

# THE BRAZILIAN ECONOMY: GENERAL OVERVIEW

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## **1. Introduction**

After more than a decade of modest growth, high inflation and a declining rate of investment, the Brazilian economy began a new cycle of growth, starting in 1993, that was associated with a gradual recovery in the rate of investment. This trend was reinforced from 1994 onwards by the success of the Real Plan in stabilizing inflation. Between 1993/97, GDP grew at an average annual rate of 4.2%, compared to 1.4% during the period 1981/92. The rate of investment (at constant 1980 prices) rose from 14.4% of GDP in 1993 to 16.1% of GDP between 1994 and 1996, and to 18% in 1997. Inflation also fell from a level above 40% a month in June 1994 to almost zero during the closing months of 1998.

Unfortunately, the international financial crises of 1997 and 1998 had the effect of interrupting, if only on a temporary basis, the trends in GDP growth, and the increase in investment. Economic growth was close to zero in 1998, and 1999 will be characterized by stagnation or even contraction in economic activity. In 1998, the rate of investment fell for the first time since 1993. It is also possible that the combination of a real devaluation of the exchange rate and stagnation (or even recession) will cause a further fall in investment in 1999.

On the other hand, the crisis was also accompanied by positive factors. Monetary policy did not accommodate the effects of the devaluation of the exchange rate in prices, and inflation remained low. Measures intended to establish equilibrium in the public-sector accounts were rapidly approved by Congress, and it is probable that significant primary surpluses will be registered over the next few years. In the external sector, the exchange rate devaluation will be followed by trade surpluses. Lower current account deficits will be largely funded by inflows of direct investment, while both the government and the private sector have already returned to the international financial markets as borrowers. Finally, the new exchange rate policy, together with progress in fiscal reform, will allow a substantial reduction in real interest rates. This reduction will have a positive impact on investment, economic growth, employment and public-sector finances, reinforcing a virtuous circle of price stability and sustained economic growth.

The objective of this paper is to present an overview of the current state of the Brazilian economy, concentrating on the prospects for the resumption of sustained economic growth after the recent changes in the exchange rate, monetary and fiscal regimes. Section 2 describes the period from 1981/92 that was characterized by macroeconomic instability and low growth. Section 3 emphasizes the search for macroeconomic stability. The Real Plan is presented as the most successful attempt so far to

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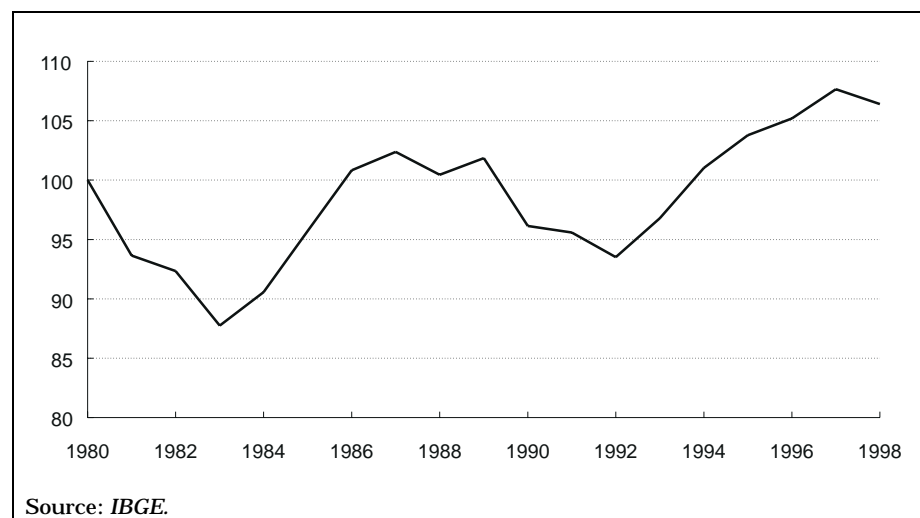
stabilize inflation and lay the foundations for the resumption of sustained growth in the Brazilian economy. The importance of the exchange rate “anchor” for ensuring price stability, and the impact of the Real Plan on economic growth and employment are discussed in this section. Section 4 is an attempt to present and discuss succinctly, from the standpoint of June 1999, the main preconditions for the resumption of sustained economic growth in Brazil. Section 5 brings together the main conclusions.

## **2. Macroeconomic Instability and Low Growth: The 1981/92 Period**

For several decades, Brazil ranked as one of the fastest growing economies on the planet. Between 1900/73, Brazilian per capita GDP grew at an average annual rate of 2.5%, a performance exceeded only by Japan and Finland. Between 1970/80, per capita incomes grew at an average rate of 6% per year. Between 1940/80, GDP in real terms was multiplied by a factor of 5, the result of economic growth that averaged 7% per year, while the population tripled over the same period. Growth fell below 4% per year in only 6 of these 40 years, and only 1942 registered a recession.<sup>1</sup>

By contrast, economic growth between 1981/92 was modest and erratic. Per capita incomes declined at an average rate of 0.5% per year, and real GDP increased by an average of only 1.4% per year over the same period (see Figure 1). Slower growth in

**Figure 1**  
**GDP Per Capita - 1980/98**  
**(1980 = 100)**



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<sup>1</sup> See ABREU, M. P., CARNEIRO, D. D., WERNECK, R. F. *Brazil: widening the scope for balanced growth*. Rio de Janeiro: PUC/Departamento de Economia, 1994 (Texto para Discussão, 332).

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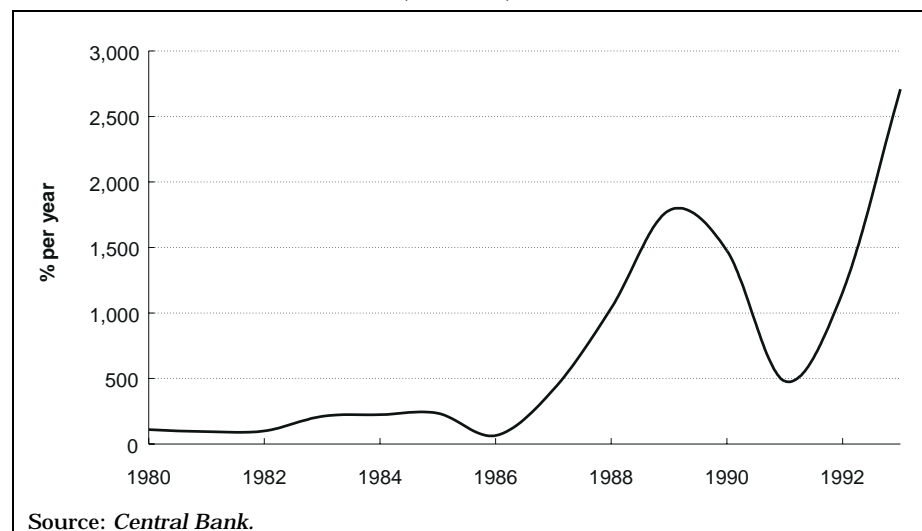
GDP was accompanied by a sharp contraction in the rate of investment, that fell from 23% of GDP in 1980 to 17% between 1981 and 1992, reaching a minimum level of 14% of GDP (at constant 1980 prices) in 1992. Which factors determined this dramatic reversal in macroeconomic performance? High inflation, a crisis in the public sector finances and restrictions on saving and funding are important factors in an explanation of this.

### **High Inflation**

During the 1970s and 1980s, the government used inflation as an instrument of monetary policy in various senses, both in order to absorb the effects of external shocks and to achieve objectives that conflicted with price stability, such as equilibrium in the balance of payments or the funding of budget deficits. In addition, the proliferation of informal and formal indexation mechanisms – of prices, salaries, interest rates and rents – allowed the population to live with high inflation for a long time, at the same time as its elimination using conventional tools of economic policy was inhibited. Figure 2 shows inflation in Brazil between 1980/93.

This response, in the form of accommodation of monetary policy to the effects of the second oil shock and the spike in international interest rates in 1979, together with the increase in the frequency of salary increases, led to the doubling of the annual inflation rate, that reached 100% per year between 1980/82. As a result of the sharp devaluation of 1983, inflation again doubled, rising above 200% per year as early as 1983. Between 1986 and 1991, five heterodox attempts to stabilize inflation ended in failure, namely: the Cruzado Plan (1986), the Bresser Plan (1987), the Summer Plan (1989), the first Collor Plan (1990) and the

**Figure 2**  
**Inflation (IGP-DI) - 1980/93**



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second Collor Plan (1991). In the first of these, the freezing of prices, salaries and the exchange rate was not accompanied by any attempts at fiscal reform. Monetary and credit policies accommodated the expansion of domestic demand and the program degenerated into a currency crisis and a moratorium on the external debt (1987).

The Bresser and Summer Plans were no more than passing attempts to curb hyperinflation by temporary freezes on prices and salaries. These attempts were continued by the first and second Collor Plans, which were characterized by intervention in private contracts and in the rules of indexation. In the first plan, around 10% of GDP in financial assets were frozen overnight in the most serious intervention in private contracts ever carried out in Brazil. With the second plan, an attempt was made to increase the flexibility of monetary policy by creating financial instruments with “forward-looking” indexation mechanisms. In both cases, the persistence of fundamental disequilibria, particularly in the finances of the public sector, and the progressive loss of credibility of economic policy led to renewed expansion of the monetary aggregates and inflation.

The successive failures of attempts to interrupt inflation via deindexation programs, and the increase in discretionary intervention in private contracts, led to change in the nature of inflation. Both the average rate and the volatility of the rate increased, as economic agents incorporated the risks of new deindexation programs into their expectations. In a sense, the ability of indexation to “anchor” inflation at a more or less stable level (as was the case in the first half of the 1980s) depended on respect for the rules of the same indexation process. When the stabilization programs introduced the possibility that the rules could be broken, the efficient functioning of the mechanism was compromised and inflation began to develop into open hyperinflation. In general terms, this was the situation with regard to inflation in December 1993, when the government announced a new stabilization program known as the Real Plan.

### **The Crisis in Public-Sector Finances**

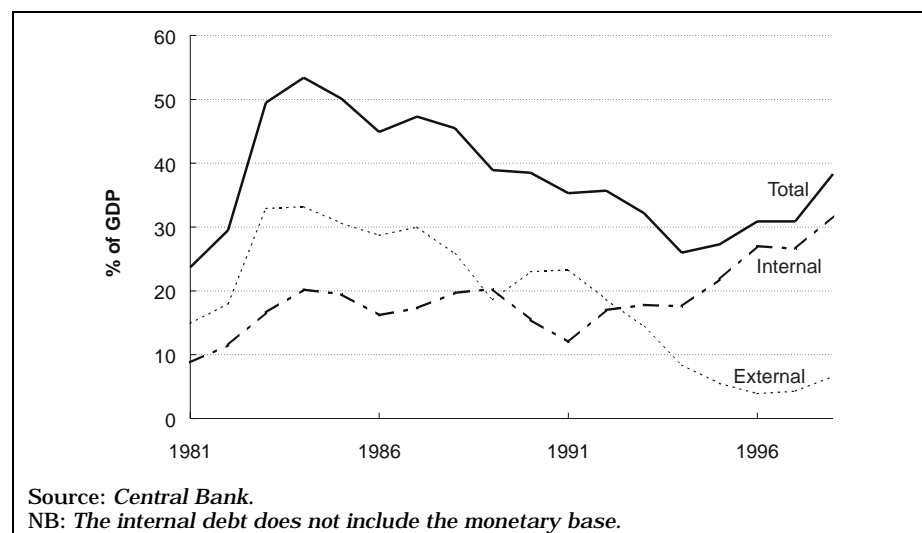
After the first oil shock in 1973, public policy-makers decided on an ambitious program of adjustments in domestic supply, based on import substitution and promotion of exports, that was funded by expanding the external debt and domestic credit. However, the involvement of the public sector in the program was inconsistent with the long-term fiscal equilibrium. On the one hand, the implementation of the adjustment required a substantial investment effort by state-owned companies. On the other, the fiscal incentives, subsidies and transfers to the private sector together with the restraining of public utility tariffs led to a fall in the public-sector’s share of aggregate income.

From 1979 onwards, this deteriorating trend in the public-sector accounts was aggravated by the worsening of conditions in the international financial markets. The increase in debt service expenses, together with the rise in international interest rates in 1979, was financed by even greater borrowing in both the domestic and external markets. The increase in domestic interest rates in 1981 also contributed to growth in the internal debt and in interest payments. From 1982 onwards, the external debt crisis was managed domestically by the transfer of exchange rate risk from the private sector to the Central Bank. For this reason, a substantial portion of the financial costs resulting from the major devaluation of 1983 accrued to the public-sector accounts. These impacts may be seen in Figure 3, which shows public-sector debt, both domestic and external, between 1981/98.

The deterioration in the financial situation of the public sector at the start of the 1980s resulted, therefore, from the fiscal inconsistencies of the 1970s strategy of growth with debt, from the effects of the monetary and exchange rate policies responses to external shocks, and from the lack of structural reforms in the public sector itself.

In the second half of the 1980s, a considerable increase in payroll and pension expenses was observed at all levels of government (federal, state and municipal), as well as in state-owned companies. Until 1993, this trend did not translate into explosive growth in the internal debt – that grew in line with inflows of foreign capital and the reimbursement of financial assets frozen in 1990 – since the government was able to use high inflation to reduce the real value of its expenses while the revenues were indexed. In this way, the apparent improvement in the financial situation of the public sector at the start of the 1990s was

**Figure 3**  
**Public Sector Debt - 1981/98**



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deceptive, and merely reflected the suppression of deficits and the importance of inflation tax for its funding.

### **Restrictions on Saving and Funding**

High inflation and the crisis in the public sector's finances created an environment that was extremely hostile to investment and growth between 1981/92. High rates of inflation undermined the allocation function of the price system, and considerably increased the uncertainties and risks associated with long-term projects. The crisis in the public sector's finances inhibited private sector investment in several ways: firstly, it led to an increase in macroeconomic uncertainty, secondly, its funding entailed high real interest rates (which attracted funds away from private investment), and thirdly, fiscal adjustment measures often concentrated on cutting public sector investments that were complementary to private investment, most notably in economic infrastructure.

This situation was aggravated by growing restrictions on savings and funding. External financing was practically halted by the external debt crisis in 1982. The domestic financial system in turn distanced itself progressively from its traditional function as a provider of credit for consumption, production and investment, and came to concentrate on intermediating the indexed public sector debt, as well as on providing substitutes for the domestic currency.

External saving that had been important for financing investment in the import substitution program during the 1970s, practically disappeared after the debt crisis. Domestic saving did not recover sufficiently to fill this gap during the 1980s and the start of the 1990s. The growing shortage of external funding for investment is also demonstrated by the reversal in the sign of foreign transfers: from 1983 onwards, the Brazilian economy became a net exporter of funds in real terms (see Statistical Appendix).

The macroeconomic instability that is characterized by high inflation and the crisis in the public sector's finances, as well as the shortage of funds, highlighted by credit rationing and contraction of savings, inevitably resulted in a fall in investment and in economic growth. The revival of growth thus depended on the success of a new stabilization program, as well as the restoration of mechanisms for funding and saving. The following section analyses, from these points of view, the most recent and most successful attempt at stabilization and restoration of economic growth within Brazil that was initiated with the Real Plan.

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## **3. The Search for Stability**

### **3.1. The Real Plan**

The Real Plan was a stabilization program first announced in December 1993, and then implemented in three sequential steps: *a*) the emergency fiscal adjustment; *b*) the elimination of inflationary inertia, through the conversion of prices and salaries to a stable unit of account (the URV – Real Unit of Value); and *c*) monetary reform through the transformation of the URV into the new currency, the Real.<sup>2</sup>

During the first stage, Congress approved a federal budget characterized by an *ex ante* operating equilibrium. The required spending cuts were made possible by the creation of a fund (the Social Emergency Fund) that decoupled 20% of the federal government's expenditures for the years 1994 and 1995, and thereby increased the margin of flexibility for implementing the budget.

Over a four-month period, salaries and most prices were converted into URVs, whose value in Cruzeiros Reais (the former currency) was readjusted every day on the basis of the average change in three inflation indices. Daily indexation practically eliminated the inertia that resulted from staggered contracts, and provided scope for the rapid reduction of inflation, without causing a recession, at the moment when the unit of account was transformed into the new currency.

The Real was then introduced in July 1994. Despite the high degree of uncertainty that naturally surrounded the new attempt at stabilization, its initial success in stabilizing inflation was undeniable. This collapsed from a level of over 40% per month in June 1994 to less than 2% per month at the end of the year. Clearly, the consolidation of price stability and the removal of restrictions on economic growth continued to depend on the fulfillment of a series of conditions that are described later in the text.

### **3.2. The Exchange Rate “Anchor”**

The correction of fundamental sources of disequilibria (fiscal and/or in the balance of payments) is a necessary but not a sufficient condition for the stabilization of high inflation, such as the kind that occurred in Brazil. Here, it was necessary to

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<sup>2</sup> It is important to highlight that the first stage of the Real Plan was only partially implemented. In 1994, the public sector achieved an operational equilibrium, but between 1995/98, operating deficits were observed. The growth in the public-sector debt revealed itself to be one of the weak points of the program, and played an important role in bringing about the financial crises of 1997 and 1998, as is discussed below.

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eliminate retroactive indexation, as well as to adjust the mechanism for setting prices and salaries to moderate or low expected inflation. The artifice of the URV was important in removing the initial effects of retroactive indexation and in aligning relative prices. The permanent harmonization between the setting of nominal prices and expected inflation nevertheless required the choice of a variable that would act as a nominal anchor. As in several other stabilization programs (in Israel and in other Latin American countries, for example), the exchange rate was chosen as the principal “anchor” of the program.

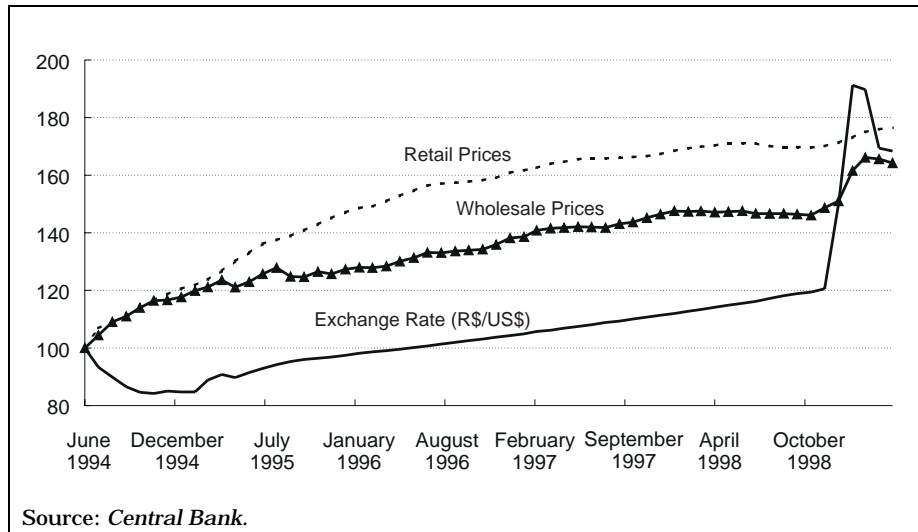
Various arguments led to the choice of this parameter. Firstly, stabilization programs based on the exchange rate tend to delay the onset of recessions, an important factor in guaranteeing the political sustainability of the program. Secondly, the exchange rate is a key price in the economy and a focal point that can be observed on a daily basis, whose stabilization sends important signals to the rest of the system. Thirdly, tradable goods form a significant proportion of the basket of consumer goods, and hence of the price index. Fourthly, the choice of a monetary aggregate as a nominal anchor was not advisable given its low visibility and instability, most notably during periods of disinflation.

At the same time, the choice of the anchor was not without its costs and attendant risks. Under imperfect credibility, the Real showed a tendency to appreciate in real terms that led to the generation of trade and current account deficits on the balance of payments. The level of international reserves, crucial for ensuring the stability of the exchange rate, began to depend on the generation of surpluses on the capital account. With a low level of international confidence in the outlook for the program or in the context of an international financial crisis, the interest rate required to attract foreign capital could be so high as to render stabilization based on an exchange rate anchor ineffective.

These difficulties suggest that at least in the initial stages of stabilization, the choice of other anchors was advisable. Restrictive monetary policy and credit controls, for example, would have been useful in avoiding an excessive expansion of domestic demand. It is also important to remember that where no effort is made to correct fundamental disequilibria (budget and/or balance of payments deficits), no nominal anchor will survive. This is particularly true of an exchange rate anchor that is based on the price of an asset (a foreign currency) that is subject to unpredictable fluctuations in a world characterized by a high level of capital mobility.

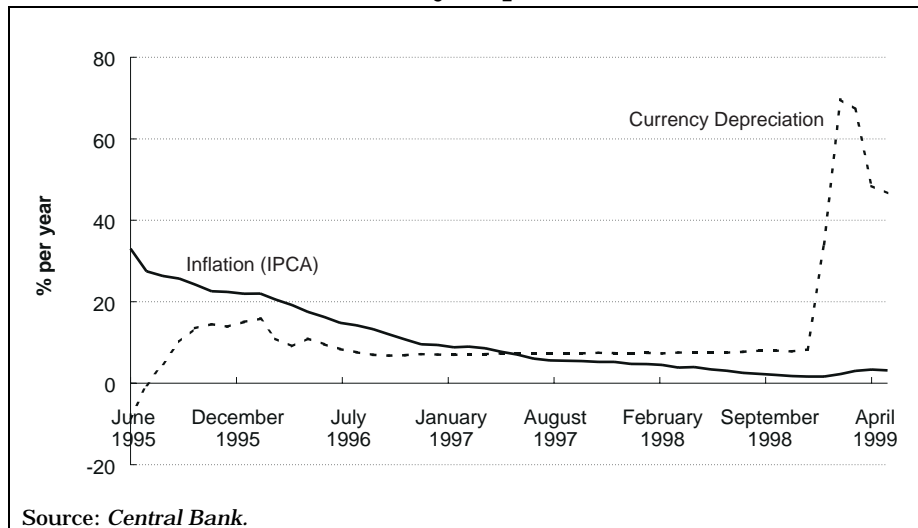
The Brazilian experience with the exchange rate anchor between 1994/99 incorporated many of the elements mentioned above. Figure 4 shows the development of the exchange rate and of prices (both wholesale and retail) between June 1994 and May

**Figure 4**  
**Prices and Exchange Rates - 1994/99**  
**(June 1994 = 100)**



1999, while Figure 5 shows the 12-month accumulated inflation and currency depreciation for the period from June 1994 to May 1999. In the first months of the Real Plan (until February 1995), nominal appreciation was used to aid in containing the pressure for reindexation resulting from a rapid expansion of domestic demand. In March 1995, in response to the effects of the Mexican currency crisis, the government introduced a series of exchange rate “mini-bands”, intervening within these in a system that lasted until January 1999. This system, which included a more or less constant nominal devaluation of around 7% per year, aimed to correct the real accumulated appreciation of the currency since the start of the Plan on a gradual basis, and thereby minimize the impact on inflation (see Figure 5).

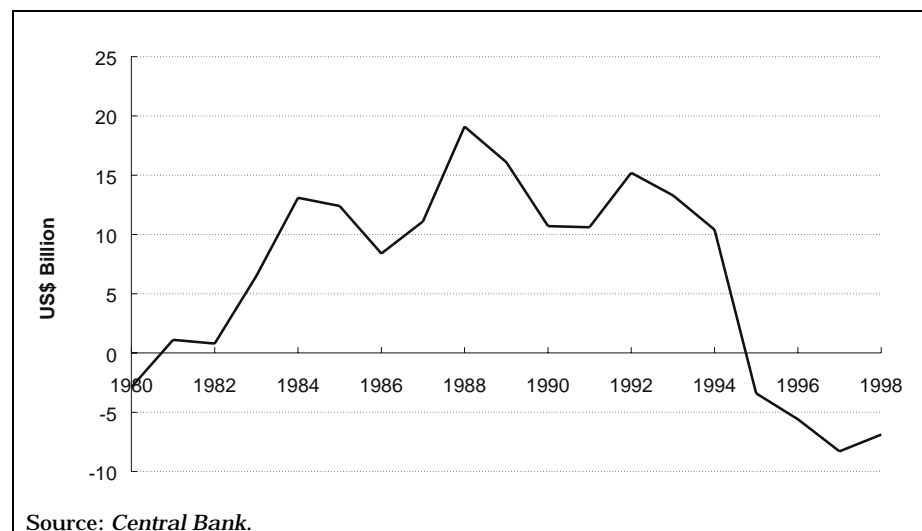
**Figure 5**  
**Inflation and Currency Depreciation - 1994/99**



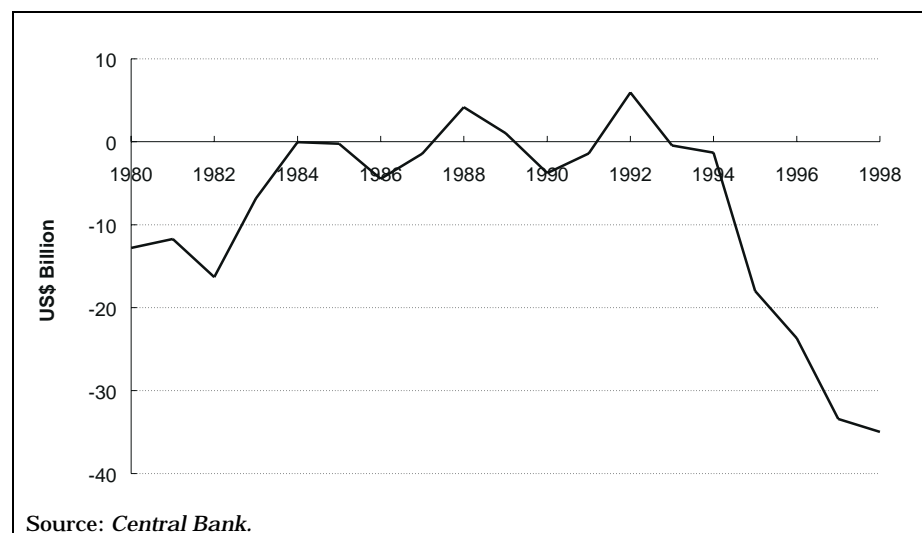
High real interest rates and credit restrictions also played their role in disinflation. From the point of view of stabilizing inflation, the success of the Real Plan was undeniable: after the monetary reform of July 1994, 12-month accumulated inflation fell continuously from over 30% per year in June 1995 to less than 2% per year in December 1998, as is demonstrated in Figure 5.

However, contagion from the Asian and Russian crises in 1997 and 1998 highlighted the extremely fragile foundations of the Brazilian stabilization program, both in terms of budget equilibria and the balance of payments. The internal public-sector debt grew continuously from 1994 onwards (see Figure 3). The real appreciation of the exchange rate, for its part, led to significant deficits in the trade balance and current accounts (see Figures 6 and 7). Until these crises broke, the funding of bal-

**Figure 6**  
**Trade Balance - 1980/98**



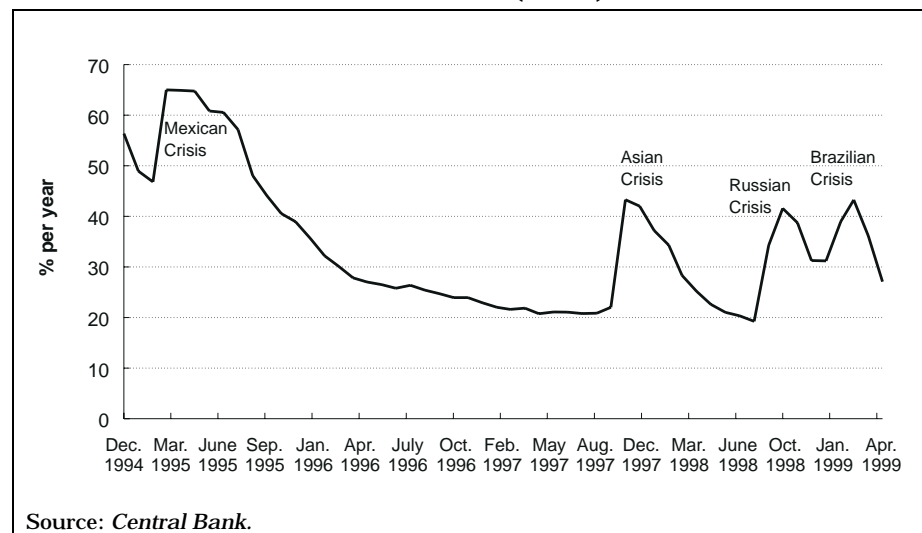
**Figure 7**  
**Current Account - 1980/98**



ance of payments deficits had been guaranteed by positive inflows of foreign capital, sustained by the differential between domestic and international interest rates, the prospect of resumption of economic growth, and the advances in the privatization program.

This situation changed radically as a result of contagion. In the last quarter of 1997 and the second half of 1998, capital flight produced a rapid reduction in reserves. The maintenance of the government's exchange rate policy required dramatic increases in interest rates (see Figure 8), with undesirable effects on the level of activity, on employment and on the public-sector accounts. In November 1998, in order to halt the loss of reserves and the spread of the international crisis, Brazil formalized an agreement with the International Monetary Fund (IMF) in return for multilateral financial aid of US\$ 41.5 billion.

**Figure 8**  
**Nominal Interest Rate (Selic) - 1994/99**



### 3.3. The New Exchange Rate Policy

In January 1999, new speculative attacks on the Real caused a transition to a floating exchange rate policy, after a futile attempt to change the limits of the exchange rate band. As is customary, there was an initial overshoot of the exchange rate, followed by a gradual return to a rate of exchange closer to equilibrium (see Figures 4 and 5). In order to avoid the creation of high rates of inflation by the devaluation, interest rates were again raised in February (to 45% per year). With the first signs of a fall in inflation, a new downward trend in interest rates was initiated in April 1999 (see Figure 8).

The effects of the devaluation on the stock of public sector debt and on interest payments made it necessary to revise the

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terms of the agreement with the IMF. In order to stabilize the net public sector debt as a percentage of GDP (at around 50% of GDP at the end of 1999 and 46.5% of GDP at the end of 2001)<sup>3</sup> the government undertook to meet primary surplus targets of 3.1% of GDP in 1999, 3.25% in 2000 and 3.35% in 2001. This represents a significant effort at a fiscal adjustment, compared to the break-even result observed in 1998. Various measures were approved to ensure the achievement of targets, most notable of which were:

a) the extension of the Provisional Tax on Financial Transactions (CPMF) until June 2002, with rates of 0.38% from June 1999 to June 2000, and 0.3% for the 24 remaining months of the effective period;

b) the increase in rates from 0.2% to 0.3% and the broadening of the base of eligible tax payers for the Social Security Funding Contribution (Cofins);

c) the creation of a pension contribution for retired public sector employees and an increase in the contributions by active public sector employees;

d) a cut in planned investments by federally-owned companies; and

e) a cut in other items of expenditure and investment (OCC) by the federal government.

The federal government will make the main contribution to the adjustment. For 1999, for example, it will be responsible for achieving around 80% of the primary surplus. The same government nevertheless hopes that the recent renegotiation agreement for individual state debts and the planned cuts in investments by public sector companies will also generate primary surpluses at these levels of government.

The balance of payments will also be subject to significant adjustments from 1999 onwards. This year, the real devaluation of the exchange rate and the fall in economic activity should be accompanied by a contraction in imports and a surplus on the trade balance. The current account deficit should fall to a level that can be largely financed by direct investments.

Finally, no significant rise in inflation is expected during 1999. Monetary policy did not accommodate the effects of the currency devaluation in prices, and the spike in inflation that

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3 These figures include the monetary base, and therefore, are not directly comparable with the values in Figure 3, that exclude it.

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occurred in the first months of 1999 should rapidly give way to annualized monthly inflation rates in single figures.

### **3.4. The Real Plan and Economic Growth**

Like other stabilization plans based on the exchange rate, the Real Plan was followed by an initial boom in economic activity and a subsequent deceleration. Indeed, the growth in GDP observed during the first four years of the program gave way to stagnation in 1998, and probably to recession (or stagnation again) in 1999. The Brazilian experience is nevertheless peculiar in certain aspects and does not exactly replicate various other episodes of temporary growth, such as those observed in Chile (1976/82), Argentina (1978/81 and 1985/86) and Mexico (1987/94).

In such cases, the real appreciation of the exchange rate caused an initial rise in the level of activity, followed by recession. In the cases of Chile and Argentina, growth was interrupted by difficulties in financing current account deficits, as well as by currency crises that coincided with the start of a recession. In Mexico, the stagnation in economic activity preceded the currency crisis, as imports had been progressively substituting domestic production.

In the case of Brazil, the real appreciation of the exchange rate observed since 1994 had sustained the stability of prices of tradable goods, and stimulated the expansion of consumption and investment. The flawed credibility of the stabilization program tended to reinforce this trend. Pessimistic expectations regarding the sustainability of the government's exchange rate policy, for example, provided economic agents with incentives to anticipate their consumption and investment expenditures, with these often borrowing at rates close to those in the international market.

Furthermore, since the Brazilian economy is less open and has a more developed domestic industrial base than is the case for the other economies of Latin America, a considerable proportion of the increase in consumption and investment was directed towards domestic production. In this way, the increase in penetration of imports brought about by the real appreciation of the exchange rate was not sufficient in itself to prevent GDP growth (as was the case in the recent experience of Mexico).

Unfortunately, like the majority of other stabilization programs based on the exchange rate, the Brazilian experience of economic growth in association with a currency anchor ended in a balance of payments crisis. There is nevertheless a positive aspect of the crisis that should not be overlooked. It is possible

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over the next few years that the new exchange rate policy (floating rate) will reveal itself to be more compatible with sustained economic growth than the previous regime (of exchange rate mini-bands).

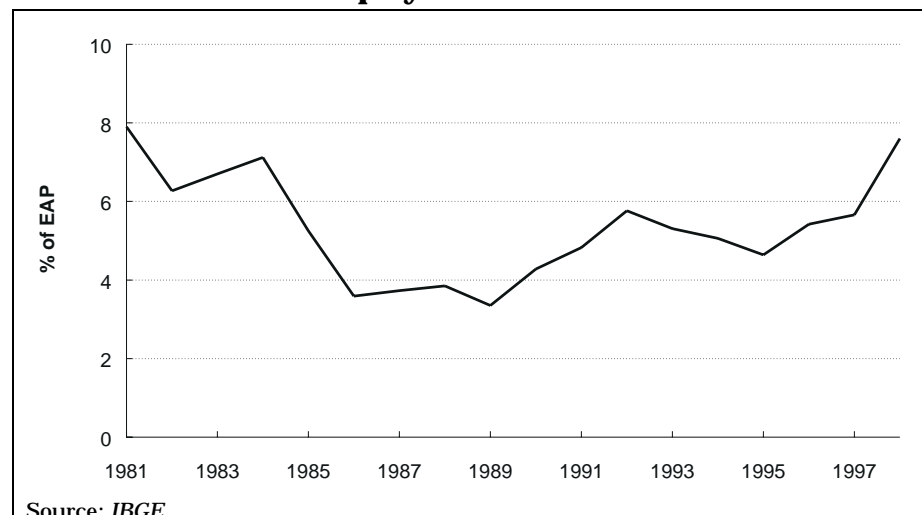
Indeed, on account of the policy's flawed credibility, the combination of a real appreciation of the exchange rate and an expansionary fiscal policy made it necessary to maintain very high levels of real interest rates that diverted investment from the private sector and limited the possibility of sustained GDP growth. The change in the currency regime has increased the scope for a reduction in real interest rates, and the more successful the fiscal reform, the greater this scope will be. Having said this, the result in terms of sustained GDP growth will depend on the government's fulfilling of a series of prerequisites that will be analyzed in Section 4.

### 3.5. The Recent Evolution of Employment

Until the 1990s, the long-term trend in unemployment within the Brazil was not a major cause of concern for policy makers, since the fluctuations in unemployment were highly correlated with economic cycles: the expansion of unemployment during a recession was compensated by the recovery in employment during an upturn in activity. On average, therefore, there was no long-term tendency for unemployment to increase.

This behavior has apparently changed during the 1990s. Economic productivity has increased, at the cost of a consistently rising rate of unemployment (see Figure 9). Since 1995, the average annual rate of unemployment has been growing continuously from 4.6% of the economically active population (EAP) in 1995 to 7.6% in 1998. Cyclical recoveries in the level of activity

**Figure 9**  
**Unemployment - 1981/98**



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have not been sufficient to reduce the accumulated unemployment, a fact that has, since 1995, been translated into an increase in long-term unemployment.

In sector terms, industrial unemployment has been increasing in a systematic fashion since mid-1995. The introduction of new technologies incorporated into machines and imported equipment, for example, has made workers with inadequate qualifications redundant. The productivity of industry has increased at the cost of eliminating jobs on a permanent basis. Against this, at least until the end of 1996, the service sector had been absorbing the workers shed by industry. These workers accepted jobs in the service sector that required fewer qualifications and paid lower salaries. The increase in the average real wages of workers, both in the industrial and service sectors, was compatible with these trends.

But even before the breaking of the financial crises of 1997 and 1998, the service sector's capacity for absorbing workers was showing signs of exhaustion. During these crises, the tendency of industry to destroy jobs became more acute, since now the service sector was no longer able to function as a shock absorber. The result was a continuous increase in the rate of open unemployment, and a reduction in the average real salaries of workers.

The resumption of economic growth is a necessary, but not a sufficient condition for the recovery of employment. The promotion of greater flexibility of labor relations that reduces the costs of hiring and dismissing workers is desirable in order to lessen the long-term growth trend in unemployment. The creation of financing mechanisms for small- and medium-sized companies could also work towards the same goal. In the longer term, improvements in the provision of public goods, particularly in the areas of health and education, are also important factors in increasing the quality of human capital and the level of employment in Brazil.

## **4. The Resumption of Economic Growth: The Main Preconditions**

A comparison between periods of high inflation (1981/92) and moderate or low inflation (1994/99) shows that various restrictions on economic growth were reduced despite the recent difficulties associated with international financial crises. The stabilization of inflation, for example, removed the inefficiencies in the system of relative prices and reduced the risk to investors in long-term projects. The renegotiation of the external debt in

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1994 reopened external funding channels. In this way, the Brazilian economy is supposedly better prepared to enter a period of sustained economic growth than was the case, say, a decade ago.

This does not imply, however, that Brazil has overcome some serious challenges. This section is thus an attempt to present and discuss the main preconditions for the resumption of sustained economic growth within Brazil, from the standpoint of June 1999.

#### **4.1. The Consolidation of Macroeconomic Stability**

We have already mentioned that the success of any stabilization program depends on the correction of economic fundamentals. In the case of Brazil, an important challenge in this sense is the implementation of a fiscal adjustment that is perceived as being durable. This does not only require the reduction of the public sector deficit through short-term measures, but also its elimination through the reform of the public sector.

The reform of the public sector entails privatization, deregulation, tax, administrative and pension reforms, and the restructuring, in terms of costs and maturity, of the public sector debt. Within Brazil, part of this reform has already been initiated. It is nevertheless essential for prospective long-term economic growth that the fiscal targets agreed with the IMF develop into a permanent fiscal adjustment.

With regard to monetary and exchange rate policies, the choice of a flexible exchange rate imposed the need for a new monetary policy regime. Inflation targets were announced, replacing the exchange rate as nominal anchors, with the intention that these aid to coordinate inflation expectations.<sup>4</sup> This regime has been functioning in a satisfactory way in various countries, although its effective implementation in Brazil will require not only correct economic fundamentals, but also the technological and institutional optimization of a series of aspects of the Central Bank's activity.

#### **4.2. The Restoration of Investment**

The most difficult stage of stabilization programs that are directed towards growth is the restoration of investment, which is not automatic, even in successful programs. This implies that even economies that reach equilibrium in their public sector

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4 The government announced targets of 8%, 6% and 4%, respectively, for inflation in 1999, 2000 and 2001, with a permitted variation of  $\pm 2$  percentage points on either side of these values. The government will use the *full* IPCA (Broad Consumer Price Index), that is, without stripping out extraordinary factors or extremely volatile items.

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budgets and their balance of payments, and that stabilize inflation in a credible manner, will face difficulties in restoring investment.

The problem is that, on account of the irreversible nature of investments and the uncertainties of the macroeconomic environment, investment opportunities are seen by investors as options. They always have the ability to delay their investment decisions until the uncertainties diminish, or alternatively, to invest only if the rate of return is sufficiently high.

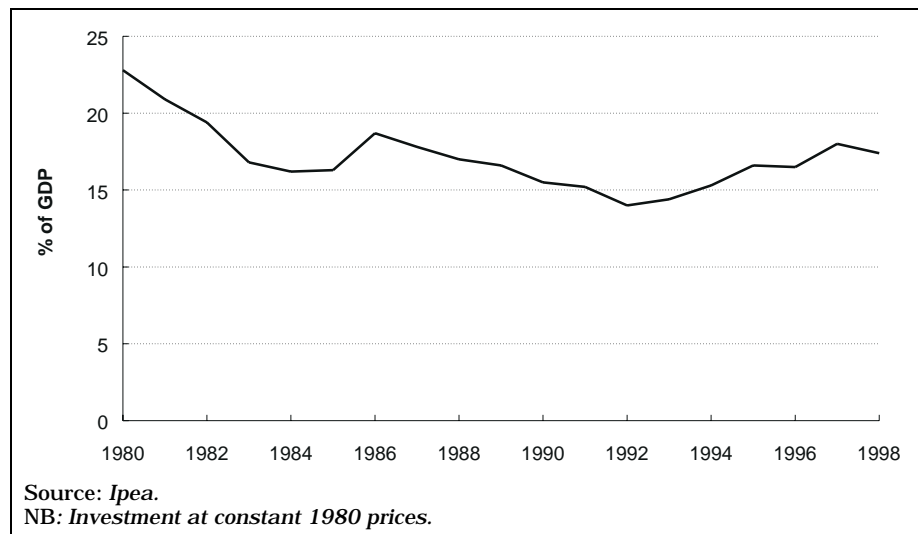
In economies like Brazil's, with a history of high inflation and macroeconomic instability, the premium demanded by investors is a high one that increases with the level of uncertainty. This can create the following coordination problem: investments are only implemented if the uncertainties regarding the success of the stabilization program are limited. At the same time, the success of the program also depends on the level of investment.

This problem of coordination is aggravated in the presence of credit rationing and when imports account for a high proportion of investments. The effects of credit rationing can be reduced in the short term by funding from abroad or from domestic development banks. The high import content of investment, that is typical of developing countries, has the effect of making the level of investment highly sensitive to the real exchange rate, as well as to uncertainties in the exchange rate policy. For example, the real appreciation of the exchange rate can trigger a surge in investment, while a devaluation in real terms can depress the level of investment on a short-term basis.

The provision of adequate incentives, whether in the form of fiscal concessions or long-term loans, can help to compensate the effects of macroeconomic uncertainty on investment decisions. These incentives form part of a set of instruments that are commonly referred to as "industrial policy". The major challenge here is the question of how to institutionalize an efficient industrial policy, while minimizing the possibility of "government failures". Examples from Asian economies such as South Korea and Taiwan may be useful in this respect.

Figure 10 shows the evolution of investment at constant 1980s prices, between 1980 and 1998. A slow recovery since 1993 may be observed, driven by the stabilization of inflation, by the prospect of domestic economic growth, by the availability of external funding, and by the privatization program, particularly in the infrastructure sectors. It is nevertheless too early to detect clear signs of a sustained long-term recovery (on average, the rate of investment stagnated between 1982 and 1998). Part of the recovery observed between 1994 and 1997, for example, could have been driven by the real appreciation of the exchange rate,

**Figure 10**  
**Investment - 1980/98**



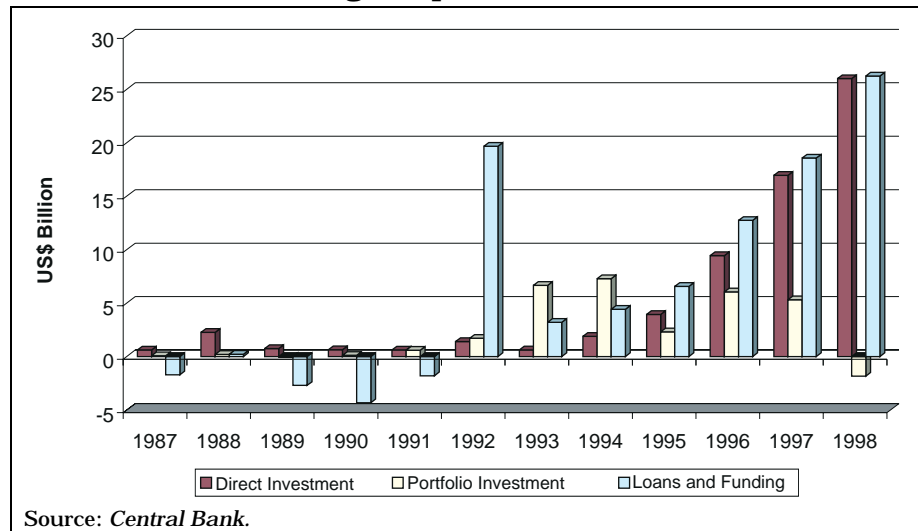
as well as by pessimistic expectations with regard to the sustainability of the former exchange rate policy.

It is extremely difficult to anticipate the effects on investment of the recent change in exchange rate regime. In the short term, both the economic stagnation and the increase in the prices of tradable goods are tending to depress investment, principally in the form of imports of capital goods. In the longer term, the substitution effect of the devaluation of the real, together with the reduction in real interest rates, the resumption of economic growth and the recovery of saving and funding mechanisms will tend to encourage investment. It is nevertheless important not to underestimate the difficulties associated with this stage of the stabilization program.

### **4.3. The Expansion of Saving and Credit**

Since the start of the 1990s, the return of foreign capital flows to Brazil had been minimizing the constraints on savings and external financing imposed by the external debt crisis in 1982 (see Figure 11). This trend was strengthened by the renegotiation of the external debt, and by the Real Plan in 1994. The first of these two events made it possible for Brazil to reduce its stock of debt and the burden of foreign debt service, removing from the economy the need to transfer real resources abroad. The second was accompanied by current account deficits. At this point, external saving began to finance the excess of domestic investment over domestic saving, for as long as the rest of the world was willing to fund current account deficits (through the entry of foreign capital). External saving increased from -1% of GDP in 1992 to 4.5% of GDP in 1998, and from 1995 onwards, the Brazilian economy began to absorb real funds from abroad, thus inverting the trend observed since 1983 (see Statistical Appendix).

**Figure 11**  
**Foreign Capital - 1987/98**



Unfortunately, the counterpart to the increase in foreign saving was a fall in domestic saving from 1994 onwards, a sign that part of the foreign funds were used to finance domestic consumption.

The importance of external saving for the funding of investment should be reduced as a result of the new conditions of the international financial market, and the effects of the real devaluation of the currency. As a consequence, the expansion of domestic saving will be essential in ensuring the restoration of investment. Private saving could be boosted, for example, by the deepening of the pension reform, while the restoration of public sector saving will depend on the progress of the fiscal reforms.

With regard to the reopening of domestic funding channels, a profound reform of the Brazilian financial system is currently in progress, characterized by a reduction in the participation of public sector financial institutions, by the growth in share of foreign institutions and by increased concentration in the banking sector. This progressive strengthening of the domestic financial system was a key element in ensuring that the foreign exchange crisis of 1999 was not aggravated by a banking crisis. Now that the initial difficulties of maintaining price stability have been overcome and since the downward trend in interest rates has been confirmed, the domestic financial market will gradually be able to resume its traditional role as a supplier of credit for consumption, production and investment.

#### **4.4. The Advance of Microeconomic Reforms**

Microeconomic reforms will contribute in various ways to the resumption of growth. These increase the efficiency of firms and markets and allow the economy to benefit from gains in

productivity. In Brazil, opening to trade and privatization are processes that have been advancing for at least a decade. In both cases, it is important to preserve the achievements to date, and to advance in other areas.

In the case of trade policy, for example, the emphasis should shift from the removal of import barriers (avoiding, of course, the temptation to return to protectionism) to the promotion of exports. The real devaluation of the exchange rate is a necessary incentive, but is insufficient to ensure a significant increase in exports. Investment in infrastructure (particularly in ports and transport) and long-term funding are important in reducing the cost of exports, and in encouraging investments directed towards international trade. Both investment in infrastructure and long-term funding for exports offer many possibilities for partnerships between the public and private sectors.

The privatization of the transformation and mining sectors has been completed, and has made substantial advances in infrastructure (see table below), where it is being accompanied by important sector reforms. In the electricity sector, most distributors have been privatized, and the sale process for the generators is well under way. In the case of the telecommunications sector, the fixed telephony, long distance and cellular segments have been privatized in their entirety. In the oil and gas sector, new exploration and production concessions are starting to be sold to the private sector. In the transport segment, the whole of the railway network and various highways and ports have been transferred to private management. The importance of regulation has been recognized, with the creation of independent regulatory agencies for the telecommunications, electricity and oil and gas sectors.

**Privatizations - 1991/98**  
**(US\$ Billion)<sup>a</sup>**

<i>Sectors</i>	<i>1991</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>Total</i>
Steel	1.8	1.6	3.8	0.9	0.0	0.0	0.0	0.0	8.2
Petrochemicals	0.0	1.5	0.2	0.5	1.2	0.3	0.0	0.0	3.7
Fertilizers	0.0	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.5
Mining	0.0	0.0	0.0	0.0	0.0	0.0	6.9	0.0	6.9
Electricity	0.0	0.0	0.0	0.0	0.4	4.0	13.7	9.7	27.8
Telecommunications	0.0	0.0	0.0	0.0	0.0	0.7	4.7	25.8	31.2
Banking	0.0	0.0	0.0	0.0	0.0	0.0	0.7	0.6	1.4
Other	0.1	0.0	0.0	0.9	0.0	1.5	1.7	1.3	5.5
<b>Total</b>	<b>2.0</b>	<b>3.4</b>	<b>4.2</b>	<b>2.3</b>	<b>1.6</b>	<b>6.5</b>	<b>27.7</b>	<b>37.5</b>	<b>85.2</b>

Source: BNDES.

<sup>a</sup>Includes concessions, sales revenues and transferred debts.

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## **5. Conclusions**

Between 1900 and 1980, Brazilian economic growth was among the fastest in the world. This performance was dramatically reversed, however, between 1981/92, when high inflation, a crisis in the finances of the public sector and constraints on saving and funding resulted in modest economic growth and a declining rate of investment.

The Real Plan, announced in December 1993, was the most successful attempt in recent history to stabilize inflation, and to lay the foundations for the resumption of sustained economic growth. The stabilization of inflation, in conjunction with the reopening of channels of external saving and funding, and the progress of various microeconomic reforms, boosted the expansion of consumption and investment, and between 1994 and 1997, promoted the resumption of economic growth and investment.

Unfortunately, the financial crises of 1997 and 1998 revealed the extremely fragile foundations of the Brazilian stabilization program, both in terms of budget and balance of payments equilibria. Capital flight caused a rapid reduction in reserves. The exchange rate anchor was defended by successive increases in interest rates, at the cost of a deceleration of economic growth, an increase in unemployment, and a deterioration in the public sector's finances. In December 1998, the country formalized an agreement with the IMF in exchange for financial aid. In January 1999, renewed speculative attacks on the Real caused the shift to a floating exchange rate regime.

Nevertheless, the crisis also had positive aspects. Fiscal adjustment measures were rapidly approved by Congress. Monetary policy did not accommodate the effects of the currency devaluation in prices, and inflation remained low. A smaller current account deficit will be largely financed by direct investment inflows. A reduction in interest rates will contribute to a recovery in economic activity, probably as early as the second half of 1999.

From a longer term perspective, it may be said that the Brazilian economy currently is in a better state to begin a new sustained growth cycle than was the case, say, a decade ago. Indeed, during this period, various constraints on growth have been removed. Inflation was stabilized. The renegotiation of the external debt reduced the debt stock and the level of service payments, and reopened external funding channels. Institutional reforms eliminated restrictions on the entry of foreign investment, whether direct or portfolio. The opening to trade increased competition in the domestic market, increased the efficiency of firms,

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as well as the well being of consumers. Efficiency gains were also observed in privatized companies.

Having said this, the Brazilian economy must still meet a series of preconditions in order to realize its growth potential: the consolidation of macroeconomic stability, the restoration of investment, and the expansion of saving and credit. These form the greatest longer-term challenges that will not be overcome unless various processes currently underway prove successful.

For example, the public sector reforms (pension, administrative, tax) will, if successful, aid in the consolidation of macroeconomic stability, increase domestic saving and allow the state to concentrate on its traditional role as a provider of public goods – education, health, security and justice. The privatization of infrastructure, together with the optimization of regulatory mechanisms, will increase the productivity of the economy and will remove physical and technological obstacles to growth in investment. A more efficient financial system, with greater participation by private and foreign banks, will gradually recover its role in financing production, consumption and investment.

The new floating rate exchange regime, combined with advances in the fiscal adjustment will allow a significant reduction in real interest rates. This reduction will have a positive impact on investment, employment and the public sector accounts. In the longer term, the favorable effects of a reduction in interest rates on investment and growth will be reinforced by the substitution effect of the currency devaluation, which will boost exports and investment in the production of tradable goods. The promotion of exports will also benefit from the creation of long-term funding, as well as the positive externalities of investments in infrastructure.

Finally, we hope that the resumption of sustained economic growth will reverse the rising long-term trend in unemployment. This movement could be reinforced by greater flexibility in labor relations and by the expansion of funding of small- and medium-sized businesses. At the same time, the recovery by the state of its role as a provider of public goods will contribute to an improvement in the quality of human capital and to a reduction in poverty.

## Statistical Appendix

### Brazil: Economic Indicators – 1981/98

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
GDP (Current US\$ Billions)	258.6	271.3	189.5	189.7	211.1	257.8	282.4	305.7	415.9	469.3	405.7	387.3	429.7	543.1	705.4	775.4	804.2	776.9
Real GDP (1980 = 100)	95.7	96.5	93.7	98.7	106.5	114.5	118.5	118.4	122.2	116.8	118.0	117.4	123.1	130.4	135.9	139.7	144.9	145.2
Real GDP Growth (%)	-4.3	0.8	-2.9	5.4	7.9	7.5	3.5	-0.1	3.2	-4.4	1.0	-0.5	4.9	5.9	4.2	2.8	3.7	0.2
Real Per Capita GDP (1980 = 100)	93.6	92.3	87.7	90.6	95.7	100.8	102.4	100.4	101.8	96.1	95.6	93.5	96.8	101.0	103.8	105.2	107.6	106.4
Real Per Capita GDP Growth (%)	-6.4	-1.4	-5.0	3.2	5.7	5.3	1.5	-1.9	1.4	-5.6	-0.6	-2.2	3.5	4.4	2.7	1.4	2.3	-1.2
Population (Million Inhabitants)	121.2	123.9	126.6	129.3	132.0	134.7	137.3	139.8	142.3	144.1	146.4	148.9	150.9	153.1	155.3	157.5	159.6	161.8
Population Growth Rate (%)	2.2	2.2	2.2	2.1	2.1	2.0	1.9	1.8	1.8	1.3	1.6	1.7	1.3	1.5	1.4	1.4	1.3	1.4
Investment (% of GDP, 1980 Prices)	20.9	19.4	16.8	16.2	16.3	18.7	17.8	17.0	16.6	15.5	15.2	14.0	14.4	15.3	16.6	16.5	18.0	17.4
Investment (% of GDP, Current Prices)	23.1	21.8	18.6	17.7	16.9	19.0	22.2	22.7	24.8	20.7	18.1	18.4	19.3	20.8	20.5	19.1	19.6	19.1
Savings (% of GDP)	23.1	21.8	18.6	17.7	16.9	19.0	22.2	22.7	24.8	20.7	18.1	18.4	19.3	20.8	20.5	19.1	19.6	19.1
Domestic	18.6	15.9	15.2	17.7	16.8	17.0	21.7	24.1	25.0	19.6	16.9	19.3	18.5	19.9	17.7	15.7	15.2	14.6
Public	-0.7	2.1	0.7	0.7	0.3	1.0	-1.5	-0.5	-1.3	5.7	3.5	1.7	2.4	4.3	-1.6	-1.1	-1.9	n.a
Private	19.3	13.8	14.5	17.0	16.5	16.0	23.2	24.6	26.3	13.9	13.4	17.6	16.1	15.6	19.3	16.8	17.1	n.a
Foreign	4.5	5.9	3.4	0.0	0.1	2.0	0.5	-1.4	-0.2	1.1	1.2	-0.9	0.8	0.9	2.8	3.4	4.4	4.5
Prices																		
GDP Deflator (%)	101.0	101.0	131.0	202.0	249.0	149.0	206.0	628.0	1,304.0	2,596.0	416.7	969.0	1,996.2	2,240.2	77.6	17.3	7.4	3.9
IGP-DI (%)	95.2	99.7	211.0	223.9	235.0	65.0	415.8	1,037.6	1,782.9	1,476.6	480.2	1,157.9	2,708.6	1,093.8	14.8	9.3	7.5	1.7
Real Wages Index (1988 = 100)	90.3	96.5	90.0	85.8	95.6	106.3	97.7	100.0	96.9	83.9	77.6	88.5	97.4	107.7	118.9	126.4	134.0	136.9
Effective Real Exchange Rate (1988 = 100)	129.7	127.5	151.0	141.5	143.1	149.3	155.2	140.1	115.7	98.0	119.0	130.7	115.1	100.0	93.8	95.5	90.4	91.3
Terms of Trade (Average 1996 = 100)	63.3	61.5	60.8	64.5	61.8	78.5	70.0	75.6	72.1	65.2	69.0	70.3	71.2	81.3	90.3	100.0	94.7	93.5
Monetary and Financial Sector																		
Real Interest Rate (%) <sup>a</sup>	-2.9	8.7	-4.0	8.4	9.9	3.5	-15.0	-5.0	19.0	-4.9	3.6	34.1	7.1	24.4	33.1	16.6	16.4	26.5
M1/GDP <sup>b</sup>	7.7	6.5	5.1	3.6	3.5	7.7	4.2	2.4	2.0	3.3	2.8	1.8	1.3	4.3	4.1	3.7	5.3	5.6
M4/GDP <sup>b</sup>	25.4	25.9	24.7	23.8	27.9	31.0	27.0	25.6	24.8	15.6	15.5	25.6	27.5	32.6	36.0	39.8	44.1	50.0
Public Sector																		
Gross Tax Collections (% of GDP)	25.2	26.2	26.9	24.2	23.8	26.5	24.3	23.4	23.7	29.6	24.4	25.0	25.3	27.9	28.0	28.2	28.2	29.0
Primary Deficit (% of GDP)	n.a	n.a	n.a	n.a	-2.7	-1.6	1.0	-0.9	1.0	-2.3	-2.7	-1.6	-2.3	-5.2	-0.3	0.1	1.0	0.0
Operational Deficit (% of GDP)	6.3	7.3	3.3	3.0	4.7	3.6	5.7	4.8	6.9	-1.4	0.2	2.3	0.8	-1.1	5.0	3.8	4.3	7.8
Net Public Sector Debt (% of GDP)	23.7	29.5	49.5	53.4	50.1	44.9	47.3	45.5	38.9	38.5	35.3	35.7	32.2	26.0	27.3	30.9	30.9	38.3
Internal	8.8	11.5	16.6	20.2	19.5	16.2	17.3	19.7	20.3	15.5	12.0	17.0	17.8	17.6	21.8	27.0	26.6	31.7
External	14.9	18.0	32.9	33.2	30.6	28.7	30.0	25.8	18.6	23.0	23.3	18.7	14.4	8.4	5.5	3.9	4.3	6.6
Investment of Federal SOES (% of GDP)	5.2	5.0	4.1	3.7	3.3	3.0	3.7	3.4	3.0	1.9	2.3	2.4	2.0	1.6	1.4	1.6	1.7	1.5
Employment																		
Rate of Unemployment (%)	7.90	6.27	6.70	7.12	5.25	3.59	3.73	3.85	3.35	4.28	4.83	5.76	5.31	5.06	4.64	5.42	5.66	7.60
Rate of Unemployment (1981 = 100)	100.00	79.37	84.81	90.13	66.46	45.44	47.22	48.73	42.41	54.18	61.14	72.91	67.22	64.05	58.73	68.61	71.65	96.20
Industrial Employment (June 1994 = 100) <sup>c</sup>	114.80	109.20	100.70	100.40	108.80	119.40	122.10	119.70	121.10	118.60	109.10	101.90	98.00	100.50	99.90	90.50	85.50	79.10
Labor Productivity (1976 = 100) <sup>d</sup>	112.50	120.60	125.20	136.00	147.90	147.60	147.50	149.30	149.10	144.70	156.60	166.20	182.60	200.90	208.90	239.30	266.50	288.40
Foreign Sector																		
Exports (US\$ Billion)	23.2	20.2	21.9	27.0	25.6	22.4	26.2	33.8	34.4	31.4	31.6	35.8	38.6	43.5	46.5	47.7	53.0	51.1
Manufacturing Exports (%)	51.8	51.5	52.3	56.7	55.5	55.9	57.0	57.2	54.8	55.4	54.9	59.8	60.8	57.3	55.0	55.3	55.1	57.4
Exports (% of GDP)	9.0	7.4	11.6	14.2	12.1	8.7	9.3	11.1	8.3	6.7	7.8	9.2	9.0	8.0	6.6	6.2	6.6	6.6
Imports (US\$ Billion)	22.1	19.4	15.4	13.9	13.2	14.0	15.1	14.7	18.3	20.7	21.0	20.6	25.3	33.1	49.9	53.3	61.3	58.0
Imports (% of GDP)	8.5	7.2	8.1	7.3	6.3	5.4	5.3	4.8	4.4	4.4	5.2	5.3	5.9	6.1	7.1	6.9	7.6	7.5
Trade Balance (US\$ Billion)	1.1	0.8	6.5	13.1	12.4	8.4	11.1	19.1	16.1	10.7	10.6	15.2	13.3	10.4	-3.4	-5.6	-8.3	-6.9
Resource Transfer (% of GDP)	-0.4	-0.7	2.6	6.2	5.4	2.6	3.4	5.6	3.5	1.7	1.9	3.4	2.2	1.1	-1.4	-1.6	-2.2	-2.0
Current Account Balance (US\$ Billion)	-11.7	-16.3	-6.8	0.0	-0.2	-4.5	-1.4	4.2	1.0	-3.8	-1.4	5.9	-0.4	-1.3	-18.0	-23.7	-33.4	-35.0
Foreign Direct Investment (US\$ Billion) <sup>e</sup>	1.8	1.4	0.9	1.1	0.8	-0.1	0.6	2.3	0.7	0.6	0.6	1.4	0.6	1.9	3.9	9.4	16.9	26.0
Privatization	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2.6	5.2	6.1
Foreign Portfolio Investment (US\$ Billion)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.1	0.2	-0.1	0.1	0.6	1.7	6.7	7.3	2.3	6.0	5.3	-1.8
Foreign Reserves (US\$ Billion) <sup>b</sup>	7.5	4.0	4.6	12.0	10.5	6.8	7.5	9.1	9.7	10.0	9.4	23.8	32.2	38.8	51.8	60.1	52.2	44.6
Gross External Debt (% of GDP)	28.6	31.5	49.5	53.8	49.8	43.1	42.9	37.1	27.8	26.3	30.5	35.1	33.9	27.3	22.6	23.2	24.9	30.3
Gross External Debt (US\$ Billion)	74.0	85.5	93.7	102.1	105.2	111.2	121.2	113.5	115.5	123.4	123.9	135.9	145.7	148.3	159.3	179.9	200.0	235.1
Medium and Long Term Disbursements (A)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	11.8	15.4	31.3	4.3	6.0	28.2	13.2	54.8	17.6	27.1	47.3	59.8
Amortizations (US\$ Billion) (B)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	13.5	15.2	34.0	8.7	7.8	8.6	10.0	50.4	11.0	14.4	28.7	33.6
Net Flow of Loans (US\$ Billion) (A-B)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-1.7	0.2	-2.7	-4.3	-1.8	19.7	3.2	4.4	6.5	12.7	18.6	26.2

Sources: Central Bank, IBGE and Ipea.

<sup>a</sup> Selic interest rate deflated by the IGP-DI c.

<sup>b</sup> Stocks in December.

<sup>c</sup> Number of workers in São Paulo's industry.

<sup>d</sup> Industrial sector (PIM - IBGE).

<sup>e</sup> From 1980 to 1986, direct investment in portfolio + foreign direct investment.

n.a. = not available.

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