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## Brazil's Remarkable Journey

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*Latin America's largest economy is finally reaping the benefits of reforms*

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In March 2005, Brazil announced that it would not renew its agreement with the International Monetary Fund (IMF). The decision, which comes after six years of successive programs with the IMF, marks an important milestone in what has been a remarkable economic journey.

After its recovery from a crisis following the turbulence in international markets in 1998, Brazil faced new market pressures in 2002. Investors, whose appetite for risk had declined due to events in emerging markets and corporate scandals in developed economies, remained unsure what to make of left-leaning presidential candidate Luiz Inácio Lula da Silva. A loan of unprecedented size, agreed with the IMF in September 2002, shortly before Lula's electoral victory, helped Brazil weather the storm. Since then, the economy has undergone a strong recovery and seems to be aiming for sustained growth. For policymakers, the emphasis remains on preserving macroeconomic stability and advancing a large reform agenda, mainly in the microeconomic arena.

### A dramatic turnaround

What explains Brazil's economic turnaround? The country has undergone enormous change over the past 10 years on the macroeconomic front. Inflation, once the bane of the economy, has been under control since 1994. The financial system, which benefits from the participation of foreign institutions, high capitalization, and good regulation and supervision, has proved its worth, weathering several external financial crises without problems. The commitment to fiscal discipline—buttressed by the Fiscal Responsibility Law—is shared not only by the government but also by a majority of the population. The strengthening of fiscal and monetary discipline following the election has allowed the country to regain the confidence of investors. This confidence has been bolstered by reforms of the tax system and the social security scheme for public

servants, and the approval of a new bankruptcy law—reforms that could not have been achieved without strong support from Congress. There have also been several improvements in capital market and utility regulation. And the social safety net has helped cushion the effects of external shocks and the transitory cost of reforms. These reforms are now paying off:

- 1 GDP growth reached 5.2 percent in 2004—the highest rate in a decade—and helped create more than 1.5 million jobs in the formal sector.
- 1 The current account registered a surplus of 1.9 percent of GDP in 2004 following a strong increase in exports, which exceeded \$100 billion in the past 12 months.
- 1 Brazil's trade surplus was the seventh largest in the world last year—despite a 30 percent increase in imports that was spurred by a strong expansion in domestic investment.
- 1 While net public debt remains high at 51 percent of GDP, it is on a declining path for the first time in five years (see Table 1). The external net debt-to-exports ratio has dropped to a historic low of 145 percent. Also, the large trade surplus-to-imports ratio means the country can generate a sizeable free cash flow for each dollar of additional exports, making it easier for Brazil to earn the foreign currency it needs to keep servicing the debt.
- 1 The composition of public debt has also improved. The share of domestic debt indexed to the exchange rate dropped from close to 40 percent in 2002 to 13 percent in late 2004, and the share of fixed-rate debt has increased to about 20 percent.

Table 1.  
**Cutting the debt**  
Tighter fiscal policies have led to lower public debt.

	1999	2000	2001	2002	2003	2004	2005- Feb <sup>2</sup>
	(percent of GDP)						
Primary balance	3.2	3.5	3.6	3.9	4.4	4.6	4.8
Primary balance target <sup>1</sup>	3.1	3.4	3.4	3.9	4.3	4.3	-
Over-performance	0.1	0.1	0.2	0.0	0.1	0.4	-
Net public debt	48.7	48.8	52.6	55.5	57.2	51.8	51.3

Sources: Secretariat of the National Treasury and Central Bank of Brazil.

<sup>1</sup>Performance criteria under IMF arrangements.

<sup>2</sup>12-month flows.

The government's willingness to adopt consistent policies, combined with the unwavering support of multilateral institutions such as the IMF, the World Bank, the Inter-American Development Bank, and several of their member countries, has helped Brazil get to where it is today. The IMF helped shield Brazil from market turbulence in the

aftermath of the Russian crisis, the September 11, 2001 terrorist attacks, and the months leading up to the presidential elections in October 2002. The IMF program was reaffirmed by the incoming Lula administration and extended in December 2003 on a precautionary basis. In fact, Brazil chose not to use any of the money that became available after this date.

Moreover, Brazil has consistently over-performed on the core objectives of its IMF-supported programs, particularly those related to the primary surplus. Other ingredients of success have been the mutual trust and openness that have marked relations between Brazil and the IMF, with the Fund being willing to support new policies as illustrated, for instance, by its endorsement of Brazil's decision to move to inflation targeting in 1999. Together with the government's strong commitment to fiscal responsibility and a broad-based reform agenda, and in keeping with the IMF's commitment to streamline program conditionality, the performance criteria and structural benchmarks in Brazil's loan were gradually slimmed down and simplified, thus paving the way for a smooth and secure exit from IMF financing.

### **An evolving reform agenda**

Looking ahead, Brazil needs to follow up on its achievements in the macroeconomic arena and on the reforms conducted in the late 1990s with microeconomic reforms that will further improve efficiency. Otherwise, bottlenecks and high real interest rates may once again prevent Brazil from reaching its full potential. For this purpose, a microeconomic agenda covering five main areas—credit, taxes, conflict resolution, the business environment, and social inclusion—is being implemented.

***Improving access to credit.*** Access to credit is important for economic growth. Without a well-functioning banking system that can channel savings to productive uses, it becomes harder for businesses to invest and for individuals to make large purchases or start their own business. Credit currently amounts to only 25 percent of GDP in Brazil, compared with about 60 percent of GDP in Chile and more than 70 percent in many developed countries. And banking spreads are high, adding further to the cost of credit. Macroeconomic and fiscal factors used to play a major role, by crowding out capital markets and promoting higher risk premia. But institutional and legal problems that lengthen the process of debt foreclosure and recovery also contribute to high lending spreads.

One of the first measures to help reduce spreads was the automatic deduction of loan repayments from payrolls and pension checks, introduced in 2003. Since then, loans with this type of collateral have risen to 12 billion *reals* (\$4.5 billion). They account for about 30 percent of the stock of personal credit and have substantially lower spreads than more traditional credit arrangements (see Table 2). Improvements in how information about loan applicants is disseminated are also under way. Credit information in Brazil has traditionally focused mainly on negative information, such as defaults and delinquency. Now, good payment records are also being registered. This will foster competition among banks, contribute to

lower spreads, and encourage effective bank supervision.

Table 2.

**Cheaper credit**

Payroll-deductible loans are much cheaper than traditional credit arrangements.

Type of credit	Average interest rate
	(percent a month)
Overdraft facility	7.8
Personal credit	4.8
Payroll-deduction loans	2.8
Car loans	2.6

Sources: Central Bank of Brazil and Ministry of Finance, Secretariat for Economic Policy.

Note: Data are from February 2005.

New regulations in the real estate sector have made it easier for home buyers and sellers to resolve conflict. The government has also created new securitization instruments and introduced legislation that provides greater legal security for the purchasing and financing of new homes. These initiatives helped the construction sector rebound by 5.7 percent in 2004 after many years of decline. The government's attention is now focused on the insurance and reinsurance business, with a view to opening the latter to competition. Finally, Brazil is weighing new legislation that would give the central bank *de jure* independence, thereby cementing the *de facto* autonomy it has enjoyed for many years. Such a move would further develop credit markets, help reduce output volatility, and increase the effectiveness of monetary policy.

***Streamlining the tax system.*** The government will continue to simplify the tax system, something that can help reduce the size of the informal economy and enhance the efficiency of enterprises. The major federal indirect tax (COFINS, which raises about \$30 billion) was transformed from a turnover tax into a value-added tax, and the taxation of capital goods was reduced. Also, portfolio adjustments have been fully shielded from financial transaction taxes, and the tax burden on real estate securities and long-term savings, including pension funds, has been alleviated. (The pension fund industry in Brazil is among the 10 largest in the world and an important source of long-term capital.)

Looking ahead, discussions on how to further simplify—and eventually unify—the state-level value-added tax continue. The government is also looking at ways to reduce the tax burden on small and very small businesses. Since most informal labor takes place in the small business sector, these initiatives will help reduce poverty by creating new jobs and encouraging on-the-job learning.

***Lowering the cost of conflict resolution.*** The new bankruptcy law, while safeguarding workers' rights, has enhanced the seniority of financial claims, thereby strengthening credit supply. It has also

provided stakeholders with a stronger voice, and encouraged negotiation between debtors and creditors with less judicial interference. This has improved the survival chances of viable firms, while reducing the cost of closing nonviable ones. Other judiciary reforms will increase the predictability of court rulings, making high-court jurisprudence binding in lower courts. They will also promote arbitration over litigation and ensure greater accountability through external review and comparisons of court rulings.

***Improving the business environment.*** This is critical to boost investment and enhance growth prospects. The regulatory framework and the institutions enforcing it continue to be strengthened. Progress has been made in the electricity sector, where competition in the generation and distribution of electricity has increased, as well as in transportation, where recent rulings have boosted the confidence of operators and private investment in railroads. A bill aimed at improving the governance of regulatory agencies envisages that directors and agency heads will have fixed terms, ending midway through the presidential term for the latter group.

Efforts to foster investment in infrastructure also include recent legislation on public-private partnerships, which will ensure high standards of transparency for the public sector and adequate guarantees for private partners. A three-year pilot project, developed with the assistance of the IMF and other multilateral organizations, will channel more investment to important infrastructure projects without jeopardizing public debt dynamics, and will help the government select, implement, monitor, and evaluate infrastructure projects. Other steps to improve the business climate include reorganizing the antitrust system and implementing measures to reduce the cost of starting and closing companies. Recent surveys of Fortune 500 companies in Brazil showed that most of them are comfortable with the level of intellectual protection in the country.

***Improving the lot of the poor.*** Brazil still has high unemployment, widespread labor market informality, and one of the world's most skewed income distributions, making social initiatives vital. The Bolsa Familia cash transfer mechanism, which provides benefits linked to requirements such as school attendance, is the central program for reducing poverty, and reaches 6.5 million families. Another program is PRONAF, which encourages micro-credit and the formalization of labor relations in small-scale farming, thereby boosting productivity and improving market access for the weakest groups in rural areas.

More generally, the government is committed to improving the quality of social spending. For instance, public spending on education as a percentage of GDP is, at more than 5 percent, among the highest in developing countries. But the illiteracy rate among teenagers in the less-developed northeast region is still above 6 percent and several tests point to insufficient achievement levels by students nationwide. Improving the quality of education and ensuring that spending reaches the poorest can help significantly reduce poverty and create opportunities for new generations without resulting in undue fiscal costs.

### **In sum**

Over the past two years, strong fiscal and external accounts and lower inflation have allowed Brazil to benefit from a favorable external environment. Of course, there are still challenges, related notably to the size of the public debt. But efforts to further improve macroeconomic conditions will continue, as illustrated by the ambitious initiative, launched in March 2005, to reduce the deficit of the social security scheme for private sector workers, and the three-year budget directive law (known as LDO) sent to Congress in April 2005. This law confirms the primary surplus targets, while putting a lid on taxes and establishing a ceiling for expenditure in 2006–08. A sound macroeconomic environment will enable the government to improve the allocation of resources and push ahead with its structural reform agenda, leading to the accumulation of physical and human capital and greater social inclusion.

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