-off against Serra, the leadership of the Workers' Party (PT) had launched a major effort to convince public opinion, and financial markets in particular, that the newly-elected government had abandoned the previous radical talk and would adopt a quite orthodox macroeconomic policy, following the paths of the outgoing government. As the new economic team took shape and seemed to give credibility to what was being promised, skepticism slowly receded, giving way to what would be a long confidence building process bound to be stretched for many months, well into Lula's presidential term.

But calming down financial markets would require stronger measures. Immediately after the first round of the election, the Central Bank finally set off what would prove to be a very sizable three-movement rise in interest rates. Over a period of less than

60 days, the basic rate was lifted from 18 to 25 percent. By year end, the exchange rate, at R\$3.5/US\$, was in a clear appreciating trend, and the risk premium of Brazilian external bonds, at 14 percentage points, was falling steadily.

The high uncertainty wave that had started to be formed well back in 2001 and had gathered much strength after March 2002 was surely taking its toll. The economy expanded only 1.9 percent in 2002, bringing the average GDP growth rate of Cardoso's second term to a mere 2.1 percent per year. The flexible exchange-rate regime had helped to make the economy bend without breaking. But the major price shock entailed by the vast depreciation of the *real*, had made the expected annual consumer-price inflation close the year well above the two-digit threshold, at more than 13 percent, putting the newly-adopted inflation-targeting policy under strain. But the depreciation had also speeded up the long-awaited adjustment that seemed to be in store for the external accounts, since the early 1999 devaluation. All in all, the trade balance had shown an improvement of nearly US\$ 20 billion over Cardoso's second term, and the current account deficit had narrowed from US\$ 33.4 billion in 1998 to US\$ 7.6 billion in 2002.

The fiscal regime had also gone through a drastic change. A Fiscal Responsibility Law, approved by Congress in 2000, had finally imposed budgetary discipline on subnational governments. In contrast to the previous presidential term, for the fourth consecutive year, the public sector had been generating a primary surplus between 3 and 4 percent of GDP, in order to meet interest payments and keep public debt on a sustainable path. However, as a large part of the public debt was dollar-linked, the sharp depreciation of the exchange rate observed during the last half of Cardoso's second term had cast new doubts on the sustainability of the debt, particularly after interest rates had to be briskly raised in late 2002. But most analysts agreed that, as long as the exchange-rate overshooting could be reverted and interest rates quickly reduced to less extreme levels, the reasons for fearing that the public debt could slip out of control would rapidly fade away.

As Cardoso's second term reached its end, it became quite clear that a political change of great economic importance had taken place while the country faced the rough passage of 2002. After three unsuccessful attempts, the Workers' Party (PT)

had finally won the presidential election. But, as it advanced towards its victory, the party had to dust off old beliefs, drop the radical talk and hastily adopt a brand new economic program, that in fact endorsed the essence of the outgoing government's macroeconomic policy. That was no small change. It meant that the alarming chasm, that had separated government and opposition in economic matters for so long, was giving way to an amazingly broad common ground of shared ideas.

The events of 2002 are still too recent to allow a complete understanding of the complex process behind the hurried metamorphosis the Workers' Party (PT) had to go through in 2002. But some basic facts seem to be uncontroversial. It was mentioned above that over the second quarter of the year, in the wake of the turmoil in financial markets, the broad idea of dropping the radical economic talk and move towards the centre gathered strength in the party leadership and finally gave rise to the June statement, in the form of an open letter from Lula to the Brazilian people. But that document required a very tough negotiation within the party and was only approved under the general understanding that it would represent the farthest the party would go in its movement towards the centre.

The fact that party's *aggiornamento* would advance well beyond that point in the following months has to be explained by the dynamics of the electoral campaign and the complex relationship that was established between the Workers' Party and the government, in a tacit joint effort to curb the worst effects of the mounting destabilization that was under way. At first, that relationship had to involve subtle games, as the one that finally made Lula feel constrained to publicly pledge to honour the general terms of the agreement that was being signed with the IMF in mid-August. But soon it had evolved to a much more explicit interchange of ideas, based on levels of understanding and collaboration that would seem completely unthinkable a few months before. The outgoing government should receive a substantial share of the credit for the smoothing of a transition that had promised to be so problematic.

The first months of 2003 would witness how far the newly-elected government would go in its effort to abide by the pledge of moderation in economic policy. The choice of

the economic team was the first concrete indication that the government was really inclined to follow policies that the Workers' Party (PT) would be ready to brand as unacceptably conservative only months before. The destabilization process that had been triggered by the electoral uncertainty in 2002 had brought about a sour inheritance for the newly-elected government. The fast depreciation of the currency had entailed both a serious inflationary shock and a sharp and worrisome increase in the dollar-linked part of public debt. Financial markets were unsurprisingly uneasy and disbelieving, far from convinced of Lula's change of course. The situation called for very orthodox economic measures. For the amazement of many, the new government responded accordingly.

The benchmark interest rate, that had been raised from 18 to 25 percent during the last two months of the Cardoso government, was lifted still further to 26.5 percent in the first two months of the Lula government. A tighter fiscal policy target was also announced. Those measures proved to be highly effective to break the reluctance of financial markets to accept the idea that the government was really committed to the adoption of a consistent macroeconomic policy. A fast confidence rebuilding process was triggered, much helped by a rapid improvement in the trade balance, that was being brought about by the joint effect of the four-year long sizable depreciation of the *real* and the strong demand for Brazilian exports in world markets. Lower uncertainty and much healthier external accounts led to a fast appreciation of the currency. The exchange rate, that had closed 2002 at more than R\$3.5/US\$, was already below R\$3/US\$ by late May. Over the same period, the risk premium of Brazilian bonds over US treasuries plummeted from 14 to 8 percentage points.

Despite the initial success of the economic policy, in mid-2003 there were still widespread doubts on how long the government would continue to show the required persistence in sustaining measures that were known to be strongly opposed by hard-core members of the Workers' Party (PT). By that time, however, the government displayed the courage of its new convictions, by managing to approve an important and politically challenging social security reform in Congress. The waning of economic uncertainty and the favorable evolution of inflation allowed the Central Bank to start a long and steady loosening of monetary policy, that would help to soften the resistance to the government's macroeconomic policy. As the benchmark

interest rate was brought down from 26.5 percent in June 2003 to 16 percent in May 2004, there was a fast increase in the level of activity. After showing a growth rate of only 0.5 percent in 2003, the economy would grow almost 5 percent in 2004.

In contrast to what had happened so often in the past, economic recovery was accompanied by a very strong improvement in the external accounts. As the trade surplus jumped from US\$ 13.1 billion in 2002 to US\$ 33.7 billion in 2004, the current account deficit of 1.7 percent of GDP was turned into a surplus of almost 2 percent of GDP. The long-awaited structural adjustment of the Brazilian economy, that had been gathering strength during Cardoso's second presidential term, had finally emerged with full force, opening up much more promising possibilities for the steering of the economic policy.

For a newly-converted government that had to face much internal resistance to the idea of adopting unpopular orthodox policies, being able to rapidly reap the fruits of such policies was certainly a great help. Growth resumption with strong external accounts already in the second year of Lula's presidential term reinforced the position of those that had defended that the Workers' Party (PT) should take a more moderate tack, and strengthened the political support of the economic team.

For the country, the success of Lula's newly-adopted economic policy meant a very promising change. The broadening of the common ground of economic ideas shared by the main political parties, that looked as no more than a mere possibility in late 2002, suddenly seemed more concrete and less reversible. A great problem Brazil had been facing for many years was the ever present spectre of a change of government that could suddenly turn economic policy upside down. Fear of such reversion was for a long time a very important source of uncertainty and instability, with dire consequences, as the events of 2002 had so dramatically shown. The possibility that reasons for such fears were finally disappearing meant that wider horizons for long-run economic decision making were being open, as a major risk factor was being left behind.

5. REFORMS, PRIVATISATION AND TRADE POLICY

Under Cardoso, efforts to deepen the programme of economic reforms started in the early 1990's were uneven. Privatisation proceeded and included public utilities, raising complex regulatory problems not always well solved. After some reversal at the beginning of the first presidential term, trade liberalization was deepened although at a much slower pace than in the earlier period. Major efforts were directed to put public accounts in order. This involved recognition of accumulated hidden liabilities, the building up of a legal framework to assure a hard budget constraint at all government levels, and intervention in state banks followed by privatisation. There was also a major effort to reduce the vulnerability of private banks through a series of interventions and government-supervised sales. Results of reform of social security were rather meagre under Cardoso.

Some reforms were quite successful. Major constitutional amendments included legislation that opened the way to privatisation of public enterprises in telecommunications, mining and electricity supply. Sales involved jewel-of-the-crown assets such as *Companhia Vale do Rio Doce*, a world leader in iron ore exports, and also public enterprises whose privatisation required a major overhaul of the regulatory framework, especially in the telecommunications and electricity supply sectors. New agencies were created to regulate activities in the oil, electricity and telecommunications industries, with much more autonomy than had been the case in the past. Regulation in the oil sector was complicated by the dominant role of publicly-controlled *Petrobras*. The government maintained a golden share when *Vale do Rio Doce* was privatized. By far the least satisfactory policies involved the electricity supply sector, with the government failing to define a clear regulatory framework able to stimulate new investments. Privatisation revenues in the whole Cardoso period amounted to more than US\$ 87 billion.

No major tax reform was implemented during Cardoso's period. The tax burden remained around 29.4 percent of GDP in 1995-1998, but jumped to an average of 33.5 percent of GDP in 1999-2002 and reached 35.9 of GDP in 2004. In order to minimize transfers to subnational governments, the federal government showed a clear

preference for increasing the importance of taxes not affected by constitutional revenue-sharing provisions. A new tax on financial transactions created in 1996, the *CPMF – Contribuição Provisória sobre Movimentações Financeiras* [Provisional contribution on financial transactions], would prove to be far from provisional. Avoidance of revenue sharing also explain the increase in the increasing importance of other contributions as *PIS – Programa de Integração Social* [Social Integration Programme] and *Cofins – Contribuição para o Financiamento da Seguridade Social* [Contribution to finance social security]. Being imposed on turnover and not on value added, those cumulative taxes were marked by well known highly distortionary effects, including taxation of exports in a hard to rebate way. Even in the case of the value added tax collected by the states (*ICMS*), only in 1996 legislation was introduced to extend rebates to exports of non-industrial products. But both the *PIS* and the *Cofins* were later transformed into non-cumulative taxes. The first in 2002, the latter in early 2004.

Foreign direct investment flows increased dramatically as privatisation efforts moved from the simpler cases of state-owned manufacturing firms to state-owned public utilities, both at the federal and state level. Foreign direct investment (FDI) rose from US\$ 1.9 billion in 1994 to US\$ 15.3 billion in 1997 and to a peak of US\$ 31 billion in 2000. Then it started to fall, reaching US\$ 12.9 billion in 2003 and recovering to US\$ 20.3 billion in 2004. In 1995 about two thirds of FDI stock in Brazil was in the industrial sector and one third in services. In 2000, the shares had been reversed

Deterioration of the balance of payments position in early 1995 provided a platform for active promotion of a reversal of trade liberalization by the *desenvolvimentistas*. The average tariff rose from 11.2 percent in 1994 to a peak of 14.7 percent in 1997 and then started to fall again. In 2002 it was still above its 1994 level. This affected more significantly the automotive sector – effective protection on motor cars rose to no less than 270 percent in 1996 – and also capital goods and industrial inputs whose tariffs were at or near the 35 percent level bound in the World Trade Organization (WTO). Price effects were significant, however, as the overvaluation of the *real* made imports cheaper. The share of imports in apparent consumption, which had risen from 4.5 percent in 1989 to 10.6 percent in 1994, continued to increase to reach a peak of

22.5 percent in 1998. It was then reversed in the wake of the 1999 foreign exchange devaluation, falling to 13.9 percent in 2003.

Total exports increased only slightly above 4 percent yearly in the whole Cardoso period and Brazil lost market share in world exports. That loss was reversed only in 2003. Trade with Mercosur, and especially with Argentina, increased substantially after 1994 and its share in exports peaked in 1998 on 17.8 percent compared to 13.6 percent in 1994. After the Brazilian devaluation of 1999 and even more after the Argentinean abandonment of its currency-board foreign exchange regime, Mercosur's share in Brazilian exports fell to 5.5 percent in 2002 and increased again to 9.1 percent in 2004. The significant expansion of Brazilian exports after 2002 was accompanied by the rising importance of non-traditional exports markets as China, whose market share trebled since 2000 to reach more than 6 percent. The European Union and the United States answered for similar shares of the Brazilian export market, hovering around a quarter of the total. But while almost 80 percent of Brazilian exports to the United States were manufactures this share fell to only a third for the European Union and to 25 percent for Asia. Almost 90 percent of Brazilian regional exports – both to Mercosur and to the rest of Latin America – are manufactures.

Several regional trade negotiations were started in the mid-1990's. In December 1994 a hemispheric summit agreed to launch negotiations seeking to establish a Free Trade Area in the Americas until 2005. Negotiations were marked by important differences between Brazil and the United States and were still deadlocked in the end of 2004. Negotiations between Mercosur and the European Union were also deadlocked. In the multilateral field, Brazil imposed in 1996 a quota system on imports of automobiles and tried to obtain a waiver under GATT 1994, which was not accepted by the World Trade Organization (WTO). But by far the most important dispute settlement episodes in which the country was involved recently was the exchange of complaints with Canada on subsidies to exports of aircraft when the decisions in favour and against Brazil were roughly equivalent. More recently, Brazil obtained important victories in panels concerning subsidies to cotton growers by the United States and sugar exports by the European Union. The launching of a new round of multilateral trade negotiations faced a major setback in Seattle in 1999, but in 2001 a new round was

launched at Doha. Brazil has played a prominent role in the negotiations as part of a G-20 group of developing economies, together with China, India and South Africa, that contributed to counter efforts by developed countries to delay agricultural concessions and to dominate the agenda including mostly issues in which they were *demandeurs*.

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Table 7.1
Brazil, main economic variables, selected years, 1980-2003

	1994	1998	1999	2002	2003	2004
Resident population, mid-year, million	156.8	165.7	168.7	176.4	179.0	181.6
GDP (1980=100)	130.7	144.6	145.7	157.0	157.8	165.5
GDP per capita (1980=100)	100.8	105.5	104.9	108.7	107.7	111.3
Gross fixed capital formation as percent of GDP	20.7	19.7	18.9	18.3	17.8	19.6
GDP deflator (1980=1)	5.6*10 ¹⁰	13.2*10 ¹⁰	14*10 ¹⁰	17.9*10 ¹⁰	20.6*10 ¹⁰	22.3*10 ¹⁰
GDP deflator yearly rate, percent	2240.2	4.8	4.7	10.2	15.0	8.2
Real exchange rate*, 1980=100	69.3	72.7	97.9	96.0	86.9	80.4
Exports, US\$ billion	43.5	51.2	48.0	60.4	73.1	96.5
Imports, US\$ billion	33.1	57.7	49.3	47.2	48.3	62.8
Current account, US\$ billion	-1.7	-33.6	-25.1	-7.7	4.1	11.6
Foreign direct investment inflow, US\$ billion**	1.9	23.3	27.6	18.8	12.9	20.3
Total foreign debt, US\$ billion	148.4	241.6	241.5	227.7	235.4	220.2
Reserves***, US\$ billion	38.8	44.6	36.3	37.8	49.3	52.9
Terms of trade (1980=100)#	113.1	130.7	113.4	115.1	113.4	114.0
Primary surplus, percent of GDP	5.6	0	3.2	3.9	4.3	4.6
Total public debt-GDP ratio, percent	30.4	41.7	49.4	55.5	57.2	51.7
Prime interest rate### USA, percent	4.21	5.35	4.97	1.67	1.13	1.35
Benchmark interest rate####, percent	1383	29.5	26.3	19.1	23.4	16.2

Sources: IBGE, Brazilian Central Bank and International Monetary Fund.

* Real effective exchange rate using wholesale prices in Brazil (IPA-IT) and in its 16 more important trade partners, weighted by exports of manufactures, Ipeadata. The higher the index the more depreciated the Brazilian currency.

** Net foreign investment, including reinvestment.

*** Central Bank, international liquidity concept.

Ipeadata.

Annual average, Federal funds, Federal Reserve.

Annual nominal interest rates on Federal government paper (Selic rate). Selic stands for *Sistema Especial de Liquidação e Custódia*.

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