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**PRIVATIZATION
IN BRAZIL:
THE CASE OF
PUBLIC UTILITIES**

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THE MACROECONOMIC BACKGROUND AND INSTITUTIONAL FRAMEWORK OF BRAZILIAN PRIVATIZATION*

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Abstract

This paper reviews the macroeconomic environment and institutional framework of the Brazilian Privatization Program since the early 1980s. It discusses the original rationale for privatization and how it gradually changed in response to developments in the economic situation. Despite the importance of changes in political perceptions, it shows that the deterioration in the macroeconomic environment has been the single most important driving force behind Brazilian privatization. Nonetheless, privatization was not an important element in the many stabilization plans launched until 1995. Starting in 1996, privatization assumed a major role in controlling the rise in public debt, while at the same time helping to finance the current account deficit. Privatization will continue to play this role in the near future, particularly if the large remaining public companies are included in the program after the sale of the electricity sector.

1. Introduction

Ever since the first oil shock, the focus of Brazilian economic policy has been shifted from growth to stabilization. It is no coincidence that the attitude towards state-owned enterprises (SOEs) also began to change during the period, eventually leading to one of the world's largest privatization programs. A link between privatization and macroeconomic policy was gradually developed as Brazil struggled to stabilize the economy and resume sustained growth for the past quarter century. When the executive sent Provisional Measure 155 to the National Congress in March 1990, containing what would become the framework legislation of the Brazilian Privatization Program (PND), its intention was to use privatization for reducing the public debt to consolidate the stabilization plan launched at the same time.

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Since then, Brazil has had three presidents – one of whom was impeached, another an opponent of privatization – and nine finance ministers. Their economic management was marked by many setbacks and a few successes. Despite the expanding scope of privatization, the PND retained throughout the period the same legal and institutional framework, which was largely based on the experience of the 1980s. However, the underlying goals of privatization, the arguments for it, and the link between privatization and macroeconomic policy have all changed.

The importance of macroeconomic objectives in encouraging and shaping privatization has been long recognized in the literature. Much more controversial is the relevance of privatization in supporting successful stabilization programs.¹ The Brazilian experience is interesting because it provides evidence of effects in both directions. Five aspects of the link between privatization and macroeconomic policy in Brazil are of particular interest.

First, poor economic performance has been the single most important reason for privatization in Brazil. Privatization limits the government's freedom to pursue interventionist economic policies, compelling it to adopt a more market-oriented development strategy. Political support for privatization increased because it was necessary to curtail public expenditure and because the unsuccessful attempt to use SOEs as an instrument of macroeconomic policy in the 1980s led to a profound deterioration in the quality of the services offered by these companies.

Second, until quite recently privatization was not a central element of the country's macroeconomic policy. It nonetheless played an important role in signaling a commitment to state retrenchment, without which it might have been more difficult for Brazil to obtain access to foreign capital markets.

Third, failure in reducing inflation limited governments' possibilities for pursuing a more ambitious privatization program.

Fourth, privatization has been essential for sustaining the Real Plan, a role it will continue to play in the coming years. The large privatizations of 1997-98 enabled Brazil to attract significant foreign direct investment, which helped finance the large current account deficit and keep the public debt from getting out of control, despite the large public deficits registered since 1995.

Fifth, although the importance of privatization in macroeconomic terms has recently been acknowledged, its short-term impact has been emphasized, with its permanent fiscal benefits, estimated to be substantial, being almost entirely neglected.

1 See, for instance, Kikeri *et al.* (1992), Wright (1994) and Pinheiro and Schneider (1995).

The main objective of this paper is to describe the macroeconomic and institutional background of the privatization of public utilities in Brazil. To illustrate the many facets of the link between macroeconomic objectives and privatization, and to show how the institutional framework developed, our analysis begins with seedtime of Brazilian privatization in the mid-1970s. Following this introduction, the economic deterioration and state retrenchment in the 1970s and 1980s are discussed. Section 3 describes the performance of the economy and privatization during the Collor and Franco administrations. Section 4 does the same for the first Cardoso government, when the privatization of public utilities began. Section 5 presents the results of privatization until March 1999 and discusses the outlook for 1999-2000. Section 6 provides some final observations.

2. Developments in the 1970s and 1980s: Forging Brazilian-style Privatization

It is possible to date the beginning of state retrenchment in Brazil to as early as 1974, when former Finance Minister Eugênio Gudin, a well-known liberal, was selected as “Man of the Year” by the then highly influential *Visão* magazine [Lamounier and Moura (1983)]. Gudin observed on that occasion: “We live, in principle, in a capitalist system. But Brazilian capitalism is more controlled by the state than in any other country, except for those under communist regimes.” Gudin’s speech was followed by a series of 11 articles on “The Path to Statization” in the *Estado de S. Paulo*, one of Brazil’s most important newspapers. They were followed by a number of public protests by the business community, which became known as the “Campaign Against Statization”.²

At that time Brazil was emerging from the most authoritarian period of military rule and entering a period of gradual political détente continuing until the second half of the 1980s. These public outcries against state intervention might be interpreted as deeply rooted feelings of the business community which could finally be expressed. However, it is more likely that these complaints were a response to economic changes that occurred at the beginning of the Geisel administration. Particularly important in this respect were the unfavorable prospects of a deceleration of economic growth and the harsh policies for adjusting to the increase in oil prices and the international recession (which, as we now know, were not actually implemented). Under that scenario, the SOEs would have augmented their competition with private firms in input and output markets.

2 For a description of the early stages of privatization in Brazil see Pinheiro and Oliveira (1991).

The government reacted to these complaints by adopting measures to strengthen the competitive position of privately owned Brazilian companies *vis-à-vis* the SOEs and multinational firms, including use of trade barriers and subsidized credit. Meanwhile, the state bureaucracy and society in general still regarded the SOEs as “national champions”. By the end of the Geisel administration, however, rising inflation and deteriorating external accounts began to make it evident that the expansion of the SOEs had to be controlled. The military would even begin to contemplate the sale of some of the SOEs, which had been forcefully rejected by Geisel’s ministers in the mid-1970s.³

The 1980s were a period of economic hardship. In 1981-89, per capita GDP rose 0.3 per cent per annum, the public operational deficit averaged 5.1 per cent of GDP,⁴ inflation accelerated from 95 per cent to 1,783 per cent⁵ and investment declined from 21 per cent of GDP in 1980-82 to 17.1 per cent of GDP in 1987-89, with scarcely any foreign direct investment coming into the country. However, the sources of economic distress had not been the same in the first and second halves of the decade, Brazil had been severely hit by the second oil shock and the concurrent increase in international interest rates, being especially vulnerable to the latter after relying for years on external financing to delay long-needed adjustments. Thus the early 1980s were dominated by the need for a dramatic adjustment in the external accounts, as financing for Brazil’s large current account deficit dried up after Mexico’s moratorium in 1982. Economic policy aimed at generating large trade surpluses, with a large exchange rate devaluation and a sharp contraction of GDP in 1983.

In the second half of the decade, as the pressure on the external accounts receded, policy makers shifted their attention to price stabilization. Inflation, which had risen in the 1970s, went out of control in the second half of the 1980s, fueled by a large public deficit and sustained by sophisticated indexing mechanisms. The Cruzado Plan in 1986 which attempted to deal with inflation by freezing prices soon failed because of a continuing huge public deficit, an excessive increase in the money supply and an 8 per cent decline in crop output. Other price freezes in 1987 and 1989 were no more successful, as the economic fundamentals continued to deteriorate.

Throughout this period, economic policy tried to control domestic absorption with varying degrees of success, first to

3 Soon after taking office, in 1979, President Figueiredo recommended to his ministers “the privatization of state companies and services not strictly necessary to correct market imperfections or to attend the needs of national security” [Palatnik and Orenstein (1979, p. 52)].

4 The operational deficit differs from the nominal deficit used in most countries because it considers expenditures with real rather than nominal interest rates. For the remainder of this paper, the terms deficit or “borrowing requirements” are to be understood as the operational deficit.

5 Accumulated inflation in the year. Unless stated otherwise, inflation rates are measured using Getúlio Vargas’s General Price Index (IGP-DI). See table in the Annex for key economic indicators in 1980-98.

achieve external balance and later, domestic equilibrium. Direct price interventions were also a staple component of economic policy, initially with the aim of increasing competitiveness of domestic producers and, from 1985 onwards, in the attempt at fighting inflation. In both instances, the SOEs were called upon to contribute to macroeconomic objectives [Werneck (1987 and 1988)]. In the early 1980s, these companies were ordered to borrow heavily on foreign markets to help finance the current account deficit. As a consequence, they were severely hit by the large 1983 devaluation. The prices of the goods and services that they produced were artificially reduced, first to increase export competitiveness and later as an element of heterodox attempts to control inflation. Policies to reduce domestic absorption led to a reduction of SOE investment, which fell by almost a third (1.5 per cent of GDP) between 1980-82 and 1987-89. The use of SOEs as instruments of macroeconomic policy contributed to a deterioration in the management of these companies (increased political interference was another major contributor to this) and greatly harmed the quality of their output.

The government established a Special Secretary of Control of State Enterprises (Sest) in 1979, to make sure that macroeconomic objectives were introduced in the daily management of SOEs and, in particular, that growth in SOE expenditures was limited. Annually, all federal SOEs had to obtain Sest approval of their investment, import and other expenditure plans [Werneck (1987)]. Under Sest, the orientation of privatization shifted from supporting private companies to impeding the expansion of the SOEs. The reason for that shift was not political, since public ownership of most of those companies continued to be seen as making an essential contribution to economic development and national security.

One of Sest's first actions was to conduct a census of federal public institutions. It identified a total of 505 such entities, with 268 of them being classified as SOEs. It was not until 1981, however, that a "Special Privatization Commission" was created, the first concrete step towards divesting state assets. This commission identified 140 companies that could be privatized in the short term, listing 50 of them for sale. Twenty SOEs were sold in 1981-84, one was rented and eight were absorbed by other public institutions. Revenues totaled US\$ 190 million.

The World Bank (1989) considered Brazil's first "flirt" with privatization a "classical example of failure." The most important of several factors contributing to that was a lack of political commitment, as the government was primarily trying to limit the expansion of SOE expenditures to reduce domestic absorption, not altering state intervention in the economy, as such. In fact, in that same initial period the Brazilian Development Bank (BNDES) absorbed six bankrupt private companies. Other major impediments to privatization were concerns about "national se-

curity” and denationalization of the economy. It is revealing that Sest enjoyed much more political prestige throughout the 1980s than any of the privatization commissions that were established at the time.

Privatization continued during the Sarney administration (March 1985-March 1990) at the same slow pace of the previous period, even though official rhetoric changed considerably. Eighteen companies were sold and generated proceeds of US\$ 533 million. Another 18 companies were transferred to state governments, two were incorporated into federal institutions and four were closed down. The same problems remained: a lack of political commitment,⁶ high inflation, low and irregular growth, and restrictions on potential investors, e.g. foreign investors were excluded.

A key feature of this early experience of privatization was the role of the BNDES. Of the 268 SOEs identified in Sest’s census, 76 were companies that had previously been privately owned. Several of these were subsidiaries of BNDES, which had become their shareholder either voluntarily or because they defaulted on loans extended by the bank. As most of those companies continued to show losses, a substantial part of BNDES’s financial and human resources were being used in their management. The bank on its own volition then decided to sell these companies and rid itself of this burden.⁷ The procedures developed by BNDES for the sale of those companies – e.g. sale by public auction at the stock exchange, use of a consulting company to propose a minimum price and the use of an auditing firm to supervise each process – were later adopted in the current privatization law. Likewise, many of those who managed privatizations in the 1990s had also participated in the early privatization effort.

3. The Early 1990s: Getting the National Privatization Program Started

By the late 1980s the situation was rapidly changing. The economy continued to deteriorate, with inflation reaching record levels. Sest’s failure to control federal SOE expenditures also

6 In fact, while privatization advanced, the new Constitution of 1988 was enacted establishing a series of public monopolies in areas such as telecommunications and oil and limiting foreign participation in mining and electricity.

7 The strategy was described by Marcio Fortes (1994), then BNDES’s president, in this fashion: “Privatization, in fact, was not a central policy. It was the need that BNDES had, in the first place, to generate resources from its own assets; in the second place, of gaining liquidity for its normal activities; and in the third place because its own internal administration was greatly harmed by the accumulation of management tasks necessary in its daily activities, since it was the owner or majority shareholder of more than 25 companies of great complexity.”

became evident, as demonstrated by the substantial increase in wage expenditures in 1989 [Pinheiro and Giambiagi (1997)]. In this period conventional wisdom regarding the state's role in economic development was changing dramatically at the level of state policy. An import-substitution strategy was being supplanted by a more open, deregulated economic model. Privatization became one of the top priorities of the new administration. Soon after taking office, the new government in March 1990 sent to Congress Provisional Measure 155 which became Law 8,031, which established the National Privatization Program (PND) and most of the rules still governing it.

The institutional framework for the PND was based on the BNDES' experience in the 1980s. A Privatization Steering Committee became responsible for supervising the program and deciding on key issues, such as recommending companies to be included in the PND to Brazil's president and approving the methods and conditions of sale of the SOEs, in particular the minimum auction price.⁸ The BNDES was assigned the tasks of daily management of the PND and implementing the directives established by the Privatization Committee. To fulfill these tasks, the BNDES selects via public tender two consulting firms (or consortia of firms) to handle each of the companies to be sold. The first consulting firm conducts an appraisal of the company and recommends a minimum price. The other, besides conducting a similar appraisal, points out obstacles to privatization, proposes solutions, identifies potential investors and suggests a sale's method. The Privatization Committee then defines a minimum auction price for the company based on the appraisals of the consulting firms. Less apparent, but also important for the transparency of the PND, is the auditing firm that follows every step in the sale's process for each SOE. A sale can be closed only after this firm publishes a proper audit report. Every privatization is also closely monitored by a subcommittee of the House of Representatives, the judiciary and by the Federal Audit Court, which regularly publishes an opinion on the minimum price established for companies being sold. Almost all sales have been the subject of court rulings concerning many different issues.

A distinguishing feature of the PND, particularly until 1996, was that investors could pay for SOE shares not only with cash but also with many types of public debt securities, which were accepted at face value, despite being traded in the market at sizable discounts. These securities were primarily unpaid government debt, dubbed "junk money" by the press. To understand the rationale behind this decision it is important to consider the macroeconomic context in which the PND was initiated.

8 This Committee consisted of 12 to 15 members, nominated by the President of the Republic and the Senate and approved by Congress. Only five of those members belonged to the government.

The Collor administration took office amidst rampant inflation – 84 per cent a month in early 1990 – and concerns about the possibility that the government might halt service of its rapidly growing debt. The need for decisive action was evident, but the drastic measures adopted surprised most analysts. After a bank holiday of three working days, a large proportion of the economy's financial assets was frozen in the Central Bank. These assets would remain there for 18 months, to be later returned in 12 monthly installments. An estimated US\$ 40 billion in new cruzados (then the Brazilian currency) had been frozen. The main rationale for this strategy was the prevailing belief that the high liquidity ratio of the public debt was a major contributor to the runaway inflation recorded at the end of President Sarney's term in office.

The government thought it could return these savings to the public without creating problems like those faced by its predecessor, by encouraging people to use the savings to buy shares of the SOEs being privatized. Thus when the PND was launched the government intended to rapidly privatize large companies. At the beginning of May 1990 privatization revenues for the year were projected to reach US\$ 9 billion, a figure reduced to US\$ 7 billion later in the month, and then to US\$ 4 billion in July 1990. However, the link between privatization and the stabilization program was affected by a failure to meet any of these targets, for not a single company was privatized in 1990. There could be no virtuous cycle in which savings blocked at the Central Bank would generate demand for SOE shares and a reduction in the stock of new cruzados would have helped consolidate stabilization. Problems in management of both programs accounted for that.

Privatization under the PND would turn out to be much more difficult than initially anticipated. The many safeguards in Law 8,031 for preventing wrongdoing in the PND and for insuring its transparency, which would later prove invaluable [Abreu and Werneck (1993)], caused each sale to take months. Delays were also caused by the poor financial health of most companies being privatized and by the need to renegotiate shareholder agreements with domestic and foreign private investors. Another cause of delay was that rulings had to be obtained to overturn lower court decisions blocking several of the most important sales. In the case of Usiminas alone, the first company to be sold, the government had to settle 37 different lawsuits before the sale could proceed.

Therefore, when Usiminas was actually sold late in 1991 the private savings frozen at the Central Bank were already drifting back into the economy and the government's original targets for the PND had to be trimmed down. The delay would also compromise the objective of selling part of the shares in a flotation that would "democratize" share ownership. In addition, the delay also contributed to a reduction in the expected revenue from

Privatization Certificates (CPs).⁹ Only about half of the US\$ 2.7 billion which the government originally hoped to collect from the CPs was actually obtained, and they were paid for with other public debt securities rather than with cash, as initially expected. Although the initial rules of the PND anticipated only the use of new cruzados, CPs and foreign debt securities as alternatives to cash payments, as time went on an increasing number of types of government debt were also transformed into “privatization currencies”. These included medium and long-term debts of state enterprises and of the federal public sector.

Several factors contributed to the decision to accept these other debts as a means of payment. First, the acceptance of these currencies allowed the creation of long-term financing instruments that would not have been available otherwise. In this way, BNDES did not have to finance the buyers of SOEs directly, as in the 1980s, which would have been politically impossible in the early 1990s.¹⁰ Second, the transfer of SOE debts to the National Treasury and their securitization made these companies much more attractive to private investors: in several cases, in fact, privatization would have been hard to accomplish otherwise. Third, acceptance of these debt securities as privatization currencies assured that these proceeds were not used to finance increased expenditure.¹¹

Economic performance in 1990-92 was disappointing, with GDP contracting by an average of 1.3 per cent per annum. In 1992, inflation reached 1,158 per cent, the investment rate declined to a record low of 14 per cent of GDP, and the unemployment rate rose to 5.8 per cent. The failure to stabilize the economy, in turn, made privatization much more difficult, since it increased the risk of investing in Brazil. Foreign investors were further discouraged by the lack of an agreement regarding the negotiation of Brazil's external debt. But this environment also made moving ahead with privatization essential to increase the government's credibility, demonstrating its intention to change the status quo, particularly to the foreign investors and multilateral institutions which the government needed as allies for implementing the necessary reforms and avoid hyperinflation.

In September 1992, when President Collor was impeached and replaced by Vice-president Franco, many feared for the future of the PND. Franco had openly voiced his opposition to the sale of Usiminas and in several episodes had clashed with the presi-

9 Privatization Certificates were a security created in March 1990, which financial institutions and insurance companies were compelled to acquire, and which could be used only as a means of payment in the privatization auctions.

10 Direct financing, either by BNDES or the National Treasury, would become the norm once more when the use of privatization currencies was abolished.

11 During the early 1990s, privatization currencies were the buyers' instrument of choice for acquiring SOEs. However, those debts did not appear – due to flaws in fiscal statistics – in the official reports disclosed by the Central Bank. Consequently, although privatization was indeed reducing the “actual” public debt, according to official reports the net effect was practically nil for a number of years.

dent of the BNDES, then president of the Privatization Committee. However, after a three-month embargo, during which all procedures of the PND were scrutinized (but not substantially changed), the Franco government continued the privatization process, while emphasizing large cash payments,¹² a broader distribution of share ownership, and the inclusion of minority stakes held by the state, directly or indirectly, in a number of companies.¹³ The law was also changed to allow the unlimited participation of foreigners in the PND.¹⁴ In the end, the PND privatized more companies and collected more revenue under the Franco government than in the previous administration, despite the president's initial lack of enthusiasm for the process. Privatization had passed from being a government policy to becoming a reform with wide political support.¹⁵

On the macroeconomic front, the Franco government brought interest rates down, allowing the economy to expand, reducing unemployment and encouraging higher rates of investment. At the same time, however, inflation continued to escalate. For this reason, the most remarkable occurrence during his administration was the launching of the Real Plan, which brought inflation down from an annualized rate of 7,336 per cent in the first half of 1994 to 91.7 per cent in the second. The reduction in inflation caused real incomes and the supply of credit to increase, providing further momentum to the recovery that began in 1993. In 1993-94 the GDP grew 11.1 per cent. Meanwhile, privatization continued to serve as a sort of "seal of quality" for economic policy, a sign of commitment to "market-oriented reforms". This placed Brazil in a competitive position among emerging countries for attracting substantial capital inflows in a world setting in which money was abundant.¹⁶

The PND represented a major expansion in the scope of privatization, its first sale alone generated more revenue than all previous privatizations. Most manufacturing SOEs were privatized in 1991-94, including all public companies in the steel and fertilizer sectors, most in the petrochemical sector, and a number of SOEs in other sectors. Interestingly, the arguments in

12 Since January 1993, a floor has been established for the use of cash in the payment for the companies. This floor is set, on a case-by-case basis, directly by the President of the Republic. For a discussion of the trade off between payments in cash or debt securities see Pinheiro and Landau (1996).

13 About 600 minority stakes were included in the program, which adopted a simplified procedure for their sale.

14 The participation of foreign investors, forbidden in the 1980s, was allowed in the PND by Law 8,031, which however stipulated that a foreign investor could acquire no more than 40 percent of the SOE voting capital, unless express authorization to the contrary had been voted by Congress. Other restrictions, many of which related to the use of foreign debt as a privatization currency, were introduced in 1990, to be gradually discontinued without ever having had major influence.

15 For further discussion of Brazilian privatization in the first half of the 1990s, see Abreu and Werneck (1993), Mello (1994) and Pinheiro and Giambiagi (1994).

16 This indirect "signaling", much more so than the dollars coming into the country directly via privatization, was a key factor behind the decision to proceed with privatization efforts during the Franco administration, despite his own opposition to it expressed early into the PND.

the early 1990s for increasing the scope of privatizations downplayed their increasing macroeconomic importance. Rather, the main arguments were:¹⁷

i) The state should not perform activities that the private sector was fully capable of undertaking.¹⁸ Instead, it should focus its efforts on areas such as education, health care, law enforcement, and regulation.

ii) Privatization would boost the investment of former SOEs, compared to what would occur if they remained state-owned, and it would raise their productivity by adopting more efficient technologies. Likewise, under private control and free from political interference and government controls, the companies would become more dynamic and efficient [Pinheiro (1996)].

iii) Privatization would reduce the concentration of stock trading and possibly increase the number of shareholders in the capital market.

iv) Dividing public monopolies into several companies or selling SOEs in the same sector separately (as in the case of sheet steel) would create a more competitive environment, leading to an increase in technical and allocative efficiency.

Although the fiscal impact of privatization was recognized in the literature, it was deemed of little significance.¹⁹ Privatization of the SOEs was expected to bring a permanent fiscal gain as a result of their future higher profitability in private hands, which would encourage buyers to pay more for them than they would be worth to the government. This higher profitability would also generate an increase in tax revenues. By the same token, privatization would free the government from the obligation to finance investment in the privatized companies, and in this way provide immediate fiscal relief. Finally, the use of privatization proceeds to repay public debt would bring fiscal benefits, since the interest rate on the public debt was much higher than the rate of return the government earned as a shareholder in its

17 Article 1 of Law 8,031 states the program's "main purposes": "I - To change the federal strategic approach to economic policy through the transfer of activities unduly performed by the public sector to private initiative; II - To reduce the government debt and thus help to bring relief to public finance; III - To assist in the resumption of investment in companies and activities transferred to the private sector; IV - To help modernize the Brazilian industrial complex, improving its competitiveness and strengthening the entrepreneurial capability of the several sectors of the economy; V - To free the public administration to center its efforts in areas where government action is vital in order to accomplish national priority goals; VI - To help strengthen the capital market by an increased offering of tradable securities and opening up equity ownership in the companies included in the program."

18 In the early 1990s this reasoning was used to justify privatization of industries with a sizable participation of private firms, such as steel, petrochemicals and fertilizers. This argument was later used to support privatization in sectors with scarcely any private activity, such as telecommunications.

19 For a discussion of the fiscal impact of privatization, see Werneck (1988), Mello (1994), Pinheiro and Landau (1996), Pinheiro and Giambiagi (1997) and Pasanezi (1997).

companies [Pineiro and Giambiagi (1997)]. However, because the magnitudes in this first stage of the PND were small in macro-economic terms, so was the size of the permanent fiscal gain.

4. Macroeconomic Policy and Privatization in Cardoso's First Term

The performance of the Brazilian economy in 1995-98 made a marked contrast with that prior to the Real Plan. Until June 1994 the economy had sky-high inflation, a depreciated exchange rate, sizable trade surpluses, a balanced current account, and a low operational deficit. In contrast, during Cardoso's first term in office there was, on average, an annual inflation of 8.2 per cent, an expansion of the GDP of 2.7 per cent per annum, an investment rate of 17.1 per cent of the GDP (in constant 1980 prices), a trade deficit of US\$ 5.9 billion, a current account deficit of 3.6 per cent of the GDP, and a public deficit of 5.2 per cent of the GDP. Therefore, the most visible success under Cardoso was the maintenance of price stability, while moderate growth resumed. In 1998 inflation declined for the fifth year in a row, to just 1.7 per cent, something unheard of since Brazil started to measure inflation regularly back in 1944. In addition, inflation was measured in single digits for the third consecutive year, another first in the country's history.²⁰

Early into the Plan, a contributing factor to the spectacular reduction in inflation was the appreciation of the exchange rate. After beginning at parity with the dollar, the real appreciated for five consecutive months to a high 0.84 R\$/US\$. Appreciation of the real was greater than inflation, still above 1 per cent per month. Meanwhile, the economy was clearly heating up, with the GDP expanding 10.1 per cent in the first quarter of 1995 compared with the first quarter of 1994. As a result of the appreciating exchange rate, the booming economy and the consolidation of distribution channels of imports the trade account moved into a deficit, despite the continued expansion of exports. After a lag, the Mexican crisis would bring an abrupt end to this policy stance. In March 1995 interest rates were increased and the real was devalued 5.2 per cent. Since then, and until the end of Cardoso's first term, the government pursued a policy of small periodic devaluations and high interest rates. Until the Russian crisis this policy served to limit the growth of domestic demand and insure a surplus in the capital account. In fact, if there is a thread of continuity in the economic policy of the 1990s, it has been a use of high interest rates as the practically the only instrument to manage aggregate demand.

20 Prior to 1994, annual inflation remained below 10 per cent only in 1947, 1948 and 1957. In 1983-94, annual inflation fell below 100 per cent in only one year (1986, when it was 65 per cent).

Fiscal policy continued to be as lax as it had been in most periods since at least the early 1980s. That is, the low deficit of the early 1990s was not the result of fiscal discipline, but largely due, instead, to the so-called “Tanzi effect on expenditures”, by which the government reduced the deficit, in a period of accelerating inflation and highly sophisticated tax indexation, simply by deferring disbursements.²¹ With price stability and high interest rates, the fiscal accounts deteriorated, leading to a substantial increase in public debt, putting further pressure on interest rates. Thus the fiscal deficit rose to 5 per cent of the GDP in 1995 and reached 7.8 per cent of the GDP by the end of 1998. Public sector debt also increased sharply, from 26 per cent of the GDP in 1994 to near 38 per cent of the GDP in 1998 (in both instances, excluding the monetary base). In spite of high interest rates, private consumption and investment did not contract to compensate for the growth of the public deficit, so the current account deficit increased substantially, peaking at 5.5 per cent of the GDP in the fourth quarter of 1997. The Asian crisis forced the government to raise interest rates again, cooling off the economy, but with little impact on the current account, which recorded a deficit of 4.5 per cent of the GDP in 1998.

The large deficits in the fiscal and current accounts played an important role in broadening and speeding up the privatization program. They also contributed to the discipline of using proceeds to redeem public debt rather than for increasing expenditures. However, this would not occur immediately. Indeed, Cardoso’s inauguration was seen as a sort of anticlimax by those who believed that his election would immediately speed up the privatization program. In the climate prevailing in 1995, President Cardoso criticized the then director of the BNDES in charge of privatization, when she proposed the sale of Companhia Vale do Rio Doce, and there was lack of a clear commitment by policy makers during the privatization of Telebrás. Given these developments, more than one analyst questioned the new government’s commitment to privatization.²²

21 Because expenditures are set in nominal terms (or, at best, include backward looking indexation), a delay *vis-à-vis* the original schedule allows the government to slash the actual amount spent; e.g. a one-month delay when inflation is 25 per cent a month and there is no indexation reduces real expenditures by 20 per cent. Note that in the three and a half years ending in June 1994 inflation averaged 31 per cent per month. Other artificial means of “balancing” the budget were the once and for all taxes collected in 1990, as part of the plan launched in March 1990, which heavily taxed financial wealth, and, until 1992, the reduction in interest expenditures that resulted from freezing private savings at the Central Bank. On how much inflation contributed to the “adjustment” of government accounts in the early 1990s, see Bacha (1994).

22 An example of this skepticism is the statement by Carlos Ivan Simonsen Leal, a respected economist from the Getúlio Vargas Foundation, to the effect that “we see a clear determination on the part of the government not to privatize anything” [*Jornal do Brasil* (October 1, 1995)]. At about the same time, the economic newsletter published by Banco da Bahia – a good yardstick of financial market “moods” – stated that “the government does not include privatization in its list of priorities” [*Weekly Economic Outlook* (September 11, 1995)]. This opinion was reaffirmed a month later, when it was remarked that “Mr. Cardoso’s administration does not believe in privatization as a priority” [*Weekly Economic Outlook* (October 9, 1995)].

But circumstances changed with time, and privatization moved up in the government's agenda to a ranking it had not previously enjoyed.²³ In retrospect, it can be seen that during the Cardoso administration privatization began its longest, most important and most difficult phase. This phase has included companies in mining and infrastructure, the extension of privatization to states and municipalities, and a change in the role of the public and private sectors in the economy to an extent not anticipated in earlier stages. This third phase of Brazilian privatization contrasts with the two preceding ones in three respects: *institutional form, scope and objectives*.

The changes in the institutional framework were initiated in January 1995 with the substitution of the National Privatization Council for the Privatization Committee, which brought the management of the process much closer to the central government.²⁴ The PND itself was maintained almost intact, but other important changes in the legal and institutional framework were made after the enactment of the Concessions Law (Law 8,987) in February 1995 and the constitutional amendments approved later in that year. The Concessions Law regulated Article 175 of the Constitution and introduced important changes in the rules governing the concession of public services.²⁵ In particular, it (i) introduced a system of penalties proportional to the fault perpetrated by the concessionaires;²⁶ (ii) created the possibility for large consumers to choose their suppliers, ending the local monopolies previously imposed by the law; (iii) established that rates no longer have to be based on cost-of-service regulation (rules on rates are now defined in the concession contract); (iv) emphasized the value of charges to consumers as a criterion for selecting among bidders for a concession; (v) stipulated that all concessions will be awarded for a fixed term, being renewed through a new bidding process; (vi) prohibited public subsidies to concessionaires; and (vii) entitled consumers to participate in the supervision process of the concession.

Also important were the 1995 constitutional amendments that discontinued public monopolies in telecommunications – necessary to permit the privatization of Telebrás – the distribution of gas by mains and in the oil sector.²⁷ Finally, the distinction

23 For the sake of fairness, it must be noted that even when apparently doing nothing for privatization, the government was taking the first steps to prepare the companies for sale, an activity often not properly appreciated, but without which privatization would simply be unfeasible. Examples are the splitting of Light into two companies, negotiations with governors to privatize state power utilities, and the drafting of the new regulatory framework for the telecommunications sector.

24 The National Privatization Council is formed by the ministries of Economic Development; Civil House; Finance; Public Administration; Industry, Commerce and Tourism; and the president of the Central Bank, if the decisions concern a financial institution.

25 The Concessions Law sets general guidelines for concessions. Specific laws apply to each sector (e.g., Law 9,074 in the case of electricity).

26 Previously, the only sanction applicable was ending the concession, which was so radical that it was never used.

27 Although the government promised not to sell Petrobrás, this constitutional change was essential to attract private investment and establish competition in the sector.

between Brazilian companies owned by domestic and foreign capital was abolished, paving the way for privatization in the mining and electricity generation sectors.

The *scope* of privatization was enlarged with the creation of the privatization programs at the state level and the extension of the PND to other sectors.²⁸ Privatization at the state level is important for its more pronounced fiscal impact and because it illustrates more vividly the influence of macroeconomic considerations in the decision to privatize.²⁹ As Table 1 shows, non-federal companies were responsible for most of the SOE fiscal deficit. In 1994-98, while federal SOEs showed a fiscal surplus of 0.4 per cent of the GDP, their state and municipal counterparts recorded a deficit of 0.7 per cent of the GDP. Privatization in states also played a central role in the process of debt restructuring, in which most states participated during Cardoso's first administration. The debt negotiation consisted of the transfer of state debts that pay market interest rates to the federal government, with future state revenues (over a 30-year period) as collateral. Since the real interest rate on the loan by the federal government to the states is 6 per cent, and the market interest rate is greater (Table A.1), the arrangement involved some "federalization of state losses". In an attempt to minimize these losses and to decrease the total deficit of the SOEs, the federal government required states entering into debt rescheduling agreements to settle 20 per cent of the principal through the sale of assets.³⁰ This requirement became a major inducement for the states to engage in their own privatization programs.

After the sale of the remaining manufacturing SOEs, at federal level the scope of privatization was broadened by the inclusion of public companies in mining, electricity, railways, ports, roads, telecommunications, water and sanitation, and banking. This required a much greater commitment by other

Table 1
Brazil: SOE Borrowing Requirements - 1994-98
(% of the GDP)

	1994	1995	1996	1997	1998*
Federal Companies	-1.66	-0.19	-0.12	-0.20	0.05
State & Municipal Companies	1.27	1.06	0.43	0.48	0.30
Total	-0.39	0.87	0.31	0.28	0.35

* Authors forecast, based on nominal results up to November 1998.

(-) = surplus.

Sources: Central Bank and Sest.

28 It is noteworthy that several municipalities also started their own local privatization processes. For instance, Ribeirão Preto privatized its telephone company, Rio de Janeiro the concession of a local freeway, Limeira its sewage system.

29 As explored in another chapter of this volume, privatization at state level was also essential to allow divestiture of federal electricity generation companies.

30 For some states, this down payment amounted to 10 per cent of the rescheduled debt, but for these the real interest rate charged by the federal government was 7.5 per cent, rather than 6 per cent.

ministries to the privatization process and involved fighting more deeply “entrenched” interests. In fact, the privatization of roads and telecommunications was carried out directly by the ministries concerned with those sectors, without going through the PND.

Privatization had to overcome a series of “life or death” obstacles during this period. The process began in 1996 with Light, the largest company sold until then, and an important breakthrough into the electricity sector. It continued in 1997 with the sale of Vale and ended in 1998 with Telebrás, the largest privatization in the world that year. The privatization of Vale was possibly the most difficult in the whole process. The company, the single largest exporter in Brazil, was perceived to be the most efficient of all the SOEs and for this reason its sale had less political support. The sale itself turned out to be a bloody battle, fought daily in the press and the courts. Before it could sell the company, the government had to contest and win 217 lawsuits, more than a quarter of the total court actions dealing with Brazilian privatization until late 1998.

The change in *objectives* involved a greater emphasis on (i) cash revenues, with the substitution of direct credits by the BNDES or the National Treasury (as in the case of Telebrás) for the indirect financing by the use of privatization currencies; and (ii) on investment commitments in the sectors being privatized. Since the Franco administration the government requested that a minimum proportion of the SOE price be paid in cash, usually between 10 per cent and 30 per cent. As more attractive companies were listed for sale, this proportion was raised and gradually the use of privatization currencies was abandoned. However, these were large companies, and buyers needed financing for their privatization bids. As Brazil remained in the non-investment category internationally and the risk of a large devaluation of the real loomed on the horizon, borrowing in foreign markets could only provide a partial solution. Therefore, the government stepped in, financing borrowers directly by sale in installments or through the BNDES.

Extension of privatization to sectors with more pronounced externalities and with lower profitability required a new approach. This was the case of roads, bridges, sanitation and, to a lesser extent, railways. In these sectors, the privatization model established output targets and/or an investment plan that the new private owner had to abide by. Except for the railways, privatization was carried out in exchange for a commitment to invest, with the winning bidder being the one offering to charge the lowest rates to consumers.

Thus privatization had been broadened and speeded up, but it was not until the 1997 Asian crisis that privatization truly became a crucial issue to the government, assuming a vital role

in the very survival of the Real Plan.³¹ There were two reasons for this development. First, for the first time the amounts received from privatization sales were becoming significant in macroeconomic terms (see next section). Second, as the Asian crisis unfolded, privatization would give the country an edge over other countries that had been or might become prey to speculative attack. In this respect, privatization was seen as a kind of “safety net” or “bridge to stability”, affording the country some leeway for resolving its two main disequilibria, the current account and fiscal deficits. The government planned to resolve both with specifically targeted policies and the so-called “structural reforms” by the time the “once and for all” funding from privatization sales was exhausted within a few years.

The “vital role” alluded to in the proceeding paragraph was twofold. First, privatization trimmed down foreign borrowing requirements to finance the current account deficit. Second, it helped to finance the budget deficit, curtailing the growth of the public debt, which would have reached 32.9 per cent of GDP in 1997 (up from 26 per cent in 1994) were it not for privatization (Table 2).³² Pastore (1997) compares this role of privatization to that of seignorage in the period of high inflation. According to him, in years of high inflation government revenues obtained via currency issues – i.e. seignorage – had been large enough to stem the growth of government debt. From this standpoint, the role of “guardian” against government debt growth played by seignorage prior to 1994 was assumed since 1996 by the proceeds of privatization. Thus privatization “... stems the growth of government debt...” but without preventing it from “... *growing in an unsustainable way once privatization sales come to an end*”

Table 2
Privatization and Public Sector Debt – 1995-97
(% of GDP)

<i>Net Public Debt</i>	1995	1996	1997
Fiscal Debt	27.3	29.0	30.7
Wealth Adjustment	n.a.	1.9	0.1
Privatization	n.a.	-0.1	-2.0
Hidden Liabilities	n.a.	2.0	2.1
Total	27.3	30.9	30.8

n.a. = not available.

Source: Central Bank.

31 The Asian crisis exerted a strong “contagion effect” on Brazil, causing a loss of nearly US\$ 10 billion in reserves between September and November 1997. The authorities reacted by hiking up interest rates, an initiative to be shortly complemented by a “fiscal package” to improve the primary fiscal accounts. The aim was to bear the brunt of a more costly government debt without worsening the nominal deficit. But the government failed to deliver on its promises of fiscal austerity, and the (operational) PSBR jumped from 4.3 per cent to 7.8 per cent of GDP from 1997 to 1998.

32 In Table 2, the net public debt does not include the monetary base, usually included in official statistics. The “wealth adjustment”, divorced from the deficit-related flow factors that affect what is known as “fiscal debt”, results from combining two factors of opposite signs: a) the incorporation of “hidden” liabilities, the so-called skeletons, into the official statistics; and b) privatization, which reduces the debt without entailing a fiscal surplus.

[Pastore (1997, p. 33, our emphasis)].³³ Privatization became instrumental in signaling stability, even if a precarious one, to a market very concerned with the fiscal situation and the chances of sustaining the exchange rate policy. These signs of stability were, in turn, crucial for enabling the country to get through the critical months of November and December 1997, when world markets were closed to Brazil, with the drastic liquidity crunch of the preceding October.

In addition, privatization once more played its role as a “sign of commitment” to the fundamentals, as it had in the first half of the 1990s, but with two differences. For one thing, privatization now also attracted a large inflow of foreign direct investment. For another, the indirect effect of stimulating capital inflows had become more important than prior to 1994 due to the need for financing a high current account deficit, which was not the case in the early 1990s. Thus, as in the early 1990s, when privatization became an asset to the credibility of the Collor and Franco administrations, again in 1997 “in a certain sense, privatization ha[d] wound up creating its own logic, beyond its original objectives” [Pinheiro and Giambiagi (1994, p. 751)].³⁴

5. Results in 1991-98 and Outlook for 1999-2000

From October 1991 to March 1999, 115 SOEs were sold, in addition to minority stockholdings in several private companies, totaling US\$ 69 billion in revenues (Table 3). In addition, debts of US\$ 16.5 billion were transferred to the private sector, reducing the public debt by an equivalent amount. It is worth analyzing these results by year, sector, and type of investor. As shown in Figure 1, while privatization remained restricted to federal manufacturing companies, revenues were of comparatively small, an annual average of US\$ 2.7 billion in 1991-95, although much larger than in the 1980s. Starting in 1996, when privatization was extended to public utilities and the states began their own programs, privatization increased by an order of magnitude. In 1997 alone proceeds surpassed the total collected in the six previous years. Twenty-eight of the 115 companies privatized by early 1999 belonged to the states, and their privatization accounted for about a third of the revenues and debt transfers.

33 For a better understanding of the dynamics of the government debt prior to 1994, see also Giambiagi (1996).

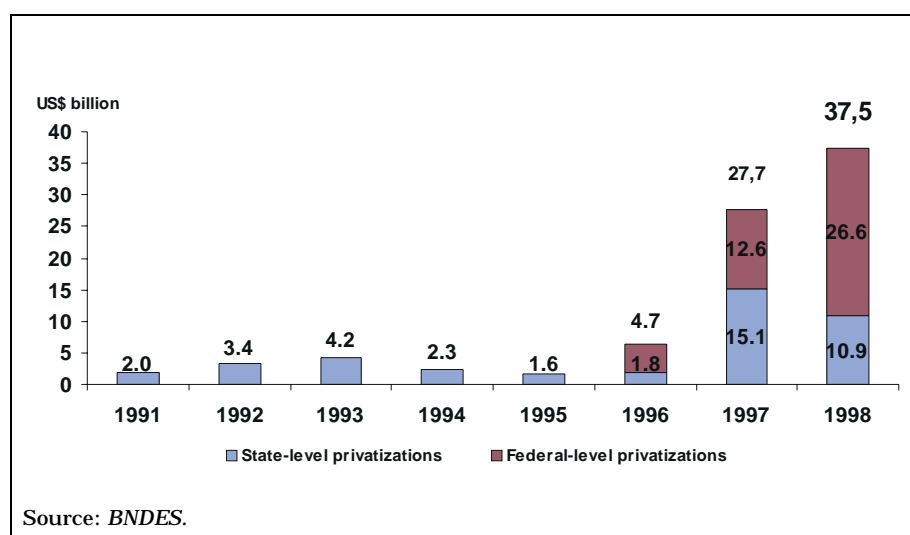
34 It is noteworthy how the public debate has stressed the short-term benefits of privatization, for its role in sustaining price stability, rather than on the permanent fiscal gains it entails. In fact, although the early debate on privatization has emphasized the small magnitude of a permanent fiscal gain arising from Brazilian privatization, the scaling up of privatization in 1996-98 also magnified these gains. Recent estimates place these gains at very substantial levels [Pinheiro and Giambiagi (1997) and Pasanezi (1997)].

Table 3
Total Privatizations in the 1990s (up to March 1999)
(In US\$ Million)

<i>Sector</i>	<i>Number of Companies</i>	<i>Proceeds</i>	<i>Debt Transferred</i>	<i>Total</i>
Steel	8	5,562	2,626	8,188
Petrochemicals	27	2,698	1,003	3,701
Railroads	7	1,698	-	1,698
Mining	2	3,305	3,559	6,864
Telecom	24	26,644	2,125	28,769
Power	3	3,907	1,670	5,577
Others	16	1,401	343	1,744
Participation	-	1,040	-	1,040
Federal-Level	87	46,255	11,326	57,581
State-Level	28	22,736	5,223	27,959
Total	115	68,991	16,549	85,540

Source: BNDES.

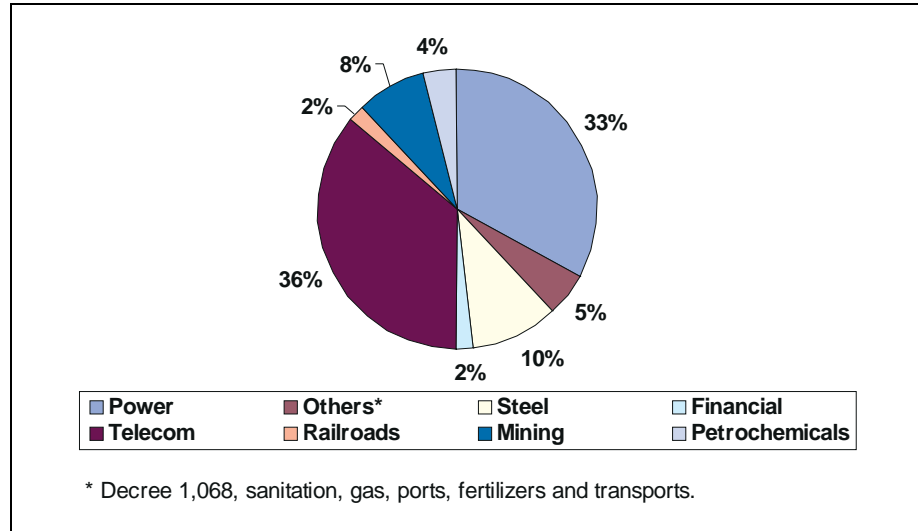
Figure 1
Annual Breakdowns - 1991-98



The sectoral distribution of privatization revenues naturally reflects the size of each sector and the extent of public ownership.³⁵ As of March 1999, the telecommunications and power sectors accounted for 69 percent of all revenues, with 36 per cent and 33 per cent of the total, respectively. With large power companies still to be sold, and most of the assets in other sectors already in private hands, this concentration will tend to increase. Steel (10 per cent), mining (8 per cent) and petrochemicals (4 per cent) accounted for most of the remaining revenues (Figure 2). It is worth noting the small amount for the transportation sector, despite the size of the assets held by the companies that were privatized. This reflects the fact that privatization in this sector

35 Pinheiro and Giambiagi (1994) show that in 1989 – the year before the PND was established – the state was dominant in mining, communications, transportation and public utilities (power, gas, water and sanitation). It also held important participations in manufacturing – concentrated in the steel, petrochemical and fertilizer sectors – and in banking.

Figure 2
Annual Breakdowns - 1991-98



(railways, roads and ports) had as its top priority increasing investment rather than collecting revenues. In addition, in this case asset ownership remained with the state.

Domestic business investors – financial institutions, pension funds and industrial firms – acquired most of the shares auctioned (61.2 per cent). However, the participation of foreign investors, small in the beginning, has increased very rapidly since 1995, from less than 1 per cent of the total at the end of 1994 to 42.2 per cent by the end of 1998. In that year alone foreign investors accounted for 59 per cent of the total proceeds. The breakdown by country shows a great predominance of American, Spanish and Portuguese investors, with 33.3 per cent, 27.9 per cent and 16.9 per cent, respectively, of the total capital apportioned by non-nationals in the program. The acquisition of shares by individuals played an ancillary role in the process, accounting for 5.3 per cent of total revenues. Of those, company employees, with acquisitions worth US\$ 728.2 million, were the most important. A total of 148,249 employees became shareholders in the companies privatized.³⁶

The sharp devaluation of the real in January 1999 produced a change in outlook for the economy in general and for privatization in particular. The drop in government credibility, the contraction of the GDP, and a perception of increased risk all contributed to depress real asset values and make privatization a difficult endeavor in 1999 and possibly also in 2000. On the other hand, privatization offers an opportunity for attenuating the constraints faced by the economy in the short run and for reducing the social cost of making the necessary adjustments in the fiscal and external accounts. Therefore, although it seems fair

36 These figures do not include the employees of Light and Meridional.

to say that the scope for future privatization is still substantial, it is very unclear from the viewpoint of early 1999 what the timetable will be and how much may be collected in revenues.

A forecast of revenues in 1999-2000, prepared in late 1998, is shown in Table 4. Future privatization revenues will still be quite sizable, despite the record sales registered in 1997-98, because of two factors: a) the incomplete privatization of power utilities, where considerable assets have yet to move into private hands; and b) the offerings of the so-called "leftover stock", i.e. the substantial minority shareholdings in companies sold before 1998 that remain with the government. If plans are more or less maintained within this two-year period, the income from privatization/sale of minority stock holdings – roughly US\$ 18 billion/year – will make an important contribution to reducing the debt/GDP ratio and financing the current account deficit.

Table 5 provides revised estimates of privatization proceeds in 1999. With an estimated 1999 GDP of roughly 1 trillion reais, the government might count on a contribution from privatization of 3.7 per cent of the GDP for reducing the value of the public debt.³⁷ Privatization could also make an important contribution to financing the current account deficit in 1999. Considering that in 1998 foreigners accounted for 59 per cent of all privatization proceeds and that the sale of leftover shares and electricity and gas companies will generate a lot of interest from these investors, it is likely that a large share of revenues in 1999 will consist of foreign direct investment. Therefore, privatization will continue to play the role of a "bridge to stability", i.e. a means of curbing the growth of

Table 4
Brazil: Privatization 1999-2000 (Cash Flow)

<i>Sectors</i>	<i>US\$ Billion</i>
Federal Government	31.4
Vale do Rio Doce	2.0
Electricity	9.4
Petrobrás*	5.0
Telecommunications	13.7
Other	1.3
States	5.4
Electricity	3.2
Other	1.2
Total	36.8
Vale do Rio Doce	2.0
Electricity	12.6
Petrobrás*	5.0
Telecommunications	13.7
Other	3.5

*Sale of the excess shares required for ownership control.
Source: Citibank (1998).

37 Table 5 also shows that the importance of privatization at state level *vis-à-vis* at a federal level, will lose its importance in the near future.

Table 5
Privatization Proceeds in 1999 (Cash Flow)
(In R\$ Million)

<i>Sector</i>	<i>Central Government</i>	<i>State Government</i>	<i>Concessions</i>	<i>Total</i>
Telecommunications	4,820		8,786	13,606
Gas Power		1,500	196	1,696
Electricity	7,136	2,010		9,146
Light, CVRD and Petrobrás	10,550			10,550
Others	1,660	160	224	2,044
Total	24,166	3,670	9,206	37,042

Source: *SPE (March 1999)*.

government debt and limiting foreign borrowing requirements, as in recent years. Although attenuating the social cost of adjustment, it is unlikely that privatization will continue to allow federal and state governments to postpone full implementation of the fiscal adjustment measures, as agreed with the IMF.

6. Final Remarks

Until early 1996, the private investment was almost completely absent from all public utility sectors in Brazil. By the end of 1998, private investors controlled all of the telecommunications and railway sectors, the country's largest ports, some of its main highways, two-thirds of electricity distribution and a large proportion of generation of electrical power, and a small but increasing share of water and sanitation services. Most of what has remained in public hands in these sectors will be privatized in 1999-2000. By then, the Brazilian privatization program will have generated revenues of almost US\$ 90 billion, making it one of the largest in the world. This process has been remarkable for its size, but equally striking is that in only 5 years the state will have retreated almost entirely from sectors in which it had reigned supreme for several decades. Moreover, this process unfolded without any political disruption. Ten years ago, not even the most optimistic liberal economist would have dreamed of such an outcome.

In this paper we argued that the main motivation behind this large and dramatic privatization effort has been Brazil's inability to stabilize the economy and resume sustained growth, a process that began in the mid-1970s and has not yet been concluded. Privatization and macroeconomic performance are in a number of ways. First, the progressive deterioration of the fiscal accounts limited the government's ability to intervene in the economy, as well as to finance the investment needs of its enterprises. The condition of these companies deteriorated when the government started to fix the prices of their output at unrea-

sonably low levels to subsidize exports and artificially control inflation. This, in turn, worsened the quality of services they provided, which contributed to increasing support for privatization, within and outside the companies.

A bold, but ill-fated attempt to use privatization to support a stabilization program occurred in 1990, when the National Privatization Program was launched. Since then, moving ahead with privatization has become essential to signal commitment to state retrenchment and the pursuit of fiscal discipline, especially amidst great economic instability. But in macroeconomic terms, privatization was little more than a commitment until 1996. Since then, however, privatization has assumed much greater significance. With annual proceeds of about US\$ 30 billion in 1997-98, privatization became a powerful tool for curbing the expansion of the public debt and helping cover the deficit on external accounts. Meanwhile, the government planned to reduce the public deficit gradually and progressively devalue the real exchange rate, so that the existing gaps would be eventually closed by the time that privatization revenues are exhausted. Even the states jumped on the bandwagon, using privatization proceeds to smooth fiscal adjustment and facilitate debt negotiations with the federal government.

But with the Asian and Russian crises, investors became less willing to cooperate with this gradual approach, especially after the public deficit began to increase rather than decrease in late 1997. Privatization alone could not provide the large capital inflows necessary to finance Brazil's large internal and external deficits, so in January 1999 the decision was taken to let the real float. In addition, a major change in the fiscal regime was adopted to reduce the public deficit. Meanwhile, privatization will continue to play an important role in reducing the public debt and attracting foreign investment, in this way reducing the short-term costs of adjustment.

If privatization provided important support for the Real Plan, the opposite was also true. It is unlikely that in the absence of price stability the government would have been able to extend privatization to the public utilities. The existence of this mutually reinforcing process partly explains why the decision to privatize those sectors came so late, and yet could be carried out reasonably quickly. Because of the circumstances and speed in which the public utilities were privatized, very little planning was done beforehand. This was reflected in the heterogeneous quality of regulation in the different public utility sectors. A modern regulatory apparatus for promoting competitiveness was put in place for telecommunications before the sale of Telebrás, but regulation lagged behind privatization in the electricity sector, while in transportation and sanitation regulations are not even completely formulated. Insufficient planning may also explain why regulatory agencies are mostly staffed, even in their leading positions,

by former SOE employees, creating a risk that regulation will be biased towards technical issues, to the detriment of a regulatory stance that promotes competition.

The frontiers of privatization in Brazil have expanded dramatically since 1974. They moved from supporting national private firms, to limiting the expansion of SOEs, to selling small SOEs, and afterwards large manufacturing firms, finally encompassing the public utility companies. Most likely, the peak in revenues is already past. Thus, while remaining significant in the next few years, proceeds will already start to decline in 1999. Will privatization in Brazil come to an end in the near future? Probably not. Large companies will remain in public hands, and it is possible that macroeconomic objectives dictate their sale. Privatization may also reach further frontiers, such as the social security system and public facilities such as hospitals, universities and penitentiaries, but the likelihood of this is difficult to ascertain. Privatization and macroeconomic policy will continue to interact for a few years, although microeconomic concerns will tend to become more important in the future.

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