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Has fear defeated hope?**

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*Assessing the economic policies of President Lula in Brazil:
Has fear defeated hope?*

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Abstract

This paper aims at assessing president Luiz Inácio Lula da Silva's economic policies and their impact on the Brazilian economy. We evaluate the president's 'neoliberal' economic policies and the extent to which they have been successful in reaching sustained economic growth. We attempt to gauge the theoretical framework upon which the president's economic policies emanate from, and also describe the actual policies pursued. The paper also offers an alternative economic policy menu that aims at macroeconomic stability, which would promote sustainable economic growth without the need to introduce policies that are designed to fight inflation through the creation of unemployment.

Resumo

Este artigo objetiva avaliar a política econômica do presidente Lula e seu impacto sobre a economia brasileira. Para tanto, avalia-se as políticas econômicas neoliberais e em que medida elas têm sido bem sucedidas em alcançar um crescimento econômico sustentado para o Brasil. Pretende-se ainda examinar a estrutura teórica subjacente às políticas econômicas e ainda avaliar a políticas adotadas. O artigo oferece também uma alternativa de política econômica que objetiva a estabilidade macroeconômica, que buscaria promover um crescimento econômico sustentado sem a necessidade de introduzir políticas designadas a combater a inflação através da criação de desemprego.

1. Introduction

In his inaugural speech on January 2003, president Lula emphasized that his government would bring changes that would tackle the social problems of the country and would refuel self-sustained economic growth. In this way, it was hoped, the solution of the problems of unemployment and of distribution of wealth that had plagued the Brazilian society for so long would be achieved. In his own words, during his administration ‘hope would defeat fear’. However, the end of president Lula’s first four-year term in 2006 witnessed high and rising unemployment (the monthly average rate is around 10.0%), uneven economic growth, and ministers and members of the government involved in corruption scandals. The result of which was that confidence in the administration suffered a great deal.

This paper seeks to assess president Lula’s economic policies and their impact on the Brazilian economy. These economic policies turned out to be surprisingly different from those that most members and electoral supporters of the Workers’ Party (*Partido dos Trabalhadores* or PT) might have expected. We attempt to demonstrate in this contribution that president Lula’s economic policies cannot deliver satisfactory economic outcomes. We suggest alternatives, which we argue are by far superior in their ability to deliver a robust economic environment without inflation. We thus offer an alternative economic policy to aim at macroeconomic stability that would keep inflation under control and promote sustainable economic growth.

We begin with Lula’s electoral campaign rhetoric in an attempt to locate the moment and the reasons that led him to adopt a very ambiguous stance in his running for the presidency and the drastic change after his election on those promises (section 2).¹ We then proceed to define what we understand as the new consensus in macroeconomics, from which we suggest the ‘neoliberal’ economic policies of president Lula emanate (section 3). Given the prominence of monetary policy in this theoretical framework, we briefly look in section 4 into the operational aspects of the policy as applied in Brazil over the period. In the fifth section, we analysis some main features of the macroeconomic policy regime that has been followed by Brazilian governments since 1999, based on floating exchange rate regime, inflation targeting regime, the creation of primary fiscal surplus (the budget surplus excluding interest payments) and liberalisation of the capital account. Section 6 focuses on the main macroeconomic policies

¹ Brazil is a democratic State by right, with a presidential system of government. The president of the Republic performs two functions: those of the Head of State and Head of the Federal Government. The Presidency of the Republic and the Vice-presidency are in the foremost position of federal public administration, assisted by ministers. There is subordination of the government bureau, public companies and other directly or indirectly controlled entities to the Presidency. With the country’s return to democracy during the 1980s – from 1964 to 1985, Brazil was under military dictatorship – presidential elections have been carried out by means of a direct and secret voting system. The first Brazilian presidential election, after the return of democracy, was in 1989.

implemented by Lula's government and their results are identified. Section 7 outlines some elements for an alternative economic policy strategy. We argue that the suggested alternative economic policies can steer the economy to an economic path that is much more promising than the one offered by president Lula. Finally, section 8 summarises the argument and concludes.²

2. Presidential candidate Lula's campaign rhetoric

Lula had been the presidential candidate of the leftist PT three times before winning the presidential elections in October 2002. He had lost three previous presidential elections: once to Fernando Collor de Mello in 1989, and twice to Fernando Henrique Cardoso (referred to below as Cardoso) in 1994 and 1998. In the preparations for the 2002 election, a major issue in the strategy debates at the PT, according to the Brazilian press, was that its policies were related to political alliances. In a context under which the PT accepted to make alliances with more centrist parties that could bring Lula the necessary votes to win a majority, the latter, finally, accepted the nomination as presidential candidate for the PT.³ In fact, an alliance was organised by the PT with the Liberal Party (PL), a small centre-right populist party, which had the privilege of nominating the candidate for vice president, the entrepreneur José Alencar.

The question of political alliances was important not only because of the immediate effect that a coalition would have in terms of the electoral majority in the presidential election.⁴ The main point of the alliance between the PT and the PL (probably too small to make a real electoral difference) was to gain the confidence of segments of the Brazilian society traditionally suspicious of the PT. All evidence points to the hypothesis that the main lesson extracted by the PT leadership from past electoral defeats, was the need to attract—or at least to neutralize—social groups that had aligned in the past with the more conservative leaders. During the campaign, Lula adopted a posture that he himself dubbed 'peace and love', while all other candidates attacked José Serra, the candidate supported by ex-president Cardoso, trying to position themselves as the runner-up in the first round who would be expected to face Lula in the runoff.

² It should be noted that when the paper was written, just before the 2006 presidential election, we utilised data as available in August 2006.

³ In the Brazilian electoral system, a candidate to executive posts has to reach 50.0% plus one of the votes in two ballots to be declared a winner.

⁴ After the election, Lula's government enlarged its political alliance with other non-ideological parties, such as the Brazilian Labour Party (PTB), the Popular Party (PP) and parts of the Brazilian Democratic Movement Party (PMDB). Later a National Congress' inquiry found out a corruption scandal related to the purchase of votes in the Congress that involved a lot of deputies of the government's alliance, including some of the PT.

The situation changed in mid-2002, when financial markets finally realized that Lula's leading position in the presidential run was probably unshakeable. As had been expected, capital flight pushed down the exchange rate and a large segment of financial investors refrained from purchasing public securities maturing after 1 January 2003, when the new presidential term would begin. In view of the possibility of a Lula victory, a number of events followed, which may not have been unrelated to that expectation: (i) capital outflows intensified and, as a result, foreign reserves fell from US\$ 42.0 billion in June 2002 to US\$ 35.6 billion in November 2002; (ii) the *real* weakened from R\$ 2.38 per US dollar in January 2002 to R\$ 3.81 in October 2002 (it ought to be acknowledged, though, that whether weakening of the currency is 'good' or 'bad' could depend on its initial value); (iii) the monthly inflation rate (measured by the IPCA) increased from 0.5% in January 2002 to 1.3% in October 2002, equivalent to around 17 percent on an annual basis, as a result mainly of the effects of the exchange devaluation on domestic prices;⁵ and (iv) the demand for Brazilian securities decreased rapidly and, as a consequence, the 'Brazil risk', measured by J.P. Morgan, increased by almost 600 basis points, at the beginning of the year, to about 2,400 basis points by October 2002.⁶

In this framework, two important related developments took place. A new rescue package from the International Monetary Fund (IMF) was sought and Lula was faced with a very heavy pressure to show his support for it. In fact, the pressure led Lula's advisors to prepare a 'Letter to the Brazilian People' in which—albeit in very vague terms—the candidate assured the financial markets of his willingness to abide by the rules set by these markets. Lula's speeches in the electoral campaign became rich on promises but short on definitions. His candidacy was supported by the voters' memory of what he stood for, rather than by a plan of the prospective government that he in fact never announced.⁷

⁵ Extensive national consumer index (IPCA) covers a sample of families with a multiple of up to 40 times the minimum wage, which is determined every year by the Brazilian federal government. The sample covered by IPCA has a broad geographical basis that includes families in the biggest cities of Brazil (Belém, Belo Horizonte, Fortaleza, Goiânia, Porto Alegre, Recife, Rio de Janeiro, Salvador, São Paulo and Distrito Federal). IPCA is calculated by IBGE (Brazilian Institute of Geography and Statistics).

⁶ It should be noted that the increased 'Brazil risk' applied only for external, foreign denominated debt. Brazil does not need this. Domestic currency debt is not affected by it. Brazil was and is heavily involved in indexed domestic currency debt, which is a mistake, very much like external debt.

⁷ The PT prepared a detailed program to be implemented in case of victory. The candidate himself, however, never showed any special attachment to what had been proposed by PT.

3. New consensus in macroeconomics and policy implications

The theoretical premise of economic policies in Brazil is based on what has come to be known as 'The New Consensus Macroeconomics', NCM for short (see, for example, Meyer, 2001, McCallum, 2001). Here, we rely on an interpretation of the NCM when extended to an open economy as in Arestis (2007) – see, also, Agénor, 2002. We may summarize the main features of the NCM, and highlight its policy implications. They are the following.

(i) The primary feature is that the focus of policy objectives is on price stability. This is monetary policy's primary long-term objective, along with the further assumption that inflation is a monetary phenomenon. Inflation targeting is a monetary policy framework whereby public announcement of official inflation target is undertaken. In doing so, the central bank pursues the principle of 'constrained discretion', which is the middle ground between 'rules' and 'discretion'. Monetary policy is, thus, taken as the main instrument of macroeconomic policy, but it should not be operated by politicians but by 'experts': independent central banks.

(ii) The level of economic activity fluctuates around a supply-side equilibrium, which corresponds to a zero output gap or to NAIRU (non-accelerating inflation rate of unemployment), a supply-side phenomenon closely related to the workings of the labour market. The source of domestic inflation (relative to the expected rate of inflation) is seen to arise from unemployment falling below the NAIRU, and inflation is postulated to accelerate if unemployment is held below the NAIRU. However, in the long run there is no trade-off between inflation and unemployment, and the economy has to operate (on average) at the NAIRU if accelerating inflation is to be avoided. Say's Law holds, namely the level of effective demand does not play an independent role in the long-run level of economic activity, and adjusts to underpin the supply-side determined level of economic activity (which itself corresponds to the NAIRU). The adjustment of demand to the supply-side equilibrium is effected by interest rate decisions whereby the 'equilibrium interest rate' is the rate which equates demand and supply. However, it should be noted that the adjustment process is an administrative one operated by the central bank in the setting of interest rate. Shocks to the level of demand can be met by variations in the rate of interest to ensure that inflation does not develop (if unemployment falls below the NAIRU). The implication of this analysis is that monetary policy cannot have permanent effects on the level of economic activity. It can only have temporary effects, which persist for a number of periods in the short run before they completely dissipate in price adjustments.

(iii) Inflation targeting is a monetary policy framework whereby public announcement of official inflation targets, or target ranges, is undertaken along with explicit acknowledgement that price stability (meaning low and stable inflation) is the primary long-term objective. The price stability goal may be accompanied by output stabilization so long as price stability is not violated. An explicit numerical target for inflation is published, either as a point or a range, along with a time horizon for reaching the inflation target. Such a monetary policy framework, improves communication between the public, businesses and markets on the one hand, and policy-makers on the other hand, and provides discipline, accountability, transparency and flexibility in monetary policy. The focus is on price stability, along with three objectives: credibility (the framework should command trust); flexibility (the framework should allow monetary policy to react optimally to unanticipated shocks); and legitimacy (the framework should attract public and parliamentary support). In fact, credibility is recognised as paramount in the conduct of monetary policy to avoid problems associated with time-inconsistency (Barro and Gordon, 1983). It is argued that a policy which lacks credibility due to time inconsistency is neither optimal nor feasible (Kydland and Prescott, 1977; Calvo, 1978; Barro and Gordon, 1983).

(iv) A further role of inflation targeting is to ‘lock in’ the gains from ‘taming’ inflation. Bernanke *et al.* (1999) are explicit on this issue, when they argue that “one of the main benefits of inflation targets is that they may help to ‘lock in’ earlier disinflationary gains particularly in the face of one-time inflationary shocks” (p. 288). In an important contribution, though, Johnson (2003) finds rather mixed results for this contention. Johnson (*op. cit.*) compares actual forecasts with predicted forecasts undertaken by professional forecasters for five consecutive 12-month periods after the announcement of inflation targets. The study isolates the additional effect of the announcement of inflation targets on the level of expected inflation in the case of Australia, Canada, New Zealand, Sweden and the UK. Immediate reduction in expected inflation is registered in New Zealand and Sweden with a smaller effect and slower impact in Australia and Canada; inflation targets do not appear to have a significant impact in the UK.

(v) In this framework, monetary policy is taken as the main instrument of macroeconomic policy. Fiscal policy is no longer viewed as a powerful macroeconomic instrument (in any case it is hostage to the slow and uncertain legislative process); in this way, “monetary policy moves first and dominates, forcing fiscal policy to align with monetary policy” (Mishkin, 2000, p. 4). Monetary policy is a flexible instrument for achieving medium-term stabilisation objectives, in that it can be adjusted quickly in response to macroeconomic developments. Indeed, monetary policy is viewed as the most direct determinant of inflation, so much so that in the long run the

inflation rate is the only macroeconomic variable that monetary policy can affect. Monetary policy cannot affect economic activity, for example output and employment, in the long run.

(vi) Monetary policy should not be operated by politicians but by experts (whether banks, economists or others) in the form of an 'independent' central bank. Politicians would be tempted to use monetary policy for short-term gain (lower unemployment) at the expense of long-term loss (higher inflation), generating the time-inconsistency problem (Kydland and Prescott, 1977). An 'independent' central bank would also have greater credibility in the financial markets and be seen to have a stronger commitment to low inflation than politicians do. There is also the question of *instrument independence*, when the monetary policy instrument is under the control of the independent central bank, and *goal independence*, when the independent central bank sets the goal of monetary policy (DeBelle and Fischer, 1994; Fischer, 1994). It is argued that instrument independence is preferable to insulate the independent central bank from time-inconsistent policies. However, in terms of the goals of monetary policy, it is thought that an independent central bank should be goal dependent so that its long-run preferences coincide with society's preferences, i.e. those represented by the elected government (Bernanke *et al.*, 1999).

(vii) A mechanism for openness, transparency and accountability should be in place with respect to monetary policy formulation. Openness and transparency in the conduct of monetary policy improve credibility. In the context of inflation targeting, central banks publish inflation reports that might include not only an outlook for inflation, but also output and other macroeconomic variables, along with an assessment of economic conditions. There is also some accountability mechanism: if the inflation target is not met, there should be specific steps in place for the central bank to follow; this may include publishing an explanation, or submitting a letter to the government explaining the reasons for missing the target and how to return to it. Furthermore, transparency reduces uncertainty about the central bank's preferences, which is expected to lead to lower expected rate of inflation.

(viii) In the case of inflation targeting in an open economy, exchange rate considerations are of crucial importance, and we highlight this aspect in the case of emerging countries, and Brazil in particular in what follows in this paper. They transmit both certain effects of changes in the policy instrument, interest rates, and various foreign shocks. Given this critical role of the exchange rate in the transmission process of monetary policy, excessive fluctuations in interest rates can produce excessive fluctuations in output by inducing significant changes in exchange rates. This may suggest exchange rate targeting. However, the experience of a number of developing countries, which pursued exchange rate targeting but experienced financial crises

because their policies were not perceived as credible, is relevant to the argument. The adoption of inflation targeting, by contrast, may lead to a more stable currency since it signals a clear commitment to price stability in a freely floating exchange rate system. This, of course, does not mean that monitoring exchange rate developments should not be undertaken. Indeed, weighting them into decisions on setting monetary policy instruments is thought desirable. Such an approach is thought to make undesirable exchange rate fluctuations less likely, thereby promoting the objective of financial and price stability (Bernanke and Gertler, 1999).

4. Operational aspects of monetary policy

In terms of the operational framework of monetary policy in Brazil, i.e. the inflation targeting type of policy, a number of issues come to the fore. To begin with, there is the establishment of inflation targets. This is the setting of a point target or a band and choosing the time period over which the target is expected to be achieved. It is important to note that the *target horizon* (over which the central bank is expected to achieve its inflation target) cannot be shorter than the *control horizon* (over which the policy is expected to affect the target variable). Clearly, choosing a range as opposed to a point for the inflation target permits a great deal of flexibility, not only for output stabilization but also for accommodating large movements in the nominal exchange rate; this is a particularly thorny issue in the case of emerging countries, and Brazil in particular as shown below. In those cases where a range is chosen, there is the question of symmetrical/asymmetrical response with respect to the central target. *Symmetrical* behaviour purports to show equal concern for both inflation and deflation. Such an approach reduces the likelihood of output declines and deflation, and indicates that the central bank cares about output fluctuations; this helps to maintain support for its ongoing independence. An *asymmetrical* approach to inflation targeting may be advantageous when high inflation rates threaten credibility. This is often the case for developing and emerging countries adopting inflation targeting. A greater weight on 'overshoots' rather than 'undershoots' in the loss function is suggested under these circumstances.

Inflation targeting also requires the setting up of a model or methodology that can provide information on future inflation, an issue that relates to the necessity of forecasting inflation. There is also the key issue of how to measure inflation. A relevant question in this context is whether the chosen price index should reflect the prices of goods and services for current consumption only, or for both current and future consumption. In the latter case constructing such a price index is, of course, not feasible. Then there is the problem of noisy or erratic short-run movements in prices, which suggests that an adjusted or core (long-term) price

index should be used. Such an index might exclude from the general or headline price index items such as food and energy prices, shocks to the exchange rate, indirect tax or regulated prices on the assumption that such changes are the result of temporary and self-correcting short-term shocks that contain very little information about long-term price movements. Another important excluded category of items relates to changes directly associated with the policy change. Items which covary directly with the policy instrument, such as mortgage payments, may be excluded from the definition of the targeted price index. Such effects, however, may contain significant and protracted second-round effects. For example, a rise in indirect taxes that lowers inflation temporarily can affect aggregate demand, which may lower prices in the long run, thereby implying an important loss of information with regard to future price developments.

There is still the question of the trade-off between, on the one hand, reducing deviations of inflation from target, and on the other hand, preventing a high degree of output variability. This is particularly pertinent in the case of supply shocks that cause inflation to exceed the target and are associated at the same time with lower output. Monetary authorities face a serious dilemma in these circumstances: the quicker the disinflation, the shorter the period of actual inflation being above its target. But then the quicker disinflation is, the greater the potential output variability. Policy preferences are an important determinant of this trade-off in addition to the magnitude of the supply shock. Flexibility is required in this context, which, however, may conflict with credibility if agents interpret it as reluctance by the central bank to deflate. There is, thus, another trade-off in this case between credibility and flexibility (Garfinkel and Oh, 1993).

This discussion highlights another important operational aspect. This relates to the question of monetary rules. Central banks on the whole are assumed to follow one form or another of Taylor rules (Taylor, 1993); in its original formulation this monetary rule took the ad hoc formulation as shown in equation (1):

$$(1) \quad R_t = RR^* + p^T + d_1 Y_t^g + d_2 (p_{t-1} - p^T)$$

where the symbols are as above, with the exception of p^T which in the original Taylor (*op. cit.*) formulation is desired inflation (clearly, in current parlance it is the inflation target set by the central bank as explained in section 3). Equations of the type depicted in (1) conform to what are known as Taylor rules, since it was Taylor (1993) who showed that a simple equation of this form, with $d_1 = 0.5$ and $d_2 = 1.5$, can be employed to capture the behaviour of the US federal-funds rate and the Federal Reserve System (Fed) monetary policy. The nominal rate is

increased more than one-to-one with respect to any increase in inflation. This policy reaction ensures that the real rate of interest will act to lower inflation. Given inflation, the real rate of interest is also increased as a result of output-gap positive changes. Taylor rules, therefore, require monetary policy to act automatically to inflation and output. These Taylor-type rules have been criticized (for example, Svensson, 2004) in terms of the possibility of real indeterminacy: if the rise in the nominal rate of interest in response to a rise in expected inflation is not high enough, then the real rate of interest falls raising demand which fails to check inflation. *Mutatis mutandis*, an excessive rise in the nominal rate of interest in response to a rise in expected inflation would also cause indeterminacy. However, indeterminacy can be avoided if monetary authorities respond rather aggressively, that is with a coefficient above unity to expected inflation, but not overly higher than unity. This result has been demonstrated in the closed-economy case (Clarida, Galí and Gertler, 2000) as well as in the small open-economy case (De Fiore and Liu, 2002).

The Brazilian inflation targeting monetary policy regime is modelled on the basis of the British inflation targeting model. The National Monetary Council (CMN) sets the inflation target, which is proposed by the Minister of Finance. The Brazilian Central Bank (BCB) Monetary Policy Committee (COPOM) has to achieve the inflation target through the manipulation of the short-term interest rate. In fact the BCB makes use of the Taylor rule as its reaction function. It is actually a slightly modified form of equation (1), as this is apparent from (2), which is adapted from Minella *et al.* (2003, p. 11). The relevant relationship is:

$$(2) \quad R_t = \alpha_1 p_{t-1} + (1-\alpha_1) [\alpha_0 + \alpha_2 (E_t P_{t+j} - P^*_{t+j})] + \alpha_3 Y^g_{t-1} + \alpha_4 \Delta e_{t-1},$$

where R_t is the 'Sistema Especial de Liquidação e Custódia' (Selic), *i.e.* the rate of interest set by the COPOM, $E_t P_{t+j}$ is inflation expectations and P^*_{t+j} is the inflation target, both referring to some period in the future,⁸ Y^g is the output gap (obtained by the difference between the actual and the Hodrick-Prescott – HP – filtered series), and Δe_{t-1} is the nominal exchange rate variation. Therefore, the Brazilian Taylor rule relates the interest rate to deviations of expected inflation from the target, allowing also for some interest rate smoothing (R_{t-1}) and reaction to the output gap as well as movements in the exchange rate. The Brazilian inflation targeting regime sets year-end inflation targets for the current and the following two years. Inflation targets are

⁸ In order to have a single measurement of the deviation of inflation from the target, BCB has used a weighted average of current year and following year expected deviation of inflation from the target, where the weights are inversely proportional to the number of months remaining in the year.

based on the headline inflation index, i.e. extensive national consumer price index (IPCA).⁹ A certain degree of flexibility is introduced through defining inflation targeting within a range, which has varied between 2.0 or 2.5 percentage points above and below the central point target. The other main reason for the introduction of this flexibility is that it helps the BCB to achieve its inflation target in view of the serious supply shocks to which the Brazilian economy is exposed.

Brazil is the only country in the world where the central bank directly determines the interest rate that remunerates public debt and uses the same rate as the operational target for the reserves of the banking sector. This anomalous situation is a heritage of the high inflation era that still remains intact nowadays. Indeed, as more than 40% of federal securities are indexed to the overnight rate (Selic¹⁰) and they are used by the banks to back up fixed income funds (short-term funds that are very popular in Brazil), any increase in the interest rate results in an immediate increase in the total stock of public debt.¹¹ It follows that under such circumstances, a rise in the interest rate (Selic) by BCB, is followed, *ceteris paribus*, by an increase in the liquidity conditions of the economy as measured by broad monetary aggregates. It can also cause a higher level of consumption expenditures by firms and households, as the increase in the remuneration of the fixed income funds results in a positive wealth effect in consumption. This increase in expenditure outweighs the negative impact on consumption as a result of the higher rate of interest (Nakano, 2005). There are two consequences of this *modus operandi* of monetary policy in Brazil. First, in order to have some effect over demand, BCB needs to increase the rate of interest sufficiently high so that banks are forced to ration credit due to the increased default risk. Second, the increase in the rate of interest, due to the arbitrage between domestic and foreign interest rates, can arguably cause an appreciation of the exchange rate. This works as a positive shock on the supply-side of the economy, since it reduces the cost of imported raw materials and the price of the tradable goods in the domestic market; it works negatively, of course, on the demand side. Under these conditions it would mainly be through the exchange rate channel that monetary policy is most effective in countries like Brazil. However, it is very well known that the evidence on this issue is very sparse.

⁹ See footnote 5 for a precise definition of IPCA.

¹⁰ The interest rate target set by the BCB is the target for the Selic interest rate, the interest rate for overnight interbank loans, collateralised by those government bonds that are registered with and traded on the Selic. This is the interest rate equivalent to the *Federal Funds* rate in the United States.

¹¹ According to data from IPEADATA, the ratio of net public debt-over-GDP increased from 34.4% in 1997 to 52.6% in 2001, and since then it has been more than 50.0%. Lula's government has succeeded in reducing the part of domestic public debt that is indexed to the exchange rate, but this policy has been followed by a reduction of the average maturity of public securities.

Still it should be emphasised that the inflation-targeting regime in Brazil can only account for demand-type shocks, not supply-side shocks. It is also pertinent to note that if inflation is a function of indexation policies, as the case is to some extent in Brazil (see below), then attempting to control and fight inflation with policies such as interest rate manipulation and tight fiscal policy could potentially create a great deal of slack and unemployment in the system.

5. Main features of the macroeconomic policy regime in Brazil

We have argued earlier that the theoretical focus of president Lula's economic policies is based on the NCM. While this is true, it is also the case that prior to Lula's election, indeed ever since the beginning of the 1990s, Brazil had followed a pattern of economic development, which in broader terms was inspired by another consensus, which has been proposed to encapsulate what appeared to be at the time relevant debates. Those debates, which were taking place in the late 1980s, evolved extensively on the reforms that were taking place in Latin America. The consensus in question was the result of proposals of what appeared "to be the central areas of policy reform that most people in Washington thought were needed in most Latin American countries at that time" (Arestis, 2004-05, p. 195; see, also, Williamson, 1990; Arestis, 2004-05, provides a comprehensive critique of this consensus in relation to another important discussion, which had been going on for a while, that of financial liberalisation). This is what has come to be as the 'Washington Consensus'.¹² This framework is not really different from NCM. It includes a set of liberalising and market friendly policies such as privatisation, trade liberalization, stimulus to foreign direct investment (FDI), financial liberalisation (including both foreign banks entry and capital account opening up), fiscal discipline, tax reform, labour and social security reforms, price stabilisation, secure property rights, independence of central bank and so on. The new pattern of development had two basic dimensions: economic integration commanded by the market and a new role for the State, which should include the promotion of price stability, and the improvement of the market performance. While it is true that the Cardoso government followed the 'Washington Consensus' or 'neoliberal' type of policies extensively,¹³ the Lula

¹² 'Washington Consensus' (WC) is a set of liberalizing propositions that intended to create conditions for economic growth in Latin American countries, and was first suggested by Williamson (1990; see, also, 2004-05). The set of reforms could be summarized in ten propositions: fiscal discipline, redirection of public expenditure priorities towards fields offering both high economic returns and the potential to improve income distribution, tax reform, interest rate liberalisation, a competitive exchange rate, trade liberalisation, liberalisation of inflows of foreign direct investment, privatization, deregulation and secure property rights. It ought to be noted that, as Williamson (2000) stressed later, the ten propositions did not include capital account liberalization in the original version of WC, although IMF included it in its own WC.

¹³ Saad-Filho and Morais (2002) show that Cardoso's economic policies were of the neoliberal type of policies.

government did not depart from them then. To the contrary, it pursued the NCM principles more closely, as we argue below.

As is well known, in 1994 Brazil implemented a stabilization programme, more specifically the Real Plan. The Brazilian Real Plan differed from Argentina's Convertibility Plan in that it adopted a more flexible exchange rate anchor. At the launch of the Real in July 1994, the government's commitment was to maintain an exchange rate ceiling of one-to-one parity with the dollar. Moreover, the relationship between changes in the monetary base and foreign reserve movements was not explicitly stated, allowing some discretionary leeway. After the Mexican crisis, the exchange rate policy was reviewed and in the context of a crawling exchange rate range, the nominal rate began to undergo gradual devaluation.

The Real Plan was successful in bringing inflation down fast, due to the combination of exchange rate appreciation, high interest rates and a huge reduction in import taxes.¹⁴ However, the expansion of demand, which had come from the fiscal side, and the overvalued exchange rate created immediate difficulties for Brazil's external sector. For while in 1994 the trade balance was around US\$ 10.4 billion in surplus and the current account was in balance, from 1995 to 1998 the trade balance accumulated a deficit of around US\$ 22.3 billion and the current account registered a deficit around US\$ 105.6 billion. Under the pressure of the speculative attack on the domestic currency, the main tool available for Central Bank to defend the *real* (Brazilian currency) was to increase the rate of interest. As a result of this external imbalance, the Brazilian economy suffered many speculative attacks on the *real*, a "mix of a 'contagious crisis' arising out of the effects on Brazil of the [Mexican crisis], East Asian and Russian crises and an outbreak of speculative activity triggered by market operators who perceived evident macroeconomic imbalances in Brazil" (Ferrari Filho and Paula, 2003, p. 77).

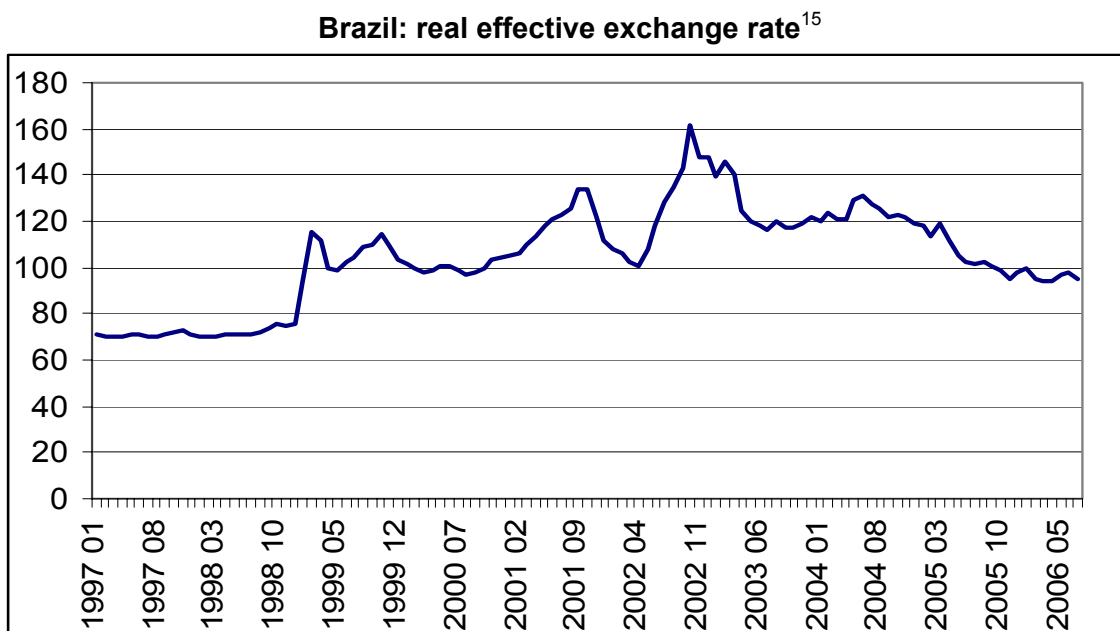
Despite the fact that, during this period, the IMF 'offered' financial support to Brazil on several occasions, the crisis in Russia affected Brazil's external capital account. As a consequence, capital began flowing out of the country and foreign reserves fell rapidly. Under the circumstances of macroeconomic imbalances and uncertainties about the Real Plan's future, Brazil was unable to defend its currency and, in January 1999, the Cardoso's government abandoned the original exchange rate policy. The 'fixed' exchange rate regime was replaced by a floating exchange rate regime.

The 1999 switch from an exchange anchor to a floating exchange rate regime plus an inflation targeting regime brought no significant improvement in the macroeconomic variables

¹⁴ In August 1994, the Brazilian government reduced tariffs on imports of more than 4,000 products, to a maximum of 20 percent.

(GDP growth, inflation rate, unemployment rate etc.), although in terms of the balance of payments the accounts in 2003-04 did improve, due mainly to the increase in the trade balance surplus. One might have expected that adopting a floating exchange regime might have allowed lower interest rates more quickly in Brazil. Although the rate of interest did decline, it picked up again during 2001, in view of the turbulence on international markets (the Argentina crisis and the effects of 11 September 2001, among others), and again in 2003 due to the market turbulence in the beginning of Lula's government (see Figures 1 and 2 below). Those 1999 developments inaugurated a period, extending to this day, over which the NCM has proven more appropriate than the Washington Consensus as a theoretical framework able to explain Lula's economic policies. Indeed, under the NCM framework, interest rates increase because the central bank raises them. Under such circumstances and under a floating exchange rate system direct market forces on interest rates are limited.

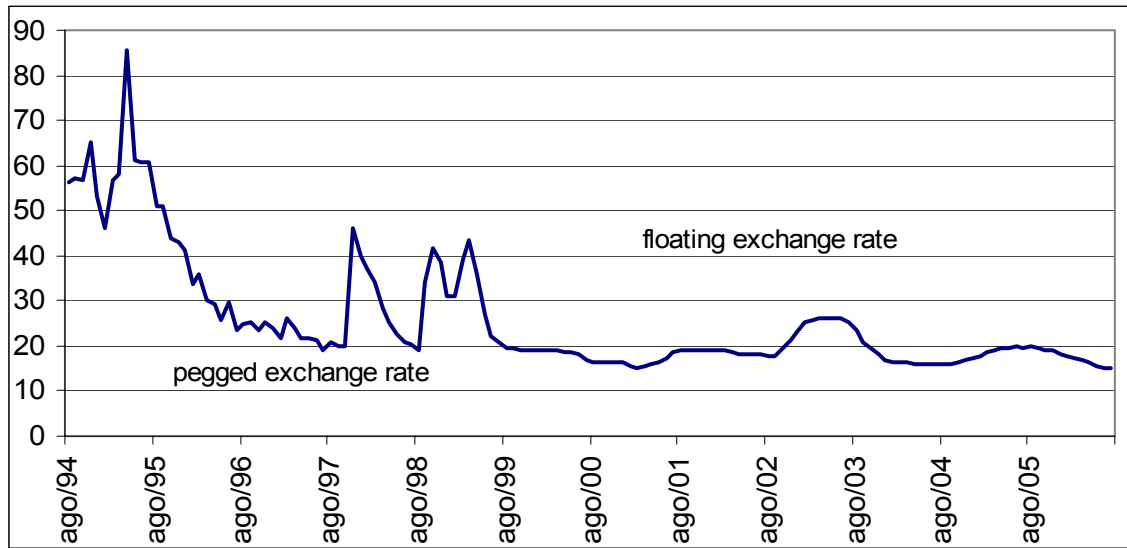
Figure 1



Source: IPEADATA. Note: 2000 = 100.

¹⁵ Real effective exchange rate (REER) is defined as a nominal effective rate index (index of the period average exchange rate of the currency in question to a weighted average of exchange rates for the currencies of selected countries) adjusted for relative movements in national price of home country and selected countries. It should be stressed that REER in Brazil and other Latin American countries is calculated differently from the most conventional way, that is REER is calculated by multiplying the nominal exchange rate by the inflation rate of home country and dividing by that of a partner country, while most frequently REER calculated by multiplying the nominal exchange rate by the inflation rate of a partner country and dividing by that of home country. As a result in the case of Brazil when REER increases this means undervaluation and when it declines means overvaluation.

Figure 2
Brazil: nominal interest rate (% p.y.)



Source: BCB.

The *modus operandi* of inflation targeting regime plus the adoption of a floating exchange rate regime, under the conditions of full opening of the capital account, has resulted in sharp instability of the nominal exchange rate. Indeed, since the end of the 1980s and beginning of the 1990s, Brazil and other Latin American countries, began gradually, but continually, to liberalize their capital account.¹⁶ Capital outflows can induce a sharp exchange rate devaluation that affects domestic prices ('pass-through effect'), which can jeopardize the BCB's inflation target. Under these conditions, BCB is compelled to increase the interest rate in order to seek to avoid both capital outflow and pass-through effect.¹⁷ The BCB's reaction to exchange rate movements causes a decline in output and employment, increasing at the same time the volume of public debt, although it should be readily acknowledged that such a decline in output is likely to also emanate from other sources. It should also be acknowledged that in terms of domestic currency the deficit can be sustained at any level necessary for full employment in

¹⁶ In 1991 Brazilian government permitted the acquisition by institutional investors of equities of Brazilian firms. In 1992 BCB allowed a broad liberalization of exchange rate market as it permitted that a special banking account called CC5 could be operated more freely by foreign financial institutions as a result of acquisition or sale of foreign currencies. This norm in practice created a privileged way to short-term capital flight that was used during periods of contagious of currency crises, as any agent (resident and non-resident) with access to a foreign bank could send dollars abroad. In 1994 BCB implemented a tax on capital inflows in order to lengthen maturities of capital flows and to give some freedom degree for monetary policy as Brazil had adopted a semi-fixed exchange rate. After the 1999 Brazilian currency crisis and the adoption of a floating exchange regime, economic authorities implemented a lot of norms that resulted in greater flexibility in exchange rate market, including the unification of the exchange rate markets (floating and free ones), simplification of the procedures related to the capital remittance to other countries and extension of maturities for exchange rate coverage related to exports operations, among others.

¹⁷ While exchange rate volatility was reduced by the end of 1998, when Brazil adopted a crawling-peg exchange rate regime, after the adoption of the flexible exchange rate regime, nominal exchange rate volatility increased a great deal.

conjunction with very low interest rate policy. This is particularly relevant in the case of Brazil where a low interest rate policy would be a major contractionary force to the extent that the full budget deficit would vanish and perhaps go into surplus in tandem with the low interest rate policy. This implies, of course, that a low interest rate policy would need to be matched by a tax cut or spending increase to be neutral fiscally. However, during 'tranquil times', in which the country has abundant capital inflows, interest rate is used in order to attract capital flows that results in the exchange rate appreciation that serves for the purpose of the inflation targets. Since 1999, there has, therefore, been a connection between exchange rate oscillations and interest rate movements in Brazil (see Figures 1 and 2), although it should be noted that the 'inflows' are not normally associated with interest rates under a floating exchange rate policy.

The rate of interest (real as well as nominal) has been high in Brazil because it serves multiple functions. First and foremost, it is designed to influence and achieve the inflation targets, in view of the inflation targeting regime in the context of various macroeconomic constraints; also to limit exchange devaluation, to attract foreign capital, to roll over public debt, and to reduce trade deficits by curbing domestic demand (Bresser-Pereira and Nakano, 2002). High interest rates in Brazil have had two effects: (i) constrained economic growth, through the price of credit (loan rates) and entrepreneurs' negative expectations; and (ii) increased public deficit through interest payments, which is formed mainly by indexed bonds to overnight rate or short-term pre-fixed bonds. Despite the significant improvement in the current account of the balance of payments figures since 2003, due essentially to the increasing trade balance surplus, Brazil's recent experience shows that in economies with a high level of external debt and a fully-liberalized capital account, external capital flows can cause periods of intense exchange rate instability. This situation has also caused low economic growth, because monetary authorities tend to increase interest rates during periods of external turbulence in order to meet inflation targets, and also stabilize exchange rates. A rising interest rate punishes firms, that need credit to operate, and workers, who lose their jobs when firms face difficulties, but rewards *rentiers* richly. Moreover, high interest rates also increase fiscal expenditures, deepening any fiscal imbalance that could already be present.

Another factor that weakens the efficacy of monetary policy in Brazil is the weight of administered prices in the extensive national consumer price index (IPCA). Monitored or administered prices are defined as those that are relatively insensitive to domestic demand and supply conditions or that are in some way regulated by a public agency. The group includes oil by-products, telephone fees, residential electricity, and public transportation. Its dynamics differ from those of market prices in three ways: "i) dependence on international prices in the case of

oil by-products; ii) greater pass-through from the exchange rate; and iii) stronger backward-looking behaviour” (Minella *et al.*, 2003, p. 7).¹⁸ This is since electricity and telephones rates are generally adjusted annually by the General Price Index (IGP).¹⁹ Our estimation of the percentage of monitored prices to IPCA is around 28% on average from April 2003 to December 2005 (see Figure 3 below). Furthermore, administered prices have increased more than market prices. Indeed, while the accumulated inflation rate related to market prices was 57.0% from 1999 to 2005, the administered price rate was 137.0%, that is it increased by more than 50.0% in relation to the former.²⁰ Administered prices in Brazil are set by contracts based on past variation of the price index. It is for this reason that some degree of persistence is evident in the formation of this particular price index. Consequently, in view of the importance of administered prices in the determination of the Brazilian inflation rate, inflation pressures result in the BCB having to increase interest rates higher than might be necessary to restrain inflation that derives from market prices. This is so since the BCB has to account for the secondary effects that emanate from the shocks of monitored prices. Given also that wages in Brazil are administered too, it follows that under such conditions it becomes illogical and contradictory to attempt to fight inflation through the normal means of manipulating the rate of interest.

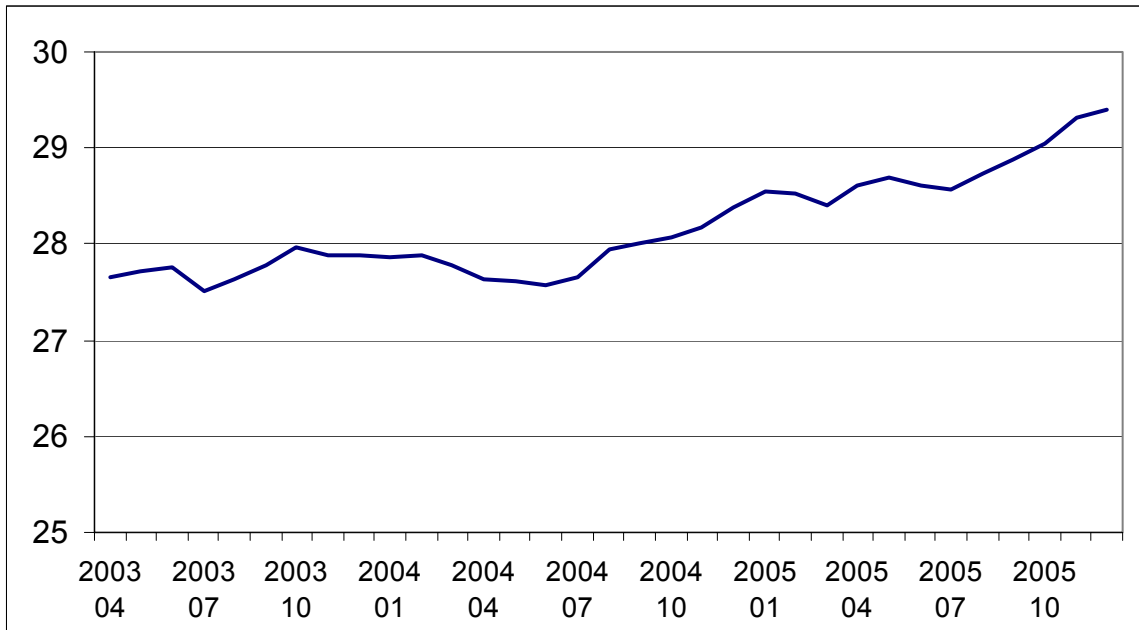
¹⁸ According to Minella *et al.* (2003), “[t]here are three basic links: i) the price of oil by-products for consumption depends on international oil prices denominated in domestic currency; ii) part of the resetting of electricity rates is linked to changes in the exchange rate; and iii) the contracts for price adjustments for electricity and telephone rates link these adjustments, at least partially, to the General Price Index (IGP), which is more affected by the exchange rate than the consumer price indexes” (p. 7).

¹⁹ IGP is prepared by Getúlio Vargas Foundation, a private foundation, and it is calculated through a weighted index that includes wholesale price index (60.0%), consumer price index (30.0%) and national index of building costs (10.0%). The reason for the use of this index to adjust electricity and telephones rates (instead of IPCA) is that when these services were privatised in the second half of the 1990s, Brazilian government was interested to attract foreign firms, and for these firms IGP is better than IPCA, as it is much more sensitive to exchange rate variations (due to the high weight of the wholesale price on it).

²⁰ The synthetic IPCA, which includes both market and monitored prices, from 1999 to 2005, was 73.9%, according to own calculations.

Figure 3

Brazil: percentage of administered prices over IPCA



Source: Authors' calculations based on data from IBGE (www.ibge.gov.br).

Note: Administered prices include utilities services, oil by-products, private health plans, that are, prices that are or determined (or authorized) directly by government (oil, private health plans) or are governmental permission that include some sort of price indexation.

Under the current conditions of the operation of macroeconomic policy in Brazil, the government has to generate primary fiscal surplus in order to maintain some fiscal balance due to the effects of movements in the rate of interest and the exchange rate on the public debt. However, orthodox economists (for example, Pastore and Pinotti, 2005) argue that fiscal imbalance is the main problem of the Brazilian economy. However, they do not explain the origins of such an unbalanced situation. Indeed, the reasons are both important and pertinent. The international financial integration of the Brazilian economy has resulted in the instability of both the exchange rate and the rate of interest. It has also restricted the government's degrees of freedom over fiscal policy. Primary fiscal surplus has been more than 3 percent of GDP since 1999 and reached almost 5 percent in 2005 (Table 1). The amount of primary surplus necessary to stabilise the public debt ratio over GDP is determined partly by movements in the rate of interest and the exchange rate. As public expenditures are very sticky due to the existence of

some mandatory public expenditures (education, health, Fund against Poverty etc.),²¹ the only option to generate fiscal primary surplus is to combine increasing public revenues, as they arise through taxation, with the decrease in public expenditures due mostly to lower public investment.²² As a result, the tax burden²³ (see Table 1) increased from 30 percent of GDP in 1998 to around 35 percent in 2004, which generated a great deal of complaints from the business sector in Brazil. Under such circumstances, there is no role for counter-cyclical fiscal policy. In the next section, we will see that Lula's economic policies are a relevant example of this sort of constraint.

Table 1 here

6. Lula's orthodox economic policies and their expected results

The showdown of mid-2002 was decisive to show wealth-owners in Brazil the extension of their power over the new government. After some specialists in economic matters of the PT were vetoed by the financial markets, Lula nominated Antônio Palocci, a relatively unknown politician from the moderate wing of the PT, for the Ministry of Finance. The president also appointed Henrique Meirelles, a former chair of BankBoston in Latin America who had just been elected federal deputy by Cardoso's political party (Brazilian Social Democratic Party or PSDB), as chairman of the BCB. Palocci's team and BCB's directorate were constituted mostly by neoliberal economists and/or economists that were working in major banks in Brazil. As a result, the economic policies have been marked by the continuation—and in some aspects radicalization—of Cardoso's economic policies in his second term from 1999 to 2002. In broader terms, there are some slight differences between Cardoso's economic policies and Lula's ones. First, the latter deepened the process of financial liberalisation with the adoption of a set of new regulations that included both facilitation to outward transactions (elimination of the limits that residents can convert real in foreign currencies, with the end of the CC5 accounts) and inward transactions (fiscal incentives to foreign investors to buy domestic public securities).²⁴ Second, primary fiscal surplus were increased from around 3.5% to more than 4.25% of GDP during Lula's government, in order to assure the conditions of fiscal solvency. Therefore, fiscal policy has been definitely set as the main anchor of the regime of

²¹ The ratio mandatory public expenditures over total public expenditures was 90.1% in 2004, according to data from the Planning Ministry. For a comprehensive analysis of fiscal policy in Brazil see Lopreato (2006).

²² Public investments in infra-structure (percentage of GDP) declined from 2.8% in 1998 to 1.7% in 2003 (Afonso, 2006, Table 5, p. 11)

²³ Tax burden is defined as the ratio country's total taxes over GDP.

²⁴ See footnote 16 above for some information relating to external financial liberalization in Brazil.

macroeconomic policies in Brazil. This conforms to the neoliberal view according to which the effects of fiscal policy are explained by the role of current policy in shaping expectations of future policy changes. This is seen as essential to improving the credibility of the economic authorities (Bertola and Drazen, 1993). It is also clear that this is consistent with NCM, whereby fiscal policy has been downgraded as a short-term stabilization instrument. Third, Lula's government has been helped by much better international conditions than Cardoso's; the latter had to face contagion by external crises, such as those in Asia, Russia, and Argentina.

Indeed, favourable international conditions included both greater economic growth (and as a result an increase in international trade) and increasing liquidity in the international financial markets, which resulted in the retaking of the voluntary capital flows to emerging countries. The recovery of the global economy since 2001, due to American economic growth and mainly to Chinese economic growth, has had as a consequence an increase in both demand and prices of commodities in the international trade. As the main item of the Brazilian exports are commodities, such as soy, steel and iron, the increase in the price of most of the commodities exported by Brazil explains why the trade balance arose from US\$ 24.9 billion in 2003 to US\$ 44.8 billion in 2005, although the real exchange rate has been continuously appreciating since 2003 (see Figure 1; also Prates, 2006, for more details). Net exports were the main source of growth for the Brazilian economy from 2002 to 2005 and allowed the BCB to increase exchange reserves from US\$ 37.8 billion in 2002 to US\$ 53.8 billion in 2005 (Table 2). In fact, the commodity boom is the entire explanation for the Brazilian 'success' and how it avoided default on its external debt obligations. It is the case, actually, that a lot of questionable policy was overshadowed by the commodity boom. When that ends Brazil may very well suffer from a situation where success has been attributed to success of the wrong factors.

Table 2 here

In spite of the better international conditions, GDP has taken a 'stop and go' pattern during Lula's government. GDP growth was 0.5% in 2003, 4.9% in 2004, 2.3% in 2005 and is estimated to be around 3.5% in 2006. The growth rates are very low for Brazilian needs, and also very low when compared with those of other major emerging countries over the same period.²⁵ It is the purpose of the rest of this section to attempt to provide an explanation of this performance.

²⁵ Ferrari Filho and Paula (2006) report that GDP growth in China, India and Russia was in 2000-2004, on average, 6.8%, 5.7% and 8.5%, respectively.

The increase in the primary surplus was from 3.75% in 2002 to 4.25% of GDP in 2003, and the institutional improvements to ensure financial discipline at all levels of government and a high average basic interest rate (Selic) (around 23.0%) allowed Brazil to reach policy credibility with domestic and international financial investors. Accordingly, there was a significant improvement in the risk premium charged on Brazilian bonds. In 2002 the average EMBI for Brazil was 1,380 basis points while in 2003 it was reduced to 830 basis points; an increase in the value of Brazilian bonds in the international secondary market also took place.²⁶ In addition to this, two important points that strengthened the market's 'confidence' concerning Lula's economic policy were the fact that the inflation rate, despite having reached 9.3% in 2003 (0.8% above the 'adjusted target' adopted by BCB), was kept under control and the trade surplus increased from US\$ 13.1 billion, in 2002, to US\$ 24.8 billion in 2003. To sum up, according to international and domestic financial markets, the Lula administration has done a 'good job' in restoring confidence. But it looks that the 'good job' has been performed in the main by international commodity prices (denominated in dollars), not policy.

Table 3 here

Nevertheless, the results were far from bright with regard to real economic activity, perhaps as a consequence of the very high interest rate (as was shown above, the annual average basic interest in 2003 was 23%). The economic policy mix led to poor economic growth in 2003, the GDP increased only by a poor 0.5%, with the productive capacity declining in several strategic sectors because of the continuing lack of investment. The average rate of unemployment was 12.3% and the distribution of income deteriorated according to the Brazilian Institute of Geography and Statistics (IBGE). In general, the average real income of workers decreased by almost 15.0% in 2003.

In 2004, the GDP increased by 4.9%, the fastest expansion in five years. Domestic demand picked up, consumers and business also increased and private investment actually recovered. The inflation rate was 7.6%, only 0.4% below the maximum limit of inflation target proposed by BCB. Moreover, the average unemployment rate decreased (from 12.3% in 2003 to 11.5% in 2004) and workers' average real income dropped only by 0.75%. At least two reasons can explain the Brazilian economic performance in 2004. On the one hand, the average basic interest rate dropped from 23.0% in 2003 to 16.4%; on the other hand, the record trade and current account surpluses (the trade balance was around US\$ 33.5 billion, built basically by

²⁶ Once again, it is important to say that, during the presidential election, in October 2002, the risk premium had reached the 2,400-point mark.

robust export growth rather than by a fall in imports; and the current account balance was US\$ 11.6 billion) contributed to the increase of output and national income, and also made the Brazilian economy less vulnerable to external shocks. Thus, the main indicator of vulnerability, that is to say, the ratio of external indebtedness to exports, improved notably. Fiscal conditions also improved in 2004, as this is clear from the reduction of public indebtedness from 58.7% of GDP in 2003 to 51.8% in 2004, due to a combination of output growth with low basic interest rate and exchange rate appreciation. The reduction in the interest-rate sensitive expenditures contributed to a better performance of the nominal public deficit, which declined to 2.67% of the GDP (see Table 1). As a result, the average country risk dropped to 542 basis points. At that time, president Lula stated that, at last, 'recovery would be lasting and the 'amazing growth' ("espetáculo do crescimento", in Portuguese) had already begun'.

However, 2005 showed that sustained recovery of the Brazilian economy was not really under way in view of the fact that productive activity slowed sharply in 2005. According to the IBGE, GDP increased only 2.3% in 2005.²⁷ It is possible to identify at least four reasons for this poor performance of GDP growth. First, to aim at keeping the inflation on target (5.1%), when the actual inflation rate was 5.69% in 2005, the BCB pursued an excessively tight monetary policy, and, as a result, the basic interest rate was very high (the annual average overnight Selic interest rate in 2005 was 19.2%); second, fiscal adjustment, predominantly by raising taxes and cutting back public investments, was also too tight (the ratio of primary fiscal surplus over GDP reached 4.8%); third, the exchange rate appreciated dramatically (in 2003 the annual average exchange rate was a R\$ 3.01 per US dollar, while in 2005 the annual average exchange rate had dropped to R\$ 2.43 per US dollar); and, finally, the performance of domestic demand, especially the agricultural sector, was very weak. It is important to emphasize that the economic growth rate did not decline even more only due to the fact that the international scenario was so favourable to the Brazilian economy.²⁸ In this context, the trade balance and the surplus of current account reached US\$ 44.8 billion and US\$ 14.2 billion, respectively. As a result of this external performance, the average country risk was 313.8 basis points.

For 2006, there are signs of a pickup in activity and some reasons why growth is expected to strengthen a little. The most important sign is the fact that, since the third quarter of 2005, a gradual reduction of interest rates has been observed; furthermore, primary fiscal surplus is expected to decline from 4.8% of GDP in 2005 to 4.25% in 2006. As a result,

²⁷ Despite this poor GDP performance, the average unemployment rate decreased a little (from 11.5% in 2004 to 9.8% in 2005) and the workers' average income increased by 5.8%.

²⁸ The international prices and the global demand for Brazilian commodities was still high, the growth rate of the main trade partners (United States, Argentina and China) were higher than the world average growth, and foreign investment, direct and portfolio, were 'flying' into Brazil.

domestic demand has been more robust with private consumption and industrial production increasing and investment recovering. Moreover, at least two further reasons could suggest some improving perspectives for the Brazilian economy in 2006. First, due to a corruption scandal, the Finance Minister, Antônio Palocci, was replaced by Guido Mantega, the former president of the Brazilian Development Bank (BNDES). In contrast to Palocci, Guido Mantega is an economist who since 2003 has been criticizing the core of Lula's economic policies. In this respect, there is a distinct possibility that in 2006 some flexibility in fiscal and monetary policies may be introduced, implying that economic policy in Brazil may be getting away from the inflation targeting principles.²⁹ Second, due to the presidential election in October, Lula is running for his possible second term. It means that monetary and, specially, fiscal policies may be more relaxed. In this context, according to the weekly report of BCB (August 21, 2006), the expectations for the main indicators of Brazilian economy for 2006 are: GDP will increase by 3.5%, the average interest rate and the average exchange rate will be around 15.2% and 2.19 per US dollar, respectively, the inflation rate will be 3.8%, slightly less than the centre of the target inflation rate (4.5%), and net exports are expected to reach around US\$ 41.2 billion (see Table 2).

Assuming that, at the end of 2006, the main indicators of Brazilian economy are similar to the BCB expectations, it means that Lula's economic performance, from 2003 to 2006, would show the following characteristics: (i) despite the fact that inflation rate would be kept under control, its average rate would be relatively high at 6.6% per year on average since the introduction of the inflation strategy. This is high especially so when it is noted that Brazil has adopted an inflation targeting regime which is supposed to not only tame inflation but also to 'lock-in' inflation rates to low levels; (ii) the annual nominal interest rate would be around 18.4%, while the average real interest rate would reach 11.1%; and (iii) the average annual growth rate of GDP would be only 2.8%.³⁰ Finally, it is important to emphasize that the course and results of the Lula's economic policies, based on inflation targeting, primary fiscal surplus and flexible

²⁹ In fact in the election of 29 October 2006, Lula was re-elected in the second round for a new term, 2007-2010. Despite some allegations of corruption and his orthodox economic policies, Lula managed 60.8% of the votes while his opponent, Geraldo Alckimin of the Social Democratic Party (PSDB) had 39.2% of the votes. The success of Lula's re-election was his welfare project, Bolsa Família (family grant), in reducing poverty. According to this welfare project, around 11 million families reached between R\$ 15.00 and R\$ 95.00 per month (US\$ 7.00 and US\$ 45.00, respectively (as per the relevant exchange rate on the 30th of October 2006). As reported in the Guardian (30 October 2006), cabinet members promised a post-election departure from the orthodox economic policies of the first Lula government.

³⁰ A recent Bulletin of the National Confederation of Industry - CNI ('Informe Conjuntural CNI', July 2006; and reported in the Financial Times, 25 September 2006), revised the GDP growth for 2006 to be around 2.9 per cent, far below the government's 4-4.5 per cent and rather close to the 2003-06 average. According to CNI the main factor that contributes to the downgrade of the GDP growth in 2006 is the performance of the trade balance. This is due to the reduction in both income and quantum of exports, which is the result mainly of the exchange rate appreciation.

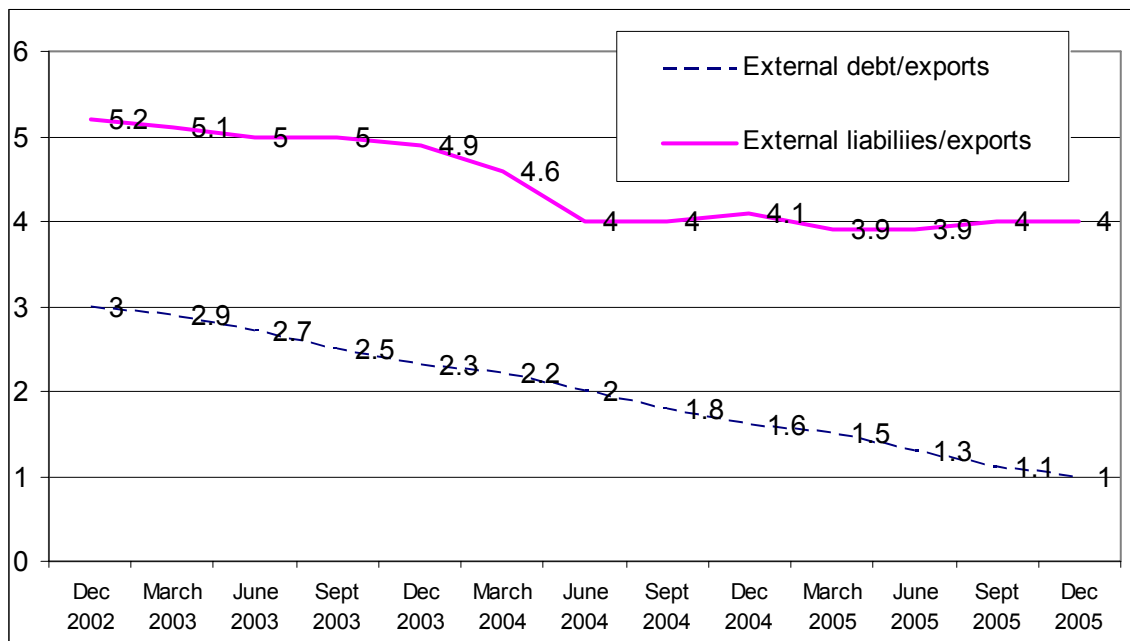
exchange rate regime, are not performing as well as they might be expected by conventional wisdom, although some indicators have improved recently.

We can now summarise the results of Cardoso's second-term and Lula's first-term economic policies, based on the inflation targeting regime, flexible exchange rate and fiscal surplus regime, as follows:

- It is notable that over the period 1999-2005 actual inflation rates in Brazil were only within the targeted range in 4 out of the 7 years of the operation of this monetary policy strategy (it is important to note that in 2003 and 2004 the inflation target was changed half way through the period). The targets were missed in 2001, 2002 and 2003 by a substantial margin, especially in 2002 (see Table 3). On another occasion (2004), the inflation target was met (it was 0.4% below the inflation target proposed by BCB) only after the target itself had been raised. It may, thus, be concluded that inflation targeting in Brazil was not completely successful over the first eight years of its implementation. It should also be noted that its average rate is relatively high at 6.6% per year on average since the introduction of the inflation targeting strategy.
- Despite the fact that the ratio of the primary fiscal surplus over GDP has increased since 1999, in 2006, due to the presidential election, the primary fiscal surplus/GDP probably might be reduced to 4.25%, the net public debt over GDP, after a reduction in 2004, has been more or less stable and over 50%. As a result, primary fiscal surplus is not enough to reduce the ratio of net public debt over GDP, which has been one of the main constraints for the management of economic policies in Brazil. There is, thus, some evidence of excluding fiscal policy from the panoply of stabilisation instruments, under a regime of macroeconomic policies in which exchange rate and interest rate movements are prominent as the main tools of stabilisation policy. There is also some concern about the quality of the fiscal adjustment due to the income distributive effects of interest payments to *rentiers*, the very high level of the tax burden and the fact that reduction in the public expenditures has been done at the expense of mainly investment expenditures.
- Due to the good performance of the trade position and also to the reduction of the external debt (both public and private) and the increase in the amount of foreign reserves, external vulnerability indicators in general improved over the period 2003-2005. The ratio of net external debt over exports (external solvency indicator) declined

sharply since 2002, although the broader indicator, the ratio of foreign liability over exports, has not improved so well, due to the increase in FDI and portfolio investment over the period (Figure 4). However, there is a great deal of concern about the future of the trade balance performance. This is due essentially to two reasons: (i) continuous real exchange rate appreciation has reduced the growth rate of exports in 2006, and (ii) the possible reduction in the volume of the international trade, mainly commodities, if a decline in the economic growth of USA and China were to materialise. Brazilian exports are still very much concentrated in agricultural and industrial commodities, natural resources, and technological low-intensive industrial products, while there is an important presence in its import contents of products that rely extensively on technology.³¹

Figure 4
Brazil: indicators of external solvency



Note: External liabilities include foreign debt, FDI stock and portfolio investments stock.

Source: Prates (2006, p. 149).

³¹ An interesting recent study by Ferreira (2007) on Brazil, Argentina and Mexico deals with the trade and financial liberalizations carried out in the 1980 and 1990s in these countries to conclude that these type of policies never helped income growth.

7. Possible alternative economic policies

We attempt to put forward in this section a set of policies, which do not sit comfortably with the policies implemented in Brazil by the two last governments. Many critics of the neoliberal recipe implemented in Brazil have advanced proposals to change the course of economic policies. Many of these proposals are designed to reach results that may be more or less radically different from those achieved so far. A sample of these proposals may be succinctly summarised. Most of the debate around Lula's economic policies has taken place, understandably, in the newspapers. Among the still few debates already published as books, one could mention, Sicsú, Oreiro and Paula (2003) and Sicsú, Michel and Paula (2005). Oreiro and Paula (2007) present a Keynesian strategy of economic policy that aims to achieve higher, stable and sustained economic growth in Brazil. The basic features of this strategy are: (i) adoption of a *crawling-peg exchange rate regime* in which devaluation rate of domestic currency would be set by the BCB at a rate equal to the difference between a *target inflation rate* and *average inflation rate* of Brazil's most important trade partners; (ii) adoption of *market-based capital controls* in order to increase the autonomy of the BCB to set nominal interest rates according to domestic objectives (mainly to promote a robust growth); (iii) reduction of nominal interest rate to a level compatible with a real interest rate of 6.0% per year; and (iv) reduction of primary surplus from current 4.5% of GDP to 3.0% of GDP. According to the authors' calculations these elements are fundamental for the required increase in the investment rate from the current 20% of GDP to the 27% of GDP, a rate that is needed for a sustained growth of 5% per year.

It is clear from this short summary that most frequently, it is monetary policy that is singled out. In general the basic idea is that monetary policy is too rigid and insensitive to the need to grow, and that some flexibility could be introduced in the inflation-targeting regime (such as the use of a core inflation index instead of the headline consumer index). In this context, many economists argue that interest rates could be reduced more extensively in the short term with virtuous impacts on the economy. They also argue for (i) reduction of public debt and consequent decline of interest payments with beneficial effects on the fiscal balance, (ii) increase in the supply of credit, and (iii) mechanisms to stimulate productive investment decisions with beneficial effects on economic growth.

A second line of criticism, even if agreeing with the argument stressed above about the need to reduce interest rates more boldly, insists that this may not be enough. Some economists defend the view that capital controls should also be adopted to protect the Brazilian economy against external shocks, to increase the degrees of freedom in the conduct of

monetary policy and also to avoid excessive exchange rate appreciation due to movements of capital flows. Moreover, they favour implementing a sort of 'managing floating exchange regime', which would aim at the same time to preserve some flexibility in the short-term nominal exchange rate (although avoiding high volatility in the exchange rate), in order to discourage short-term speculative capital flows. It would also aim to reach a stable and competitive real exchange rate (RER) in order to stimulate the expansion of tradable sectors. The strategic need for a strong growth of exports, preserving at the same time the feasibility of implementing active development policies, means that trade negotiations (e.g. via the Free Trade Area of the Americas and the World Trade Organization) are of paramount importance to Brazil.³²

We actually share the views summarised above in this section. A minimal programme would be the one that focuses on the attainment of full employment and the creation of conditions for a recovery of private and public investment. In fact, the conditions favourable to the promotion of full employment and the recovery of investment largely overlap. On the macroeconomic side, it is necessary to wake up and stimulate the *animal spirits* of entrepreneurs by signalling support for policies generating aggregate demand. Not only does this mean that monetary policies should explicitly consider the goal of maintaining employment stability along with price stability, but also that fiscal policy should be reoriented to enable expansion in public investment, rather than debt service or even current expenditure. Monetary policies should be refocused and the BCB should be assigned employment *and* inflation targets. In other words, the BCB should be given a broader mandate than the current monolithic concentration on price stability. There is nothing particularly revolutionary about this suggestion. It is in fact very closely to the policy framework of the US Federal Reserve in the United States, which arguably has been practised with considerable success for a number of years now. It is not without its problems. But it avoids an exclusive preoccupation with price stability, which does not appear to have been applied in the history of mankind with any particular success. Fiscal policy, on the other hand, should not sacrifice all other objectives simply to guarantee the service of public debt at any price. Some reduction in the primary fiscal surplus and some control over current expenditure in the long run should be necessary in order to increase public investment in economic and social infrastructure in Brazil. We propose that the entire reduction in primary surplus is used to increase public investment. Note that the reduction of the ratio of public debt over GDP could be obtained, even with some reduction in the primary fiscal surplus

³² The suggestions discussed in the text have been proposed by a number of contributors, and a good example is Frenkel (2004). Note that the operation of this sort of exchange rate regime would require both a comfortable level of foreign reserves and some restrictions on capital flows in order to increase central bank's ability to intervene in the exchange markets.

if combined with a reduction in the real interest rate and an increase in the GDP growth.³³

Reduction of the ratio of public debt to GDP could contribute to reaching the long-run objective of fiscal balance, so that fiscal policies could operate again as an important counter-cyclical tool.³⁴

Monetary policy has to be formulated jointly with other macroeconomic policies and their implementation often coordinated. Since in developing countries like Brazil, exchange rate is the main transmission mechanism that affects inflation, a more stable exchange rate can contribute to avoid inflation acceleration. The new mix of fiscal, monetary and exchange rate policies should strengthen *animal spirits* through influencing expectations that earned profits would further encourage increases in aggregate demand. Macroeconomic policies are closely interconnected and should be coherently designed and implemented. The new mix of policies, however, would not stand a chance if the current degree of capital account liberalization was maintained, thereby allowing residents to promote capital flight as easily as is now the case. For this reason, regulation of capital flows through the adoption of market-based capital controls that could create market incentives for the reduction of short-term capital flows would be necessary in order to preserve some autonomy of domestic economic policies.³⁵

Under the scenario discussed, reaching full employment can go hand-in-hand with stimulating growth and investment in order to provide the capital equipment upon which the workers can be employed. But to achieve this objective, interventionist policies are vitally necessary. Not merely to expand economic activity but also to produce significant distribution-type effects, so desperately needed in Brazil to alleviate if not fight poverty entirely. Active economic policies are clearly necessary. In addition healthy industrial policies would also be necessary to coordinate private and public efforts at accumulating capital at the necessary rate. This is a neglected area in economic policy, but one that recently has received a great deal of

³³ The required level of primary surplus is determined by government inter-temporal solvency condition, as follows:

$$s = \left[\frac{r - g}{1 + g} \right] b$$

where s is the primary surplus as a ratio to GDP, r is the level of real interest rate, g is the growth rate of real GDP, and b is the ratio of public debt to GDP.

³⁴ On this particular matter, and following Keynesian lines, Kregel (1994-1995) suggests that a budgetary policy that aims at reaching a full employment growth should include: (i) the government budget should be divided into a current and a capital account; (ii) the current account should be in balance or run a surplus that is transferred to the capital budget, which serves to offset exogenous cyclical changes in investment spending; (iii) although the capital budget may be in deficit, it should be balanced over the long run; (iv) investment spending financed by the capital budget should be countercyclical relative to private spending on plant and equipment; (v) the capital and current account budgets should balance at a long-run target rate of unemployment between 3 percent and 5 percent.

³⁵ This could include Chilean-style of capital controls (reserve requirements on capital inflows), in order to avoid short-term capital inflows, and also some restrictions on capital outflows, that have been the main culprit during periods of speculation against Brazilian domestic currency (*real*).

attention in the case of the EU countries. This work shows that unless capital stock is increased it may be difficult to fight unemployment successfully (see, for example, Arestis and Biefang-Frisancho Mariscal, 2000). This is an important issue, we suggest, in the case of other countries also, including Brazil. This may be a pertinent issue mainly in the more dynamic manufacturing sectors that could contribute towards stimulating exports in goods with greater income elasticity.³⁶ It would certainly be more plausible to assume that growth policies would have a higher probability of success in situations where aggregate demand was not maintained at low levels by macroeconomic policies, as it is the current practice in Brazil. In such a case, maintaining and expanding trade surplus is a strategic element for economic growth. On the one hand, the implementation of a 'managing floating exchange regime', as discussed above, to promote the profitability of tradable activities and to provide incentives to firms to invest and expand production and employment through a stable and competitive real exchange rate should be desirable.³⁷ On the other hand, resisting the demands of industrial countries to liberalize non-traditional sectors, such as government procurement, is essential to making any efficient industrial policy feasible. We recognize that the work of the Ministry of Foreign Affairs would be advanced by giving priority to trade and financial partnerships with Mercosur bloc countries and other emerging countries. This is important in the attempt to increase the bargaining power of Brazil and other block countries in trade talks, such as the FTAA.

To sum up, to address the objective of expanding effective demand and stabilizing the inflation process, the Government should (i) operate fiscal policy to implement social programmes and to promote investments, in particular to rebuild public utilities in energy production and road construction, among others; (ii) ensure that monetary policy has a positive impact on the level of economic activity; this, however, can only be done by very low interest rates; (iii) implement a 'managing floating exchange regime' that aims at maintaining a stable and competitive real exchange rate. To be sure, this is only a short-term measure for 'market

³⁶ Developing countries, particularly, can face a structural problem in their balance of payments, due to the effect known as the Thirwall's law (Thirwall, 2002). This law states a link between the rate of economic growth and the income-elasticity of imports and exports of an economy. According to this law, in the long run, demand-side variables play a key role in economic growth through the 'balance of trade constraint'; a country cannot grow at a rate higher than what is consistent with its balance of trade equilibrium. The low income-elasticity of products of smaller aggregate value exported by developing countries *vis-à-vis* the greater income-elasticity of products imported from developed countries can generate structural deficits in the balance of payments of the former countries. These increasing deficits can result in a significant constraint for economic growth in developing countries, as the maintenance of a non-exploding deficit requires that the domestic growth rate is maintained below the world growth rate so that imports and exports grow in line with one another. Holland and Canuto (2001) estimated in the case of the ten most important Latin American economies (including of course Brazil), for the period 1950-2000, that for each 1 percent of GDP growth, total imports increased between 2% to 4.5%. This means that there is some evidence of balance of payments constraint to economic growth in these economies.

³⁷ Hausmann, Pritchett and Rodrik (2004) analyzing experiences of growth accelerations (economic growth that is sustained for at least eight years) found that growth accelerations tend to be correlated with increases in investment and trade, *and with real exchange rate depreciations*.

making' purposes, but certainly not as a policy that accumulates foreign exchange. All that the latter achieves is either to export real savings or reduce and/or defer domestic standards of living with a very high risk of never getting real compensation; (iv) operate an industrial policy that should aim at integrating the Brazilian economy in the international scene. This would create the context in which Brazil can incorporate the technological innovations occurring in the world in her relevant sectors, and enable her to attract FDI that would add aggregate value to exports. In other words, industrial policy should be used both to increase and change the composition of Brazil's exports, in order to incorporate other products with high levels of aggregate value. Alternatively, and perhaps more promisingly, exporters could be organized to maximize profits nationally and utilize any international market power that could be gained by organizing export strategies. Domestic industries need not be forced to compete individually in world markets if they can collude for export purposes in the national interest; at the end of the day it is true that it is full domestic employment policy that attracts FDI – a good example here is the US that gets so much inflow of FDI in healthy economic circumstances; vi) implement trade and financial agreements with other developing countries, such as Mercosur countries, Latin America countries and emerging countries in Asia (dropping all import restrictions unilaterally may not be a bad idea either and could help greatly in this respect); (vii) create efficient anti-speculation mechanisms to regulate movements of capital in order to prevent exchange rate crises and augment the autonomy of domestic economic policies; this may become unnecessary if banks were to be well regulated; (viii) adopt incomes policies to regulate wages and prices in which case the private sector would necessarily follow and not lead; and (ix) introduce fiscal initiatives, such as truly progressive income tax schedules and capital levies, guaranteed minimum income and social expenditure, with the objective to improve the standard of living of poor people. Such policies are paramount and urgently required to promote personal income redistribution. We might add at this point that transactions taxes are necessarily counterproductive and that other progressive taxation would accomplish the same ends more efficiently. In terms of guaranteeing minimum income and social expenditure, offering a job with benefits to anyone willing and able to work automatically can do the job very well (Mosler, 1997).

Full employment policy is so important that the last observation becomes paramount. The policy description under what has come to be known as 'employer of last resort' (ELR) is a significant contribution in this regard.³⁸ This can be done, as Mosler (*op. cit.*) argues, by the

³⁸ This policy could sit very comfortably with additional programmes that aim at redistributing income and wealth more fairly in Brazil.

government proceeding “directly to zero unemployment by offering a public service job to anyone who wants one as a supplement to the current budget. Furthermore, by fixing the wage paid under this ELR programme at a level that does not disrupt existing labour markets, i.e. a wage level close to the existing minimum wage, substantive price stability can be expected” (p. 2). Indeed, “Lower real interest rates will tend to keep more individuals in need of employment. Combined with a well-run ELR policy, low rates should increase output dramatically with much of the increased output being investment. It may be possible, for example, to repair, rebuild, enhance and maintain the public infrastructure without a decrease in private consumption from current levels” (p. 26). The counter argument to this proposal is that it may require substantial government deficits to implement it, in which case it becomes politically unacceptable. The response to this is that the growth in the economy that would emanate from the policy could very well produce the necessary receipts to the Brazilian treasury so that the deficit does not become excessive, if any at all. It could also be the case that such policies are implemented when deficits do not threaten to become a burden to the economy.

8. Summary and conclusions

We have attempted in this paper to examine the economic policies of president Lula. We have demonstrated the theoretical premise of the president’s economic policies, and have discussed their performance over the life of president Lula’s first term in office. In conclusion we may ask the legitimate question of what macroeconomic stability is in the context of these policies. The monetary authorities appointed by president Lula, just as those appointed by former president Cardoso, seem to believe inflation stabilization is the only goal of macroeconomic policy. From the fiscal side, all that matters is building credibility with financial agents. As John Maynard Keynes once suggested, macroeconomic stability should mean a combination of full employment and stable prices. For developing countries, we should add, macroeconomic stability also means long-term economic growth and social development. In this context, economic stabilization cannot neglect fiscal, monetary, exchange rate, trade and income policies as instruments for stabilizing prices and expanding effective demand.

It is very unfortunate that Lula has not advanced a more progressive vision and project for Brazil. His electoral slogan, ‘hope has defeated fear’, has been so deflated that not even the president himself mentions it anymore in his speeches. There is very little to show for hope, but a lot for fear. Unemployment is still high and rising, GDP performance is below par and it is led almost entirely by the export sector which is being helped along only by the healthy international economic conditions. No long-term vision of Brazil’s future has been offered. Inflation targeting

was implemented in 1999, when the balance of payments crisis led to the change in the exchange regime as a new nominal anchor for price stabilisation purposes. Eight years later, the regime has become a straightjacket holding back real activity. Instead of an inflation-targeting regime, what Brazil really needs is an *economic growth regime*. Lula was elected on the promise that he would move the country away from the many years of stagnation promoted by president Cardoso. Regrettably, the opposite is true. In other words, it seems that the fear has defeated hope!

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Table 1
Public Sector Accounts: 1998-2005 (percentage of GDP)

Year	Primary fiscal surplus	Interest rate expenditures (nominal)	Nominal public deficit	Tax burden
1998	0.02	7.49	7.47	29,6
1999	3.23	9.05	5.82	31.7
2000	3.46	7.08	3.61	33.4
2001	3.64	7.20	3.57	35.1
2002	3.89	8.47	4.58	36.6
2003	4.25	9.33	5.08	35.9
2004	4.59	7.26	2.67	37.0
2005	4.83	8.13	3.29	38.9

Source: BCB and also Afonso and Meirelles (2006) for the tax burden data.

Table 2
Some Macroeconomic Indicators of Brazilian Economy

Notes: (1) Unemployment rate according to the IBGE methodology. (2) BCB expectations based on weekly report of August 21, 2006. (3) Average unemployment rate from January to July.

Source: IBGE, IPEADATA and BCB.

Macroeconomic Indicators/Year	1999	2000	2001	2002	2003	2004	2005	2006 ²
IPCA (%)	8.94	5.97	7.67	12.53	9.30	7.6	5.69	3.8
GDP growth (%)	0.8	4.4	1.3	1.9	0.5	4.9	2.3	3.5
Unemployment rate (%) ¹	8.3	7.9	6.8	7.9	12.3	11.5	9.8	10.2 ³
Interest rate (Selic), average (%)	25.5	17.4	17.3	19.2	23.0	16.4	19.2	15.3
Exchange rate, average R\$/US\$)	1.815	1.829	2.350	2.926	3.077	2.922	2.43	2.19
Exports (US\$ billion)	48	55.1	58.2	60.4	73.1	96.5	118.3	n.a.
Imports (US\$ billion)	49.2	55.8	55.6	47.2	48.3	63.0	73.5	n.a.
Trade balance (US\$ billion)	-1.2	-0.7	2.6	13.1	24.8	33.5	44.8	41.2
Current account (US\$ billion)	-25.3	-24.2	-23.2	-7.6	4	11.6	14.2	9.0
Foreign debt (US\$ billion)	241.5	236.2	209.9	210.7	214.9	201.4	168.8	n.a.
Foreign reserves (US\$ billion)	36.3	33.0	35.9	37.8	49.3	52.9	53.8	n.a.
Country risk/EMBI, average	1,030	730	890	1,380	830	542	313.8	n.a.
Fiscal surplus/GDP (%)	3.2	3.5	3.6	3.9	4.3	4.6	4.8	4.25
Net Public debt/GDP (%)	46.9	49.9	53.3	56.5	58.7	51.8	51.0	50.5
Investment rate (% of GDP, 1980 prices)	14.8	14.8	14.8	13.9	13.1	13.8	13.8	n.a.

Notes: (1) Unemployment rate according to the IBGE methodology. (2) BCB expectations based on weekly report of August 21, 2006. (3) Average unemployment rate from January to July.

Source: IBGE, IPEADATA and BCB.

Table 3
Brazil - inflation targets and headline consumer price index (IPCA)

Year	Inflation target	Tolerance intervals +/-	IPCA
1999	8.0%	2.0%	8.94%
2000	6.0%	2.0%	5.97%
2001	4.0%	2.0%	7.67%
2002	3.5%	2.0%	12.53%
2003	4.0%*	2.5%	9.30%
2004	5.5%*	2.5%	7.60%
2005	5.1%	2.5%	5.69%
2006	4.5%	2.0%	3.8%**

Source:BCB (data obtained in August 2006)

(*)The original inflation target was 3.25% (tolerance interval of 2.0%) in 2003 and 3.75% (tolerance interval of 2.5%) in 2004. Later BCB decided to change again to inflation target in 2003 to the maximum limit of 8.5%, that was known as 'adjusted target'.

(**) As expected by the BCB based on the weekly report of August 21, 2006.