

# ISSUE BRIEF **03.30.15**

## After Tight Elections, Brazil Faces Hard Choices

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Brazilian President Dilma Rousseff is starting her second term in office facing economic and political problems that feed into each other. These problems can be attributed to a large extent to mistakes her administration made during her first term. Rousseff's macroeconomic policy proved to be inconsistent, and the choices she made in some key economic sectors, especially energy, were demonstrably disastrous. She inherited from her predecessor and political mentor, Luiz Ignacio Lula da Silva, a consumption-led economic model boosted by eight consecutive years of extremely favorable terms of trade for commodities-producing countries like Brazil.

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### **LULA'S EIGHT YEARS IN OFFICE: BLESSED OR CURSED LEGACY?**

By keeping in place the fiscal and monetary institutions laid down during Fernando Henrique Cardoso's two terms in office from 1995–2002, Lula managed to take full advantage of an extraordinarily positive external environment (high commodity prices plus abundant international liquidity for emerging markets) to ignite Brazil's huge domestic market. Thanks to the existence of better fiscal and monetary institutions and to unprecedented international conditions, a consumption-led acceleration of growth did not end up in a balance of payments crisis or an inflationary surge as had been the case throughout the second half of the 20th century.

Given social programs implemented in accordance to provisions of the constitution of 1988—especially after the Real Plan brought two decades of high, chronic, and growing inflation to an end in 1994—economic growth in the first decade of this century had a positive distributive impact. Lula's policy choices—such as consecutive above-inflation increases of the statutory minimum wage and unification and enlargement of preexistent conditional cash-transfer programs—were also instrumental in reducing poverty and even narrowing inequality gaps in income distribution among wage earners. The emergence of a new middle class made up of an estimated 40 million people, in a country with 200 million inhabitants, epitomized Brazil's political and economic success under Lula, although whether the new middle class will retain its economic gains is far from clear.

Notwithstanding its positive results, the economic mode supposedly put in place by Lula was already showing signs of a relative exhaustion when his second term in office came to a close at the end of 2010. On the demand side, there was little room left to further expand credit (after it leapfrogged from slightly above 20 percent to more than 50 percent of GDP) and boost wage increases through market forces (labor costs were already damaging industrial competitiveness) or by means of government decisions (due to fiscal restraints). On the supply side, a series of problems accumulated. Investment rates increased during Lula's eight years in office but never crossed the 20 percent of



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GDP threshold (the lowest among “emerging countries”). In particular, investment in infrastructure was clearly lagging behind what was needed to meet growing demand in all sectors, especially transportation. Not least, relative scarcity in the supply of high-skilled labor was proving to be a drag on growth prospects; most of the jobs generated from 2003 to 2010 were low-skilled and low-paid positions in the service sector.

From a political perspective, problems were becoming visible despite record highs in Lula’s popularity ratings near the end of his second term. After overcoming the risk of being impeached in the wake of a corruption scandal that erupted two years into his first term, Lula built a larger coalition to assure support in Congress in his second term. The scandal was nicknamed “mensalão”—a reference to the alleged fact that stipends were paid to congressional members on a monthly basis. It led to the indictment of 39 people, including politicians and business executives. Twenty-five were convicted and given prison sentences, including top figures in Lula’s political party—Partido dos Trabalhadores (PT)—and ministerial team.

With the collapse of the “mensalão” scheme, Lula decided to play the more conventional game of coalition-building in his second term in office. Large coalitions are an intrinsic component of Brazil’s presidential system, characterized by the coexistence of an institutionally strong president (after the constitution of 1988) with a multiparty system that is increasingly fragmented. Presidents use their power to choose political appointees in order to build a majority coalition in Congress. Academic studies show that executive-legislative relations tend to work better when the president fills key positions in his or her administration in accordance to the number of seats parties have in Congress.<sup>1</sup>

In his second term in office, Lula became “more Catholic than the Pope,” so to speak, when it came to coalition-building. He struck an agreement with the Partido do Movimento Democrático Brasileiro (PMDB) and built, around the PT-PMDB axis, a coalition of 10 parties, the largest (and most politically heterogeneous) coalition

ever formed until then in Brazil. Under the surface, this new political arrangement strengthened a system already in the making from 2003 to 2006: a Brazilian version of crony capitalism where the new elite (the PT and trade unions gravitating around the party) were at the commanding heights of state power.

To weld together the emerging power system, the new elite intensified its use of all the tools available in the Brazilian state. Infiltration of party politics in the state apparatus, including regulatory agencies set up as independent bodies under the Cardoso administration, progressed in tandem with the expansion of direct and indirect state participation and intervention in the economy.

In the period from 2006 to 2011, without abandoning fiscal and monetary orthodoxy in the macroeconomic policy area, Lula pushed forward a “developmentalist” industrial policy in which leading roles were assigned to state-owned companies, banks, and pension funds, in close partnership with big Brazilian business groups. This combination of widespread political infiltration in the state apparatus and a developmentalist industrial policy led by a handful of state-owned and private actors would prove to be economically and politically fateful, as the recent scandal involving Brazil’s oil giant, Petrobras, clearly shows.

The “new development model” converged with the South-South foreign policy introduced at the very beginning of Lula’s first term. Previously, from 2003 to 2006, economic policy and foreign policy sounded like they were playing a different tune, since the former was in keeping with Cardoso’s orthodox legacy, whereas the latter was hailed as the hallmark of a “new Brazil.” To emphasize the contrast, Cardoso’s foreign policy was depicted as passive and subservient to the Developed North, whereas Lula’s was portrayed as “proactive and independent.” From 2007 to 2011, economic and foreign policy sang the same grandiloquent melody, as the new development model was implemented domestically and the South-South foreign policy was carried on abroad. In no other

region was the convergence between the two models clearer than in South America. Instead of throwing its weight in favor of a rule-based integration, Brazil adopted an ad hoc foreign policy reliant on political affinities with incumbent governments and personal relationships between Lula and his counterparts, especially in the so-called Bolivarian axis and Argentina. At the same time, Brazil financially and diplomatically backed the expansion of Brazilian state-owned and private companies throughout the region (the same companies that were at the center of the “new industrial policy”).

The international financial crisis that originated in 2007/2008 at the heart of the US financial system was instrumental in boosting, both in symbolic and material terms, the new development model as well as the South-South foreign policy. Lula’s administration took full advantage of the “debacle of neoliberalism” to praise the virtues of its developmentalist agenda. The international financial crisis was also interpreted as signaling that the reshaping of the international order was accelerating. In this context, emerging countries of the South would play a much greater role in global affairs if they only dared to do so. From this perspective, Brazil was not only responding well to the biggest financial crisis since 1929 but also, and more importantly, charting a new course of development.

Domestically, this “transformational moment” was epitomized by the introduction in 2010 of a new regulatory framework for the oil and gas sector, specially designed for the exploration of the then-recently discovered pre-salt area. With Petrobras as the sole operator and responsible for no less than 30 percent of all investment projects in the pre-salt area, the new regulatory framework reflected deep-seated nationalistic beliefs after the short marriage of convenience with the so-called “neoliberal” legacy from the Cardoso administration.

It is difficult to exaggerate the political importance attributed to the discovery of the pre-salt area and the state-centered new regulatory framework. It is enough to recall the pictures of Lula and Rousseff

dressed like Petrobras workers and showing the palms of their hands covered with oil, which were extensively deployed as political ads during the campaign that led Rousseff, in October 2010, to become the first woman ever to be elected president of Brazil.

### ROUSSEFF’S FIRST TERM IN OFFICE: A CURSED LEGACY

Heir to the good and the bad in Lula’s legacy, Rousseff was not gifted with the political talent and communication skills of her predecessor and mentor. Whereas Lula is a politically adaptive animal, a pragmatist par excellence, Rousseff is an economist by training and strongly influenced by the ideas associated with the experience of import-substitution industrialization that mark Brazil’s history from the 1950s to the 1980s. Whereas Lula favored a mix of orthodox and heterodox economic measures and programs, adjusted to the circumstances, Rousseff is a strong believer in state intervention.

Rousseff was true to her beliefs in her first term in office. After a brief and slight adjustment of the fiscal and monetary policies in 2011 to cool off an overheated economy (GDP grew 7 percent in 2010 and put pressure on inflation), Rousseff’s team, under her strict instructions, adopted a series of ad hoc measures to reignite the economy. By doing so, Rousseff was not only being true to her beliefs but also responding to a challenge: earning her own political capital. To that end, resuming the growth trend observed under Lula was seen as critical. Under a less favorable international economic environment and with a more restricted fiscal space to boost demand, this would be a tall order.

From the very beginning, Rousseff decided to extend tax breaks on consumer goods introduced in 2009–2010, but she went much further than the previous government in its “developmentalist experiment.” From mid-2011 to the end of 2012, the Central Bank’s benchmark interest rate was cut by 5.25 percent, tax breaks were granted to numerous economic sectors, and public expenditures increased. Two state-

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owned banks, Banco do Brasil and Caixa Econômica Federal, respectively number one and two in rank by value of assets, took the lead in forcing market interest rates down. Banco Nacional de Desenvolvimento Econômico e Social (BNDES), Brazil's development bank, which lends more money annually than the World Bank, expanded its loans portfolio. To fund this expansion, the Treasury issued more than R\$400 billion in public debt and transferred the money to BNDES, which then lent it at subsidized rates to the private sector.

Concerned with the diminishing competitiveness of the industrial sector, in 2013 Rousseff took another ad hoc measure. She issued an executive order that made the renewal of concessions due to expire in 2014 dependent on electric power companies' agreement to reduce energy prices to consumers. The measure proved disastrous to the balance sheet of these companies and sent the wrong price signal to consumers (families included), stimulating consumption when the level of water reservoirs was clearly on a dangerous downward trend.

Following the footsteps of the local-content promotion policy in the oil and gas sector, a similar program was adopted for the automobile industry (in response, the European Union requested a panel investigation at the WTO).

The results of this developmentalist experiment were rather disappointing: growth went down from an average of 4 percent in the two prior presidential mandates to 1 percent in Rousseff's first term in office and investment dropped from 20 percent in 2010 to 17 percent of GDP in 2014, reducing growth potential. Furthermore, inflation went up from close to 5 percent to 6.4 percent, calling into question the credibility of the inflation-targeting regime itself (it would have risen even further if it were not for the decision to manage administrative prices, such as those of gasoline, on a discretionary basis); the fiscal primary surplus shrank from 3 percent of GDP in 2011 to a deficit of 0.6 percent in 2014, with the gross public debt to GDP ratio climbing from 53.4 percent in December 2013 to 63 percent of GDP in November 2014; and

the deficit in the current account jumped from 2.2 percent to 4.6 percent of GDP in the same period. During this time frame, Brazil featured one of the worst economic trajectories among emerging countries.

While the economic results of the "developmentalist experiment" were poor, worse still was the damage to the credibility of monetary and fiscal institutions created under Cardoso and kept in place under Lula. These included not only the inflation-targeting regime but also a rule-based fiscal regime epitomized by the Fiscal Responsibility Law approved by Congress in 2000. Rousseff's government did not terminate the law, but the economic team inflicted severe damage to its spirit, if not its letter. Creative accounting, for example, was heavily used to pretend the primary fiscal target was met in 2012 and 2013; in 2014 the shortfall was so big that no creative accounting would have made the trick work. Debt-credit operations between state entities and off-budget subsidized loans to the private sector compromised public accounts transparency.

To make things worse, in spite of the developmentalist rhetoric and ambitions, the experiment led to a disaster in the energy sector and witnessed the industrial sector declining to its lowest share in the Brazilian economy since the mid-20th century. The regulatory framework designed to promote the exploration of the pre-salt area inhibited foreign investment and placed too heavy a burden on the shoulders of Petrobras. In consequence, Petrobras' total debt tripled from 2010 to 2014 and its market value plummeted (the company lost more than half of its market capitalization in this period).<sup>2</sup> At the same time, with gasoline prices being held by the government, the ethanol industry was dragged into a full-blown crisis. The hydropower energy sector, which accounts for 70 percent of the Brazilian energy matrix, was another victim of clumsy government interventions, compounded by an extremely adverse hydrological situation in 2014.

In the political arena, Rousseff's first term in office was characterized by increasing tensions between the president

and the majority coalition in Congress, including her own party. Faced with a series of scandals involving high-ranking officials of her administration, Rousseff reacted strongly. No less than four ministers were fired under accusations of corruption in her first year in office. However, she finally had to end her so-called “cleaning operation” as dissatisfaction among coalition parties mounted and economic problems accumulated in the second half of her first term in office.

Notwithstanding accumulating mistakes in the management of the economy, Rousseff was reelected. The explanation of this apparent paradox can be found in a combination of factors. First and foremost, even as GDP growth decelerated, job creation remained in positive territory from 2011 to 2014, with the exception of the industrial sector and, more recently, of civil construction, leading the country to a virtual state of full employment. With demand for labor still high, especially with regards to low-skilled and low-paid jobs in the service sector, the aggregated labor income of salaried workers still grew in real terms, in spite of rising inflation and diminishing salary increases. The income of poor families also benefited from larger government transfers through a variety of federal programs. Well-structured and richly funded, Rousseff’s electoral campaign made the most out of the “incumbent advantage.”

As the race tightened, the official campaign tuned up to levels of aggressiveness rarely seen before, using a deluge of negative ads to destroy the reputation and political credentials of Marina Silva and Aécio Neves, Rousseff’s opponents in the election. In both cases, the accusation was that the opposition was secretly planning to introduce “unpopular measures” that would sacrifice social gains on the altar of unnecessary, if not counterproductive, fiscal adjustment. Nonetheless, Rousseff came close to defeat, winning the election in a runoff with the Partido da Social Democracia Brasileira’s Neves by the narrowest majority ever seen in a presidential election in Brazil: Rousseff received 51.4 percent of the valid votes, while Neves received 48.6 percent.

#### FOUR MORE YEARS: WHAT CAN BE EXPECTED?

Reelected on October 26, 2014, Rousseff made a surprising decision one month later, after much speculation on whether she would double down on her developmentalist experiment or defer to the argument that the experiment was unsustainable and counterproductive. Arousing anger among her party’s political base, she appointed Joaquim Levy, an economist with impeccable orthodox credentials, as finance minister.<sup>3</sup> The appointment of a more heterodox economist to the Ministry of Planning—Nelson Barbosa, who is considered a developmentalist—was not sufficient to appease Rousseff’s political base, especially because both ministers agreed on taking the necessary measures to stabilize the public debt to GDP ratio and then set it again on a downward path. In a joint announcement, Levy and Barbosa said fiscal policy will target a primary fiscal surplus of 1.2 percent in 2015 and at least 2 percent of GDP from then on, a considerable task given the fact that it will start virtually from zero.

From the perspective of the PT political base, the Central Bank—with Alexandre Tombini reconfirmed as chairman—added insult to injury by increasing the reference interest rate four times after the elections (as of March 2015 the benchmark annual interest rate reached 12.75 percent, five percentage points above where it was in 2012–2013).

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Fiscal adjustment will inevitably cut expenditures on social programs and produce a downward effect, at least in the short run, on an already weak economy. Sacrifices would be more easily absorbed by society and the political system if they were seen as temporary and instrumental to accelerate growth (from something close to 0 percent in 2014 to 3–4 percent in the coming years). But it will be harder

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to kick-start and sustain growth this time than it was in 2003 and 2004 when Lula's first administration introduced a severe fiscal adjustment in order to gain the private sector's trust. This time fiscal adjustment will start from a lower point (the primary surplus was 3 percent of GDP in 2002) and with a weaker economy (the economy grew by more than 2 percent in 2002). Moreover, fiscal adjustment will not be helped by the external sector to counterbalance the contractionary effects of tighter fiscal policy (2003/2004 marked the beginning of the long cycle of high commodities prices).

With private and public consumption limited, economic growth will have to come chiefly from a robust and sustained increase in aggregate investment, which is now at its lowest point in years. Given that public sector investment will by definition be constrained by fiscal adjustment, economic growth will fundamentally depend on private sector investment. To boost this investment, the new economic team will need to dissipate the defensive mood prevalent among firms, workers, and consumers. To that end, the team will need to deliver results not only on the fiscal front, but also introduce microeconomic measures conducive to private investment.

The situation is compounded by the scandal involving Petrobras. An investigation carried out by federal prosecutors and agents of the Federal Police from March 2014 to March 2015 revealed the biggest corruption scheme ever attempted in Brazil. The scheme involved approximately 20 big companies and high-ranking Petrobras executives (three of whom were politically appointed directors of the company), with the ultimate purpose of sustaining slush funds to finance electoral campaigns through a vast network of money laundering with ramifications abroad. Estimates are that approximately US\$5 billion was diverted from Petrobras to parties and politicians allied with Lula's and Rousseff's administrations, as well as to key intermediaries in the corruption scheme.

Given that Petrobras alone accounts for no less than 10 percent of aggregate investment in Brazil and that some of the

companies under criminal investigation are key players in big infrastructure projects, it is hard to exaggerate the negative impact of the so-called "Petrolão" on growth prospects for the coming years. Moreover, the Petrobras scandal has strong political effects since it involves the core of Lula and Rousseff's political base. Damage to Rousseff's own image is hard to avoid, given that in addition to being the country's president, she was chairperson of Petrobras' Board of Directors during part of the period under investigation. The scandal feeds into the perception that corruption has assumed a systemic nature in the current political environment dominated by the PT.

To make matters worse, Rousseff's broad but heterogeneous political base in Congress has been increasingly unstable in the last two years. This may not preclude majority support for implementation of fiscal adjustment measures that depend on congressional approval, given the amount of "tradable goods" (especially the ability to fill government positions with political appointees) the executive branch holds in the Brazilian presidential system. But the instability of Rousseff's congressional base certainly increases the political costs of getting adjustment measures approved and virtually rules out the possibility of passing into law any bold reform that might fundamentally change the investment climate in Brazil. What can realistically be expected at best is that, along with progress in the fiscal adjustment effort, the new economic team will be able to eliminate the various distortions the developmentalist experiment added to the economy, especially in the price and tax systems. Rebuilding the financial and operational health of Petrobras is the single most crucial challenge. Significant adjustments in the regulatory framework set up for the pre-salt area are required.

Opting out of fiscal adjustment is not an alternative. The new administration is conscious of the risk of Brazil losing its investment grade, which it earned in 2008. However, two to three years of fiscal adjustment may prove to be, politically speaking, too long a period of

time if economic growth does not recover significantly. For growth to resume, fiscal adjustment is a necessary but not sufficient condition. It remains to be seen if Rousseff will be ready to recognize the utter economic failure of her first term in office and to lead the country onto a different path.

So far, signs of change are limited to the macroeconomic arena. In regard to foreign policy, it is telling that Rousseff chose Mauro Vieira as the new minister of External Relations. Vieira is a disciplined career-diplomat, who has been serving as Brazil's ambassador to Washington since 2010. No less telling was the cursory treatment she gave to foreign policy issues in her inaugural speech for her second term in office.

Big countries change slowly. History tells us that change in Brazil normally happens when prompted by an acute crisis and when proper political leadership is available. Both are absent at the present time (not only in the presidential palace but also in the political system as a whole). With large international reserves, an uncomfortable but not explosive debt/GDP trajectory, and still-functioning fiscal and monetary institutions and tools, Brazil is not on the edge of a cliff. In the next four years, we will probably see it muddling through. In 2018, Brazil will still be an important country to the international system and the global economy. But the postponement of strategic decisions—for lack of vision or political skill—may usher in an era of diminished possibilities for Brazil.

## ENDNOTES

1. Octavio Amorim Neto, "Presidential Cabinets, Electoral Cycles and Coalition Discipline," *Dados* 43, no. 3 (2000): 40.

2. See Aswath Damodaran's piece on Petrobras in <http://aswathdamodaran.blogspot.com.br/>.

3. Levy not only graduated from the University of Chicago with a degree in economics, but also held several positions at the IMF before joining President Cardoso's economic team in 2000. Under Lula, he was appointed secretary of the treasury by Finance Minister Antonio Pallocci and played a key role in the implementation of a severe fiscal adjust from 2003 to 2006. It is worth remembering that in 2006 when Pallocci proposed a structural program of fiscal consolidation based on a rule that would not allow government expenditures to increase above GDP growth, Dilma Rousseff, then President Lula's chief of staff, dismissed the proposal as inopportune.

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