

## Brazil's Macroeconomic Performance in the 1990s

Armando Castelar Pinheiro  
 Fabio Giambiagi  
 Joana Gostkorzewicz\*

\* Respectively, head and manager of the Economic Department of the BNDES and economist of the BNDES/PNUD Association.

### Abstract

This study examines the macroeconomic performance of the Brazilian economy in the 1990s, with a principal focus on the period marked by the first term of President Fernando Henrique Cardoso. Following a description of the legacy of the 1980s and the problems left for the ensuing decade (the fruit of economic stagnation and spiraling inflation), the paper delves into the first phase of the *Real Plan*, highlighting the successes of the adoption of a new model of economic policy, the most important of which is the war against inflation. Other issues that are explored are the problems related to the external sector, the worsening of fiscal results and higher unemployment rates. The paper concludes with an overview of the challenges and opportunities that lay before Brazil in the decade to come in the light of recent events.

### 1. Introduction

Were the 1990s a second lost decade for Brazil? In large part, a simple comparison of the country's macroeconomic performance in the 1980s with that of the 90s suggests that the answer is yes. In the 10 years from 1990 to 1999, GDP grew at an average annual rate of 1.7% (2.9% p.a. in 1980-89); average annual inflation was 278% (272% in 1980-89); the average investment rate at 1980 constant prices was 15.9% of GDP (18.2% of GDP in the 1980s); exports grew at an average annual rate of 4.5% (8.5% p.a. in 1980-89); and unemployment stood at an average of 5.7% (compared to 5.4% in the previous decade).<sup>1</sup> But there are two fundamental differences between the two decades. The first is that the 80s were accompanied by a progressive worsening of the drama of high inflation, while in the 90s the economy generally performed much better in the 1995-99 period than in the 1990-94 period. The second difference is that in the 1990s – in contrast to the 1980s, which was characterized by the closing of the economy and by successive price freezes – profound structural reforms were carried out that could lead the country to higher economic growth rates in the future.

Thus, after a long history of high and growing inflation rates, beginning in 1994 Brazil managed to stabilize prices and post positive economic growth rates, although at modest levels. In addition, throughout the 1990s Brazil passed through profound structural changes that paved the way for a new type of role in the international scenario [Malan (1998)]. Privatization and the opening of the economy to foreign trade, together with economic stability, resulted in strong incentives for foreign and domestic investment, leading the

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<sup>1</sup> The figures take into account the following data for the whole of 1999: a 1% contraction in GDP, inflation of 12% (IGP-DI); investment rate of 17% of GDP; exports of US\$ 49 billion; and unemployment of 8%.

restructuring of the industrial sector to advance, clearly in some sectors more rapidly than in others. Consequently, productivity grew, although at very low levels.

The state's role in the economy changed drastically. The state transformed itself from an "entrepreneur" state, which sought to boost economic development, directly defining where the factors of production should be allocated, into a "regulator and fiscal administrator" state. The priority was no longer the simple accumulation of capital, but the pursuit of efficiency, with the market substituting the state in the role of deciding the allocation of resources. Thus, the new development model is characterized by a more open economy with greater integration with the rest of the world, not only in respect to trade flows, but also in terms of foreign direct investment.

The topic of this study is the structural reforms, and in some cases, the lack of equivalent reforms in other sectors. The initial objective is to show the macroeconomic backdrop against which these reforms were advanced. Thus, the paper describes the economic performance of the Brazilian economy in the 1990s, with a principal focus on President Fernando Henrique Cardoso's first term. This is preceded, however, by a brief analysis of the so-called "lost decade" of the 1980s and the legacy of problems carried over into the next decade. The next section addresses President Cardoso's first term (1995-1998) accompanied by an overview of the challenges and opportunities for the Brazilian economy in the next decade.

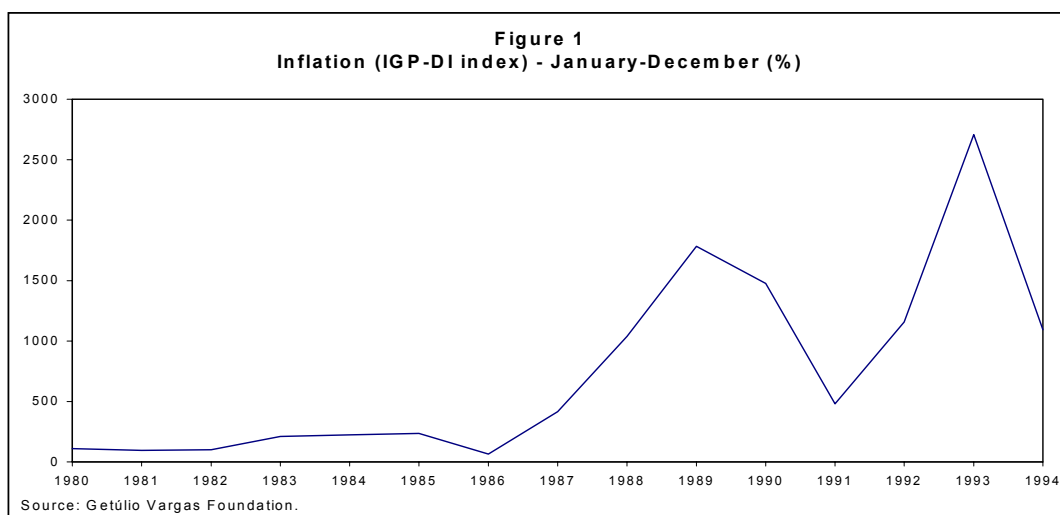
## 2. The Legacy of the 1980s and the Era of Hyperinflation

The 1980s were marked by economic stagnation, profound macroeconomic imbalances and, especially, the constant threat of hyperinflation. In the 1980-1993 period, the average growth rate of the Brazilian economy was very low (only 2.1% p.a.), leading the country to post stagnant per capita GDP figures between 1990 and 1993. GDP growth was also very irregular, with years of high growth alternating with years of significant contraction. Industry, the principal engine of economic growth since the Juscelino Kubitchek administration of the 1950s, was particularly hard hit, and its contribution to GDP growth fell from 33.7% in 1980 to 29.1% in 1993 [Pineiro (1996)].

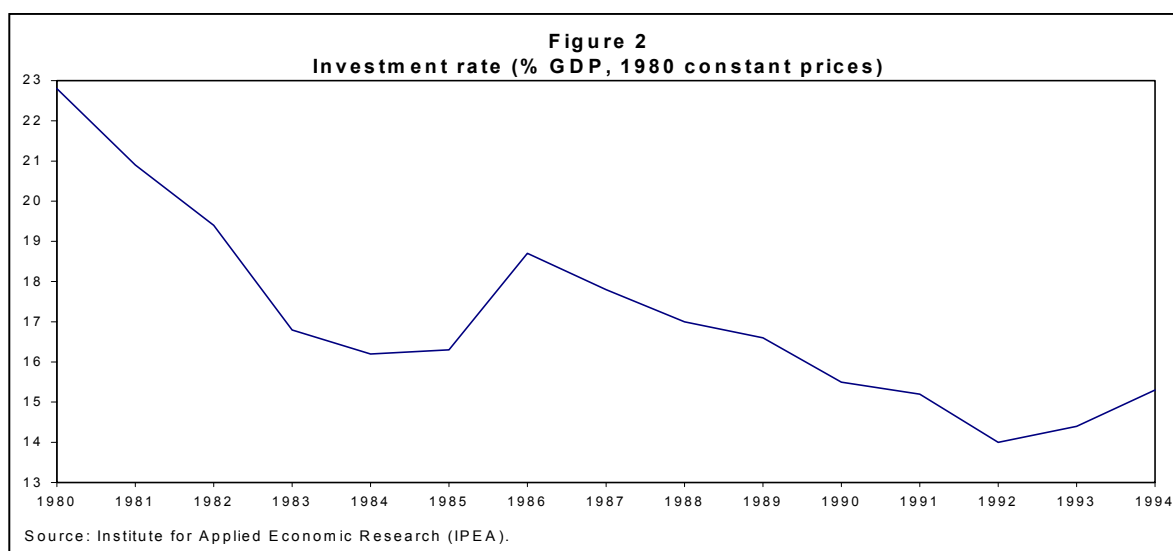
In this same comparison period (1980 to 1993), the average inflation rate, as measured by the IGP-DI index, was 438% p.a. (see Figure 1). Paradoxically, at the same time that Brazil tried to contain inflation, mechanisms were being created that sought to allow the economy to support this inflation, which in the end facilitated higher inflation. The failure of a series of heterodox stabilization plans in a short period of time (five plans in five years) contributed to instability in the economy, further intensifying the inflation rate.<sup>2</sup>

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<sup>2</sup> The failure of these various attempts to stabilize the economy were in large part the inability to recognize the need to promote structural changes that were able to resolve the root of the inflation problem and lead the country to a new standard of development [Levy and Hahn (1996)].



As important, or even more so, than the stagnation of industry was the lack of technological development that the sector was subjected to in Brazil, in view of the fact that, at the international level, industry underwent significant technological and organizational changes in the period. Further, there was a sizable reduction in the country's investment rate, especially in the second half of the 1980s. In 1980 the investment rate was 23.6% of GDP, at constant 1980 prices. In 1990, this figure had fallen to 15.5% of GDP and continued to fall until 1992 when it leveled off at 14% of GDP (see Figure 2). This reduction reflected both the lower total savings, especially the lower government and external savings, and the higher relative price of investment assets resulting from instability in the economy and government policies to fight this instability.



On the other hand, throughout the 1980s, Brazil was able to deal with the currency crisis caused by the second oil shock and Mexico's debt moratorium through the generation of mega-surpluses in the trade balance. Thus, the current account deficits registered in the period 1980-1982 were transformed into a small surplus in 1984. The trade balance went from a deficit of US\$ 2.9 billion in 1980 to a surplus of US\$ 13.1 billion in 1984.

In the 1980s, fiscal results suffered serious deterioration as a consequence of lower revenue resulting from low economic growth and policies providing fiscal incentives and subsidies to

boost economic growth. The 1988 Constitution aggravated the fiscal deficit problem by transferring a portion of fiscal revenue from the federal level to individual states and municipalities without the offsetting effect of redistributing spending to the same extent. Thus, in 1989 the fiscal deficit (operational concept) reached 7% of GDP. Throughout the 1980s, the operational deficit averaged 5% of GDP.

The “lost decade” also was characterized by the end of growth in industry through import substitution, in which the state was the driving force behind the installation of a diversified national industrial base, at times assuming the role of direct investor, as was the case with the steel and infrastructure sectors. Growing fiscal deficits, the state’s difficulty in assuring economic stability and providing basic social services (education, health and safety), and the burden imposed by its agenda as direct investor resulted in, before the end of the 1980s, a process of redefining the state’s role in the economy that was to mature over the course of the 1990s.

### 3. The First Phase of the *Real* Plan: 1994-1998

#### 3.1. *Economic Policy and Activity*

In the same way as one view’s the right side of oneself on the left in a mirror image, one can say that Brazil’s macroeconomic performance after the introduction of the *Real* Plan in June 1994 was the mirror image of events up until that point.

In fact, during most of the first half of the 90s, Brazil posted:

- high and growing inflation;
- relatively modest fiscal deficits, as measured by public-sector borrowing requirements (operational concept), in part due to the erosion of the value in real terms of expenses (included in the budget and contracted in nominal terms) in a context of rapid increases in the level of prices;
- a very weak currency, still reflecting the debt crisis of the 1980s in which external credit lines disappeared; and
- a favorable external situation, as shown by, on average, a current account surplus between 1991 and 1993 and capital inflows that led the international reserves (cash concept), after closing 1990 and 1991 at less than US\$ 9 billion, to begin to rise in 1992 and to reach more than US\$ 40 billion following the introduction of the *Real* Plan.

In contrast to this situation, in 1995 the Brazilian economy began to take on the following characteristics:

- very low (relative to the country’s historical standards) and declining inflation;
- high fiscal deficits;
- a significantly stronger currency in relation to the 1991-1994 period, before the *Real* Plan; and
- rapid deterioration in the current account.

Three factors are at the root of this disparity. First, the reduction of inflation itself, which had become – with the almost complete indexation of taxes and the low level of protection of

spending against the erosive effect of price increases – the government’s important ally in the ex post adjustment of fiscal results. Secondly, the significant increase in public spending in the period. And, third, the combination of the delayed effects of the process of the opening of trade begun in the early 1990s together with the foreign exchange policy in practice in the first months of the *Real Plan*.

There are four basic explanations for the change in the level of public spending:

- the increase in the number of retirees, especially among civil servants;
- the upsurge in 1995 of the value in real terms of the minimum wage (increasing 43% in nominal terms in a year in which inflation, as measured by the IGP, was 15%), which was fully transferred to the pension benefits paid by the INSS social security system;
- increased spending on programs and activities by various federal government agencies, grouped under the “other current and capital expenditures” (OCC) account; and
- the worsening of the fiscal situation of the individual states.

The government reacted somewhat late to this situation, which resulted in an important reversal in this process being made only beginning in 1999. However, in the period 1995 to 1998, fiscal policy was clearly growth oriented, which translated into several successive turns for the worse in the primary result until 1997, with a balanced result only in 1998. In parallel, the government put into practice a monetary policy that was unquestionably anti-growth that initially served to stabilize prices by controlling the strong growth in consumption following lower inflation. Nevertheless, over time, this policy began to be dictated by the need to adequately remunerate the capital to which the country was turning to finance its current account deficit and rollover its external debt amortizations. Consequently, interest rates were kept high to compensate for both the country risk and, since 1997, the expectation of a gradual devaluation in real terms in the currency.

The combination of a growth-oriented fiscal policy with high interest rates can be sustained for some years through the contracting of public-sector and external debt securities. Nevertheless, it establishes a mix of economic policies that cannot be maintained for an indefinite period [Sargent and Wallace (1986)]. Only with the government’s attempt to implement tax reform in 1999 did this combination begin to be modified, by giving less weight to monetary policy in an effort to stabilize the economy and with an improvement in the primary result.

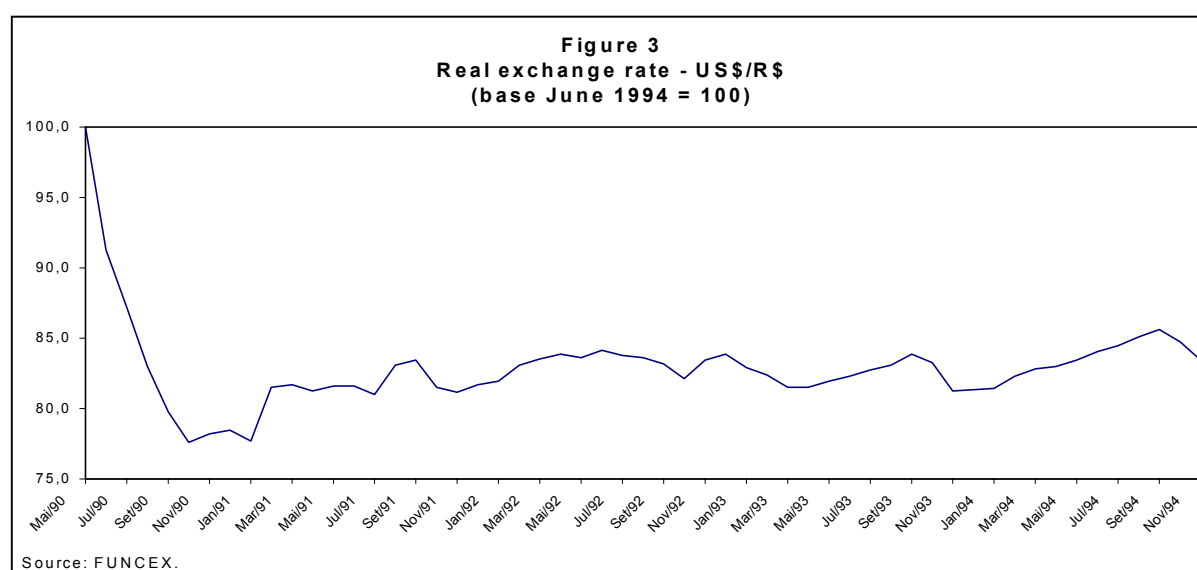
The impact of both the drop in import duties in 1991 and the strengthening of the currency in nominal terms on demand for imports was extremely strong. The exchange rate fell to R\$/US\$ 1 at the beginning of the *Real Plan* to R\$/US\$ 0.84 five months later in a context of measurable inflation. As later discussed, this combination provoked a rapid and substantial reversal in the trade balance, which posted deficits throughout the 1995-1998 period.<sup>3</sup>

Following the mini devaluation in early 1995 (subsequent to the Mexican crisis in late 1994), exchange rate policy was characterized by an attempt to adjust the exchange rate in nominal

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<sup>3</sup> These issues were responsible for a good part of the debate on economic policy after June 1994. For an official evaluation of the effects of the opening of the market to foreign trade, see Franco (1997) and Mendonça de Barros and Goldenstein (1997). For a critical evaluation of economic policy, see Pastore and Pinotti (1996), Almonacid (1998) and Batista Jr. (1999). For a measurement of the initial effects of the opening of the economy, see Mesquita and Correa (1997).

terms at a rate similar to the variation in the IPA producer price index. This policy was maintained throughout 1996 and 1997, during which the nominal exchange rate was devalued by an average of 0.57% per month, very similar to the monthly inflation rate of the period as measured by the IPA-DI of 0.64%. However, there occurred a kind of implicit change in the objectives of the exchange rate, in which as the periodic nature of the devaluations of some 0.6% per month crystallized, the objective began to be associated with the continuity of the nominal devaluation at the rate of 7% to 8% p.a., which was maintained throughout 1998. Over the months, beginning in late 1997, this was translated in practice into a gradual devaluation of the exchange rate in real terms, since the increase in the IPA, which was slightly less than 8% in 1997, fell to less than 2% in 1998 (see Figure 3).



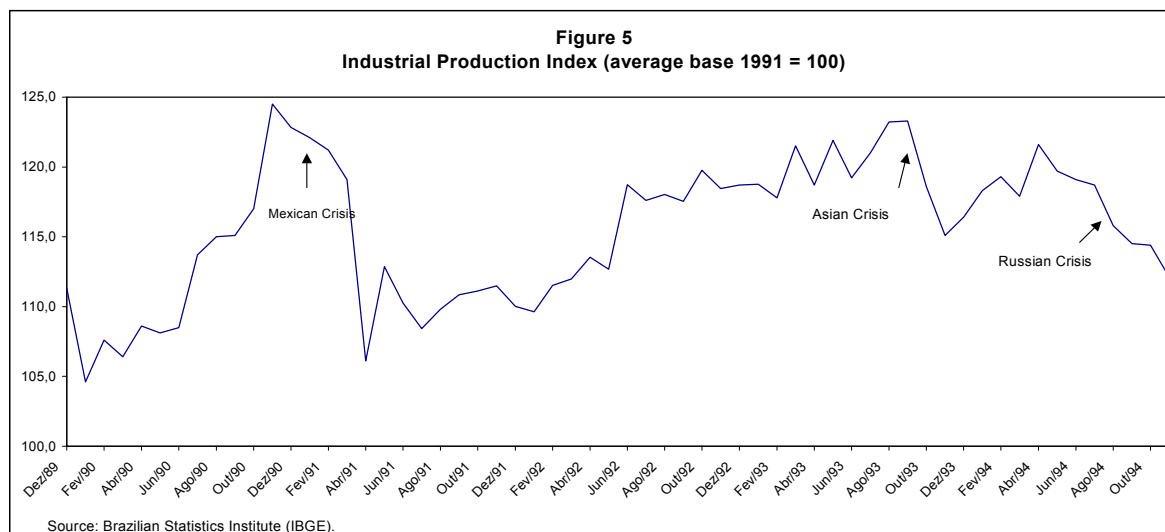
Thus, the concept of “defending exchange rate policy” changed from “defending a certain real level in the exchange rate” to the “continuation of nominal devaluation of approximately 0.6% per month” throughout 1998. In contrast to the stability of the exchange rate (in an external context marked by successive crises) was the instability of interest rates, especially the dramatic hike in rates (followed by a slight downward tendency) in March 1995, November 1997 and September 1998, following the international financial crises of Mexico, Asia and Russia, respectively (see Figure 4).<sup>4</sup>



In this context, the level of economic activity also was subject to strong variations, not coincidentally associated with the sharp changes in interest rates (see Figure 5). In fact, using the month just prior to each of these crises as a comparison base, at their lowest point, seasonally adjusted monthly industrial production figures fell 13% after the Mexican crisis, 7% after the Asian crisis and 6% after the Russian crisis, establishing a pattern of sharp falls with slow recoveries.<sup>5</sup>

<sup>4</sup> The 12-month cumulative exchange rate figures beginning at end 1996 varied between a narrow margin of between 6.8% in the January-December 1996 period and 8.3% in the January-December 1998 period, with a slight upward trend.

<sup>5</sup> An observation of quarterly GDP figures shows less accentuated moves, in part due to a reduction of seasonal effects, and in part due to greater stability in the services sector.



The recovery that followed each crisis were characterized by a loss of strength in industry as shown by economic growth, which averaged 5.4% p.a. in the 1993-1994 period, falling to 3.6% in the 1995-1997 period and to almost zero in 1998 (see Appendix). Although one can argue that in the last few years the seeds have been sown to create the conditions for a resumption of growth beginning in the year 2000, clearly macroeconomic performance in the five years following the introduction of the *Real* Plan has been much lower than the initial expectations generated by the plan.

### 3.2. The Fall in Inflation

The principal success of the *Real* Plan during President Fernando Henrique Cardoso's first term was the elimination of the greatest problem facing the Brazilian economy until 1994: the phenomenon of "hyperinflation".

The *Real* Plan was introduced in late June 1994, following the failure of five previous stabilization programs since 1986<sup>6</sup>. The previous plans all had in common price freezes, which led to an immediate fall in inflation, with subsequent acceleration of the rate of price increases, leading to a path of hyperinflation. In June 1994, Brazil's cumulative 12-month inflation rate, as measured by the IGP-DI general price index, was 5,154%. The *Real* Plan's success in fighting inflation could not have been more dramatic: for the first time in its history, the inflation index published by the Getúlio Vargas Foundation posted lower inflation for five consecutive years, culminating in an inflation rate of 1.7% for the whole of 1998.

The success of the new economic stabilization plan was based principally on the series of steps that preceded its implementation: the adoption of measures targeting balanced public accounts<sup>7</sup>; the establishment of a unit of value (the reference unit of value – *URV*) to bring the

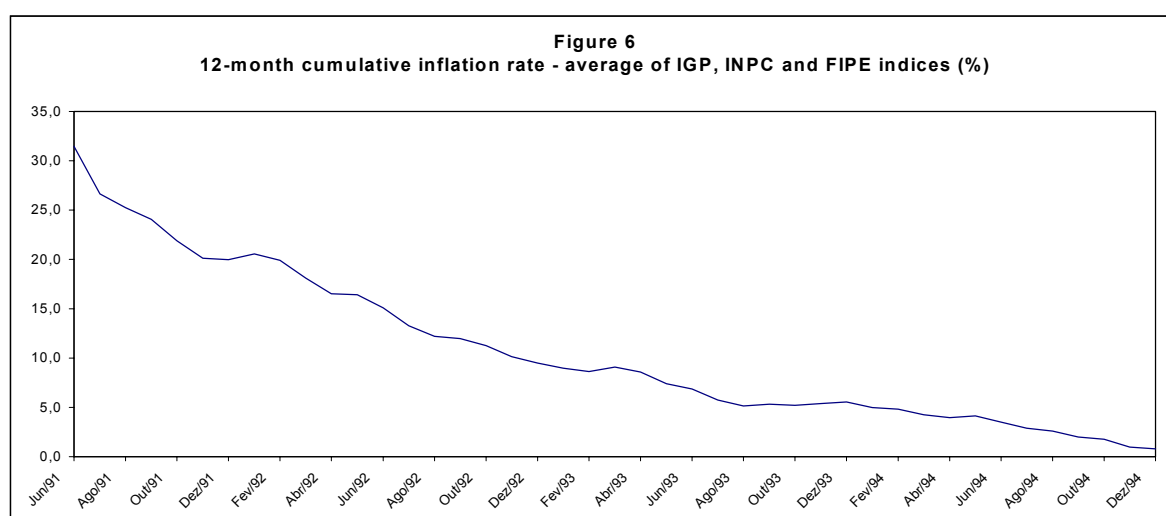
<sup>6</sup> The Cruzado (1986), Bresser (1987), Verão (1989), Collor I (1990) and Collor II (1991) plans.

<sup>7</sup> This is a reference to the Social Emergency Fund (FSE). Although the fiscal situation later worsened significantly, the approval of the FSE in 1994 was an important factor in setting expectations related to the plan's chances of success.

relative prices of the economy into line; and the conversion of this unit of value into the economy's new stable currency, the *real*.

The first stage sought to create macroeconomic conditions favorable to the stabilization of prices [Bacha (1995)]. The goal of the second and third stages of the plan was to align the more important relative prices of the economy, since the existence of indexed contracts with varying dates resulted in a wide dispersion of prices. The alignment of relative prices was necessary to free the economy from inflationary inertia. Thus, the implementation of the *Real* Plan was able to eliminate the retroactive indexation with no need to freeze prices or salaries in order to contain inflation, as was the case in the previous stabilization plans. Further, the combined effects of the strengthening of the *real* against the dollar and the opening of the economy to foreign trade – and the resulting fierce external competition – allowed the prices of tradables to be strictly controlled from the beginning of the *Real* Plan, making the exchange rate anchor effective in controlling inflation.

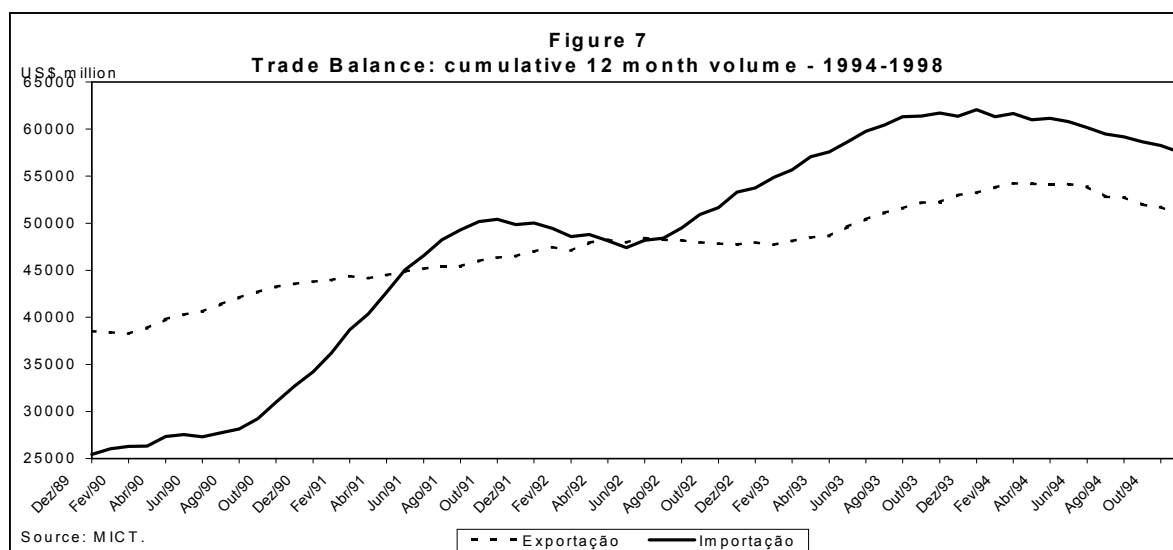
A drastic fall in inflation ensued as a result of this process (principally in tradables, but also in nontradables) without a severe recession at the beginning of the plan. In fact, until 1997 the reduction in inflation took place in an environment of moderate growth in the country's economic activity. The cumulative 12-month inflation rate, as measured by the average of the IGP-DI, INPC and IPC-FIPE indices, followed a downward path, as clearly shown ever since the *Real* Plan completed its first year (see Figure 6). In December 1995, the 12-month cumulative average inflation rate was 20%. In the following two years and in the same month, this inflation rate was in the single digits, falling to 9.5% and 5.6%, respectively. Finally, in December 1998, the 12-month cumulative average inflation rate reached 0.8%.



### 3.3. External Sector Problems

The combined effects mentioned above of the strengthening of the *real* against the dollar at the beginning of the plan and the opening of the economy to foreign trade resulted, on the one hand, in a drastic reduction in inflation but, on the other hand, it was associated with a significant deterioration in the country's external accounts during President Cardoso's first term [Castro (1998)]. In particular, the huge trade surpluses of the second half of the 1980s were transformed into significant deficits beginning in 1994. This transformation was specifically set off by the rapid growth in imports, since growth in Brazilian exports was not sufficient to compensate for the increased external purchases (see Figure 7). While imports in

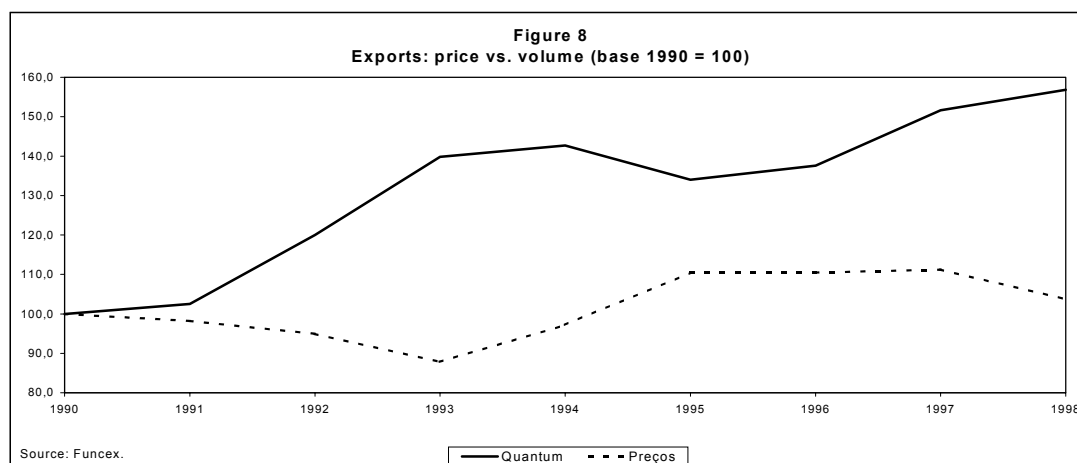
1998 were 77% higher than in 1994, in the same comparison period exports were only 17% higher.



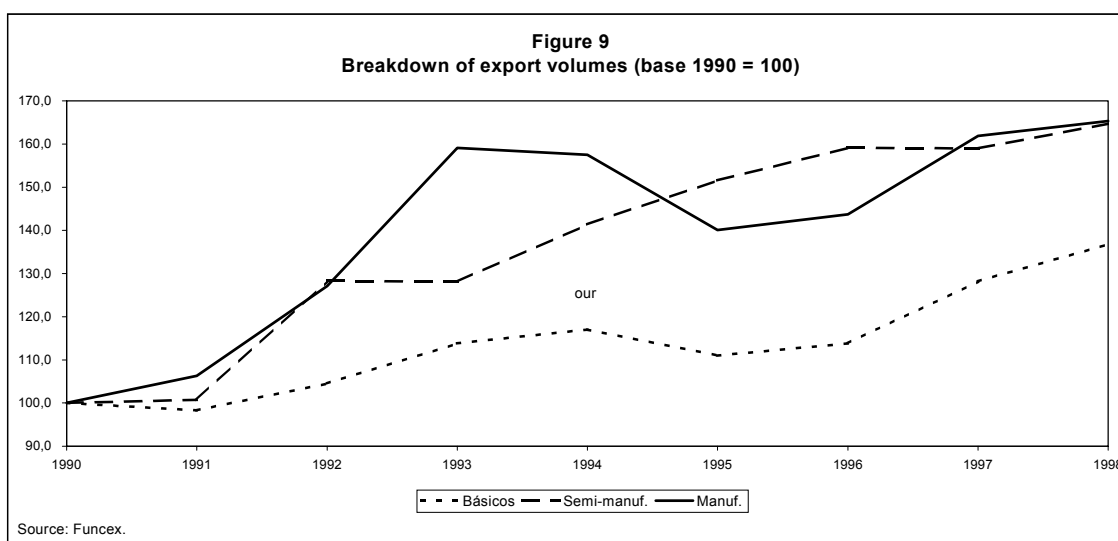
In 1993, Brazilian imports totaled US\$ 25.5 billion. In 1995, imports had almost doubled in value to US\$ 49.9 billion. In the two following years, imports totaled US\$ 53.3 billion and US\$ 61.4 billion, respectively. Only in 1998 did imports stop growing and even register a (significant) reduction to US\$ 58 billion. This reduction is partially explained by the country's lower economic growth at the time. A breakdown of 1998 imports showed that imports of capital and consumer goods increased the most in comparison to 1994: 113% and 94%, respectively.

Exports also followed an upward path until 1997, although at a much slower pace than imports. In 1993, Brazilian exports totaled US\$ 38.6 billion. In the three following years, exports totaled US\$ 43.5 billion, US\$ 46.5 billion and US\$ 47.7 billion, respectively. In 1997, Brazilian exports reached US\$ 53 billion. However, in 1998 exports fell to US\$ 51.1 billion, principally due to the Asian financial crisis, the fall in prices of the principal commodities on the international market, and the cooling of the world economy. In all, in the 1994-1998 period exports increased an average of 4.1% p.a., much slower than the increase in foreign trade as a whole in the period (7.6%), showing the lack of strength in Brazilian exports and the need to improve the composition of exports in terms of products and markets. A breakdown of exports shows that the weak performance affected all types of products: in the same comparison period, both exports of manufactured and basic goods also increased 4.1% p.a.

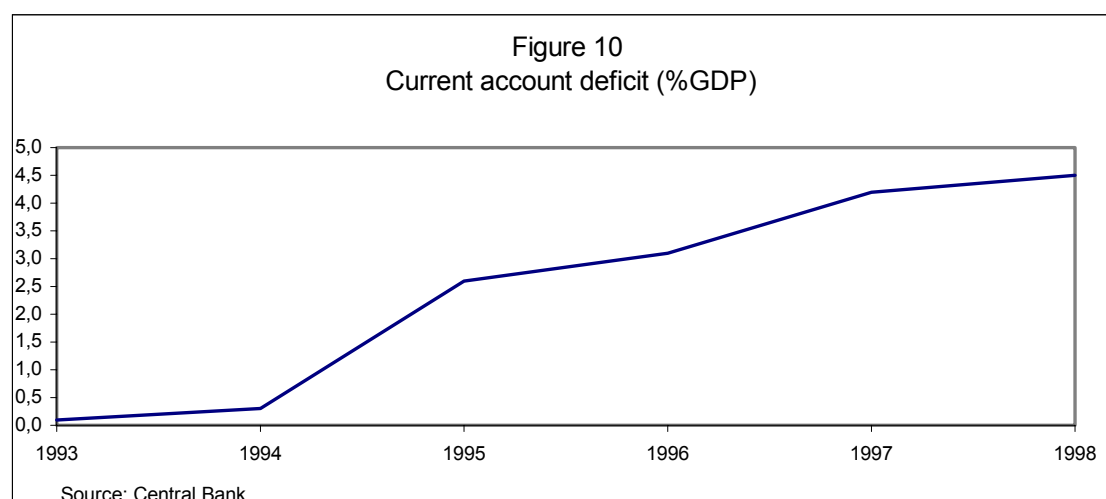
According to the Foreign Trade Research Center of the Trade and Industry Ministry (Funcex), in 1998 export volumes were only 9.9% higher than in 1994. In the same comparison period, Brazilian export prices were 6.7% higher (see Figure 8).



A breakdown of exports by type of good shows that the volume of exports of manufactured goods in 1998 was only 4.9% higher than in 1994, while the volume of exports of basic and semi-manufactured goods was 16.9% and 16.4% higher, respectively (see Figure 9).



In addition to the fiscal deficit, Brazil currently faces another serious problem, the current account deficit (see Figure 10). In 1994, the current account deficit was only 0.3% of GDP. In the following years, however, this deficit surged until it reached 4.5% of GDP in 1998, a process which ended in the currency crisis at the end of 1998 and the devaluation of the *real* in early 1999. The worsening of the current account deficit in the second half of the 1990s was due not only to the deterioration of the trade balance but also in the services account. The increase in the deficit of the services account is especially due to the performance of the interest payments and profit remittances accounts, which are, respectively, the direct consequence of the higher interest rates paid abroad by Brazil, and the higher external debt and foreign direct investment in Brazil.



### 3.4. The Worsening of the Public Accounts

President Cardoso's first term was marked by high fiscal deficits. The public-sector borrowing requirement (flow concept) increased from 0.4% of GDP in the 1991-1994 period to 5.2% in the 1995-1998. This increase in PSBR was the result of not only higher real interest expenses (which in the same comparison period increased from 3.3% of GDP to 5%), but principally the increase in the primary deficit, which went from a surplus of 2.9% of GDP in 1991-1994 to an average deficit of 0.2% in the four subsequent years (Table 1). It is important to note that the deterioration of the primary result was significantly more dominant than the increase in the weighting of interest rates when the average results of the 1995-1998 period are compared with those of the 1991-1994 period, a comparison in which there was a clear preponderance of the effect of higher interest rates on the fiscal deterioration of 1998.

Table 1  
Public Sector Borrowing Requirement (PSBR) – Flow Concept (% of GDP)

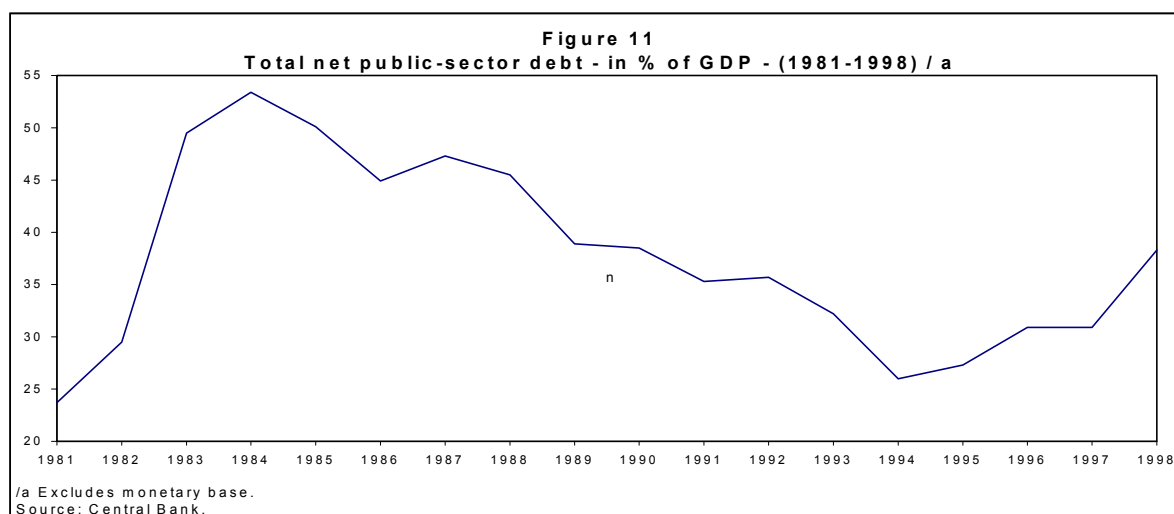
	Average	Average	
Composition	1991-1994	1995-1998	Difference
PSBR	0.4	5.2	4.8
Primary Deficit <sup>a</sup>	-2.9	0.2	3.1
Real interest rates	3.3	5.0	1.7

Source: Central Bank.

<sup>(a)</sup> (-) = surplus.

The principal result of this fiscal imbalance was the rapid increase in public-sector debt (see Figure 11). In 1981, total net public-sector debt was 23.7% of GDP<sup>8</sup>. In the next few years net public-sector debt increased to 53.4% of 1984 when it began to fall significantly as a proportion of GDP, reaching 26% of GDP in 1994. That year net internal public-sector debt was 17.6% of GDP, later reaching 31.7% of GDP in 1998 (see Table 2). At the same time, net external public-sector debt fell in the first few years of the *Real Plan*, decreasing from 8.4% of GDP in 1994 to 3.9% of GDP in 1996. However, with the subsequent loss in international reserves, net external debt reversed its downward trend, reaching 6.6% in 1998. In 1998, total public-sector net debt was 38.3% of GDP.

<sup>8</sup> The debt figures that follow do not include the monetary base.



**Table 2 - Net public-sector debt - end of period (% GDP) / a**

Breakdown	1994	1995	1996	1997	1998
<b>Internal debt</b>	17,6	21,8	27,0	26,6	31,7
Federal government	3,0	6,6	12,0	13,2	16,7
Sovereign debt	11,6	15,5	21,4	28,2	35,4
Central Bank credits	-4,6	-5,3	-8,5	-7,8	-5,7
Renegotiation w/ states /b	0,0	0,0	0,0	-5,5	-9,5
Other accounts /c	-4,0	-3,6	-0,9	-1,7	-3,5
States and municipalities	9,5	10,3	11,1	12,5	13,7
Renegotiation w/ states /b	0,0	0,0	0,0	5,5	9,5
Securitized debt	4,7	5,5	6,2	4,3	2,4
Other accounts /d	4,8	4,8	4,9	2,6	1,8
State-owned companies	5,1	4,9	3,9	0,9	1,3
<b>External debt</b>	8,4	5,5	3,9	4,3	6,6
Federal government	6,2	3,5	1,6	1,9	4,3
States and municipalities	0,3	0,3	0,4	0,5	0,7
State-owned companies	1,9	1,7	1,9	1,9	1,6
<b>Total debt</b>	26,0	27,3	30,9	30,9	38,3
Federal government	9,2	10,1	13,6	15,1	21,0
States and municipalities	9,8	10,6	11,5	13,0	14,4
State-owned companies	7,0	6,6	5,8	2,8	2,9
<b>Total debt</b>	26,0	27,3	30,9	30,9	38,3
<b>Fiscal debt</b>	26,0	27,3	29,0	30,8	37,4
Variation in equity (stock)	0,0	0,0	1,9	0,1	0,9
Privatization	0,0	0,0	-0,1	-2,0	-3,4
Other	0,0	0,0	2,0	2,1	4,3

Source: Central Bank.

n.a. (=) Not available.

/a Excludes monetary base.

/b Law No. 9496/97.

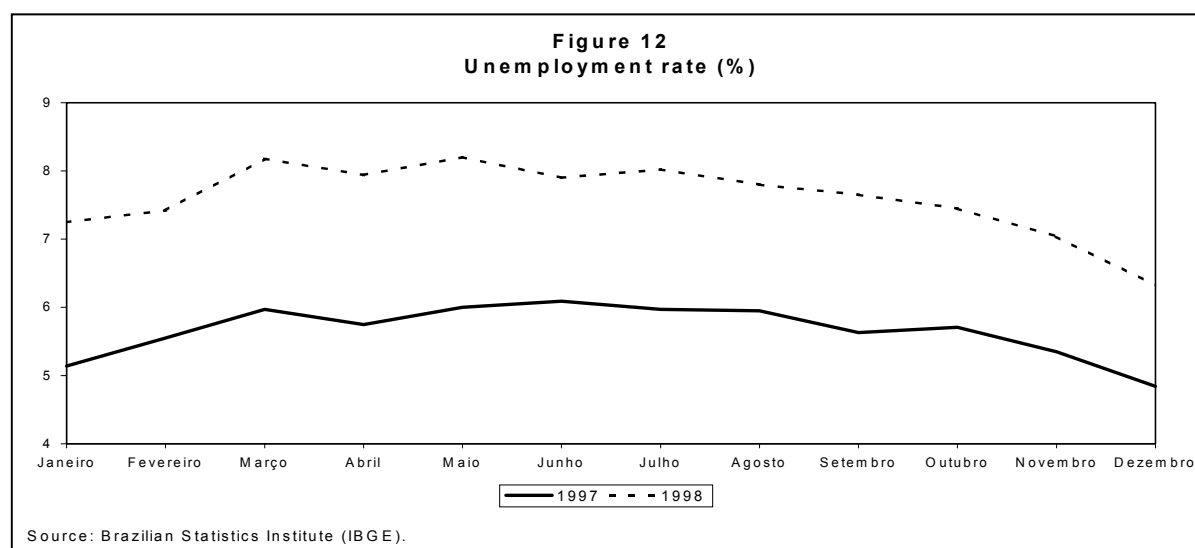
/c Includes assets of FAT.

/d Includes bank debt.

In addition, the fiscal imbalance was responsible for almost all of the recent increase in the public-sector internal debt. The fact that the average operational deficit in the period exceeded 5% of GDP explains the jump in public debt between 1994 and 1998. This is because the acknowledgement of past debt (the so-called skeletons) was in part offset by the use of proceeds from privatizations to service federal securitized debt. In this light, the deterioration of the fiscal result during President Cardoso's first term and the resulting rapid expansion of public-sector debt showed a temporary inconsistency of macroeconomic policy. This led to the adoption of the Fiscal Stability Program at the end of this year, through which the government provides for a significant improvement in the primary result that allows public-sector debt to stabilize as a percentage of GDP.

### 3.5. Unemployment

The issue of employment is a theme that has received much attention due to growth in Brazil's unemployment rates and its negative effects on the well-being of society. According to the Brazilian Statistics Institute (IBGE), the open unemployment rate rose steadily during the second half of the 1990s, increasing from an annual average of 4.6% in 1995 to 7.6% in 1998, a year in which there was a substantial jump in relation to 1997 (see Figure 12).



Until this year, it was often said that the greatest problem in the labor market in Brazil was not unemployment but “job quality”, since, with unemployment levels much lower than in the majority of countries, the government’s principal concern should not be related to the need to employ people but to the aim of reducing the level of the informal work force, which represented a significant percentage of the total labor force<sup>9</sup>. In 1998, however, this scenario clearly changed for the worse. In fact, with unemployment levels threatening to reach the double digits, the statement that Brazil “does not have a problem with unemployment” is no longer pertinent. To analyze the issue it is helpful to separately view the principal vectors that are responsible for the higher unemployment.

The level of employment – and thus that of unemployment – is affected by three factors:

- labor costs and, within this item, the costs imposed by labor laws;
- technological processes; and
- the scenario for demand.

Brazilian labor laws have been cited by labor market specialists as an obstacle to increased absorption of labor by companies in Brazil. The viewpoint is that the combination of high above-wage costs with the impact of the Labor Court on companies’ activities discourages the contracting of employees, leading companies to adapt to increases in demand through the

<sup>9</sup> For related information, see Ramos and Reis (1998).

contracting of overtime hours or increasing the productivity of each work hour. Without negating the importance of this discussion, it is important to note however that this foremost affects the formal labor market more so than the overall level of employment and, secondly, labor laws have not become stricter in the last few years, which makes it highly unlikely that is the principal cause of the increase in unemployment after 1995.

This said, however, one issue does support the argument that labor laws have contributed to the higher unemployment. With the opening of the economy to foreign trade, price stability and the appreciation of the exchange rate, the relative cost of capital has fallen significantly, providing incentive for the substitution of labor by machines. High above wage costs and the contingency cost of appearing before the Labor Court raise the relative cost of labor from the point of view of the employer and contribute to making it relatively expensive.

Thus, the absence of changes to labor regulations has prevented a reduction in the impacts on employment levels in the last few years of the process of modernizing the Brazilian economy and the intense adjustment of the private sector to the new conditions imposed by the opening of the economy to imports after 1990. In fact, companies' organizational and industrial restructuring methods, which have transformed into the cutting back of workforces, have significantly reduced the amount of labor per unit produced, resulting in a trend towards a reduction of demand for labor by companies.

Finally, as would be expected, the labor market was especially hard hit by the effects of the recent contraction of the Brazilian economy. Thus, with the annual unemployment rate falling continuously from 1992 to 1995 (from 5.8% to 4.6%), exactly coinciding with the three-year period in which the Brazilian economy was recovering from the recession of the early 1990s and growing at an average rate of 5% p.a., it is perfectly understandable that unemployment rose in 1996 and 1997, when the average growth rate of the economy fell to 3.2% p.a., and that it rose even further in 1998 when economic growth was minimal. Clearly, the level of demand in the Brazilian economy is expected to be the principal determinant of the outlook for future unemployment levels both in 1999, when the recession is expected to reduce the working population, and in subsequent years, when an economic recovery is expected to reduce unemployment levels.

Thus, Brazil did not suffer a serious unemployment problem in the 1980s, since low GDP growth rates were accompanied by weak growth rates in industry. Beginning in 1990 and until 1996, the impact on unemployment of the combination of a large increase in productivity in industry with relatively low economic growth was attenuated by the increased generation of jobs in the services, which absorbed the high number of workers unemployed in the industrial sector. However, the sectors that have until recently driven employment have stopped demanding new workers. Examples are the falloff in the absorption of jobs by the retailing sector; the emergence of new management methods that economize labor; the contraction in the financial sector following the crisis in certain banks in 1995 and 1996 and the wave of mergers that resulted; the impact of the budget crisis on hiring of civil servants in public administration in 1998. Thus, the changes that continued to be made in industry were no longer counterbalanced by higher growth in employment in other sectors.

In such circumstances, employment levels remained practically stagnant in 1997, falling in 1998 (see Table 3). In 1998, this did not reach the point that it was reflected in a jump in unemployment because the economically active population (EAP) increased by only 0.6%.

But in 1998, the EAP surged higher by 1.8% and high growth in unemployment was the natural result of a fall in the level of employment.

Table 3: Change in working population with breakdown (%)

		1992	1993	1994	1995	1996	1997	1998
Position	Registered	-4,5	-0,2	-0,2	0,6	-1,4	-0,4	-1,4
	Unregistered	6,0	5,1	5,7	4,2	5,3	0,4	2,2
	Self-employed	3,7	1,3	6,5	3,5	6,1	2,4	-0,7
	Employer	-2,3	1,2	-0,5	9,0	5,1	-1,8	0,3
	No data	6,6	-4,6	10,9	-0,5	11,4	-8,6	0,2
Sector	<b>Industry</b>	<b>-4,9</b>	<b>-1,2</b>	<b>1,2</b>	<b>0,1</b>	<b>-2,1</b>	<b>-3,1</b>	<b>-3,3</b>
	Mining	-1,8	-9,0	16,0	-14,6	-7,7	5,5	-13,6
	Manufacturing	-7,9	-0,2	0,1	1,2	-4,4	-3,8	-4,7
	Public Utilities	0,5	0,3	-4,4	-3,8	-4,8	-4,2	-5,3
	Construction	3,5	-4,0	4,9	-1,8	4,7	-1,2	0,5
	<b>Agro-Industry</b>	<b>-1,2</b>	<b>0,2</b>	<b>7,9</b>	<b>-0,4</b>	<b>-13,5</b>	<b>-6,4</b>	<b>-7,9</b>
	<b>Services</b>	<b>1,5</b>	<b>2,3</b>	<b>3,1</b>	<b>3,4</b>	<b>4,1</b>	<b>1,6</b>	<b>0,9</b>
	Retailing	-0,1	3,6	3,8	3,5	2,6	1,0	-2,1
	Services	2,0	2,7	4,2	4,9	4,9	1,8	2,3
	Public Administr.	3,8	1,5	0,5	-0,9	4,6	0,3	-1,5
	Other	0,0	-0,5	0,3	1,0	2,6	3,1	2,5
	<b>TOTAL</b>	<b>-0,5</b>	<b>1,3</b>	<b>2,6</b>	<b>2,4</b>	<b>2,3</b>	<b>0,3</b>	<b>-0,3</b>

Source: IPEA.

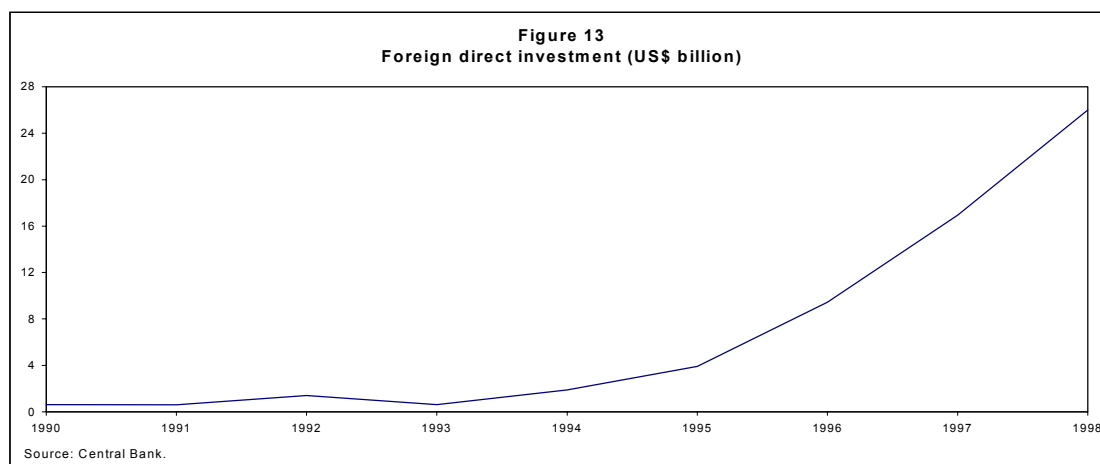
#### 4. Balance of Payments

There are two ways to interpret what has occurred in the Brazilian economy in the last five years. On the one hand, the performance of some traditional macroeconomic indicators are not cause for any celebration, as figures clearly show: economic growth has been only moderate and the growth rates have declined; unemployment has risen; fiscal deficits have been high; net public sector debt has increased extremely quickly; the external sector has seen low growth in exports and high current account deficits. On the other hand, it is undeniable that stabilization represents a substantial improvement in relation to Brazil's situation in the period 1981-1993. Further, important reforms have been implemented that could lead to conditions for a growth cycle in the next decade.

Without taking into account the huge success in cutting inflation, from the stratospheric levels registered until June 1994, to levels which Brazil has rarely seen this century, the following outlines the important results of the changes occurred throughout this decade: the higher investment rate, which (measured at 1980 prices) increased from 14% of GDP in 1992 to 17.5% in 1997-1998; the incredible transformation of industry, especially in the private sector; and the transformation of Brazil into one of the most important destinations for foreign direct investment flows worldwide.

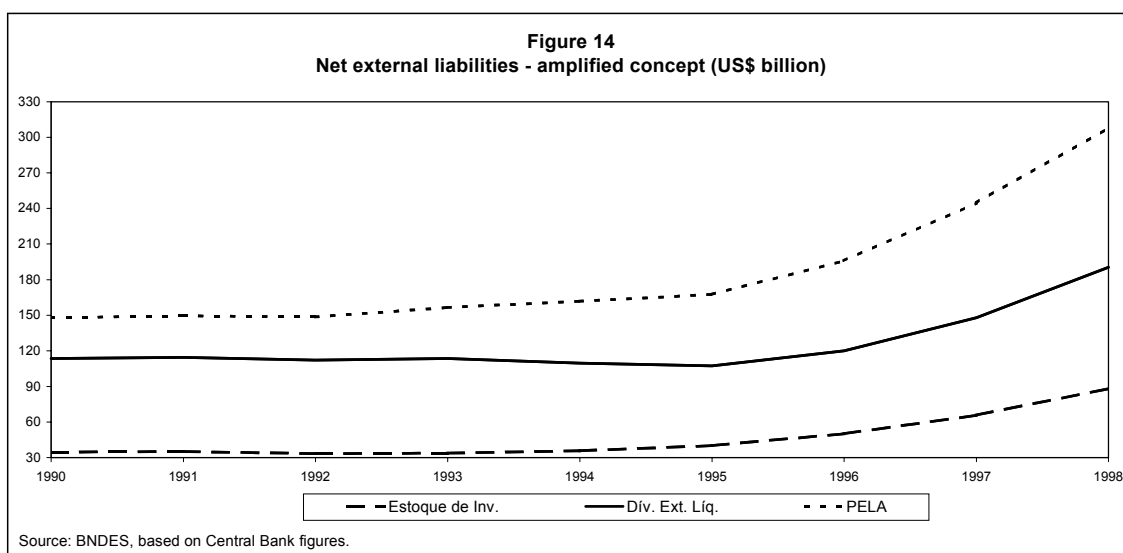
The transformation of industry is shown, for example, by the increase in industrial productivity beginning in 1991 of almost 6% p.a. – result of the comparison of the National Account's indicator for production with the level of employment shown by the Monthly Employment Report. Similarly, a highly positive factor for the outlook is the fact that the economy (following direct investment inflows of only US\$ 1 billion per year in the 1981-1993 period) received US\$ 2 billion in direct investment (excluding portfolio) in 1994, US\$ 4

billion in 1995, US\$ 9 billion in 1996, US\$ 17 billion in 1997 and US\$ 26 billion in 1998 (US\$ 20 billion excluding privatization proceeds).



This type of investment has several advantages. First, the investments are external savings that help to increase the investment rate. Second, it allows Brazil to incorporate new and modern technologies and industrial processes. Third, compared with external loans, this type of capital is much more committed to the development of the Brazilian economy in the long term. Fourth, in terms of cost, historically, this type of funding is cheaper than borrowing. And fifth, in terms of volatility, it has minimal risk of reversal, in clear contrast to the violent variations that have characterized international liquidity flows in the last 20 years. However, it is advantageous for Brazil to continue to receive investment flows of some US\$ 20 billion per year. To not have this source of funds in the future would result in a various costs for Brazil, in the form of a move to a reduction in savings and investment, a departure from the incorporation of technology and greater difficulties in financing the current account.

On the other hand, high investment inflows in the form of foreign direct investment in the last few years do have their costs, as shown by the increase in expenditure in the services account of the balance of payment. In this respect, it is important to note that the profits and dividends account, which averaged US\$ 2 billion per year in 1991-1994, reached an average of US\$ 7 billion in 1997-1998. Net external liabilities (by the amplified concept) – represented by the sum of total foreign investment in Brazil (net Brazilian foreign investment) and net foreign debt – increased from US\$ 162 billion in 1994 to US\$ 308 billion in 1998 (see Figure 14). In this context, expenditures with interest and dividend payments also tend to increase naturally over time.



However, there is a need for the benefits related to Brazil's new inclusion in the international arena, with the strong penetration of foreign capital, to be obtained in an external situation in which the problems that occurred in the last few years do not recur. This means, on the one hand, assuring that the current account deficit does not exceed certain prudent levels and, on the other, that above-mentioned net external liabilities contain a growing percentage of direct investment (much less volatility and a greater commitment to the country's long term strategies) at the cost of short term funding. Clearly, these concerns are expected to transform in coming years with Brazil's creation of an aggressive exporting strategy.

Several studies have noted the gains for Latin America as a whole in terms of higher rates of potential GDP growth, structural reforms, and the stabilization efforts implemented in the region over the 1990s [Easterly, Loayza and Montiel (1996), Fernández-Arias and Montiel (1997) and Lora and Barrera (1997)]. According to these studies, the structural reforms, and to a lesser extent, the reduction of inflation in Latin America have increased the potential rate of GDP per capita growth in some two percentage points per year. In Brazil's case, this yearly increase was estimated at between 1.4 [Fernández-Arias and Montiel (1997)] and 2.2 percentage points [Lora and Barrera (1997)], although these estimates only take into account changes occurred up to 1995, thus underestimating the possible gains resulting from the macroeconomic and structural reforms in Brazil during the 1990s.

These studies further estimate that the intensification of the structural reforms and the consolidation of macroeconomic stability could add some 2.4 percentage points to the long-term per capita GDP growth rate in the region, increasing it to some 5.4% p.a. However, in order to obtain growth rates similar to those of East Asian countries in the last few decades (around 7% p.a. in per capita terms), it is also necessary to not only promote a significant increase in the level of education of the work force, but also increase the scope of the reforms to other areas. Along these lines, there are three great challenges to overcome for Brazil to increase its potential for growth in economic activity.

First, the country needs to consolidate the macroeconomic stability, which principally consists of establishing a balanced fiscal regime and promoting growth in exports. If fiscal reform is successfully completed, leading the country's risk perception to fall, the result could be a significant reduction in interest rates. Another important factor for this goal is maintaining the current account deficit at levels that are compatible with the stability of net

external liabilities as a ratio of GDP. In this scenario – with a significantly more devalued exchange rate than in the recent past, with the current account deficit under control, with the public sector deficit in good shape, with civilized real interest rates and with inflation brought down to international levels following the inflationary solution of 1999 – the country will be able to enter a phase of macroeconomic discipline unlike any other in its recent history.

Second, Brazil needs to advance the structural reforms implemented in the 1990s. Much still needs to be done in term of privatization, opening the economy to foreign trade and deregulation. The financial sector, for example, has only begun the reforms necessary for the reduction of costs and spreads and significant growth in credit volumes. In the same way, reforms in the labor market have barely begun. The manufacturing sector also has not concluded its restructuring and Brazil's levels of production remain well below those of developed countries.

Finally, a so-called second generation of reforms must be started, focused on the improvement of institutions and finding solutions to new problems, such as those caused by the demographic changes now taking place in Brazil. The reform of institutions acquired particular importance beginning with the advance of the first generation of reforms, including the institution of the democratic process itself in Latin America in general (and in Brazil in particular) in the 1980s. Broadening this list of institutional reforms are political reform, reform of the judicial system, reform of the federation, tax reform and the reform of regulatory institutions (antidumping and antitrust agencies and agencies to regulate public utilities). These institutions make for a more efficient state and increase the level of competitiveness in the private sector. Reforms with a strong focus on the new problems include social security reform, reform of the health sector (to deal with growing expenditures on the elderly, with higher spending on medicine, etc.) and the reform of education (related to the new profile of demand for specialized labor).

## **Appendix**

**Appendix**  
**Brazil: Economic Indicators - 1990-97**

	1990	1991	1992	1993	1994	1995	1996	1997	1998
GDP growth (%)	-4,3	1,0	-0,5	4,9	5,9	4,2	2,8	3,7	0,2
Investment (% of GDP, 1980 prices)	15,5	15,2	14,0	14,4	15,3	16,6	16,5	17,5	17,4
Investment (% of GDP, current prices)	20,7	18,1	18,4	19,3	20,8	20,5	19,1	19,6	19,1
Savings (% of GDP)	20,7	18,1	18,4	19,3	20,8	20,5	19,1	19,6	19,1
Domestic	19,6	16,9	19,3	18,5	19,9	17,7	15,7	15,2	14,6
External	1,1	1,2	-0,9	0,8	0,9	2,8	3,4	4,4	4,5
Prices									
Monetary correction of GDP (%)	2596,0	416,7	969,0	1996,2	2240,2	77,6	17,3	7,4	3,9
Exchange Terms (Base 1990 = 100)	100,0	105,8	107,8	109,2	124,7	138,5	153,4	145,2	143,4
Public-sector borrowing requirements (% of GDP)									
Nominal	29,6	26,8	45,7	64,7	27,0	7,3	5,9	6,1	8,0
Operational /a	-1,4	0,2	1,7	0,7	-1,1	5,0	3,8	4,3	7,8
Nominal interest rates	31,9	29,5	47,3	67,0	32,2	7,5	5,8	5,1	8,0
Real interest rates /b	0,9	2,9	3,3	3,0	4,1	5,3	3,7	3,4	7,8
Primary /a	-2,3	-2,7	-1,6	-2,3	-5,2	-0,3	0,1	1,0	0,0
Monetary Policy									
Real interest rates (%) /b	-4,9	3,6	34,1	7,1	24,4	33,1	16,6	16,4	26,5
Employment									
Unemployment rate (%)	4,3	4,8	5,8	5,3	5,1	4,6	5,4	5,7	7,6
External sector (US\$ billion)									
Exports	31,4	31,6	35,8	38,6	43,5	46,5	47,7	53,0	51,1
Imports	20,7	21,0	20,6	25,5	32,7	49,9	53,3	61,4	57,6
Trade balance	10,7	10,6	15,2	13,1	10,8	-3,4	-5,6	-8,4	-6,5
Current transactions	-3,8	-1,4	5,9	-0,4	-1,3	-18,0	-23,7	-33,4	-34,9
External reserves /c	10,0	9,4	23,8	32,2	38,8	51,8	60,1	52,2	44,6

Source: IBGE, Central Bank, IPEA.

/a (-) = Surplus.

/b Gross real Selic Rate January=December (monetary correction: IGP-DI centered).

/c At end of year.

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