

THE OECD ECONOMIC SURVEY OF BRAZIL 2005

**Introductory remarks by Andrew Dean,
Deputy Director, OECD Economics Department,
at a seminar at the Getúlio Vargas Foundation, Rio de Janeiro,
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1. I would like to start by thanking Mr. Simonsen and the Getúlio Vargas Foundation for hosting this seminar and Mr. Appy and the Brazilian authorities for their support during the preparation of this second *OECD Economic Survey of Brazil*. It was a pleasure for us to work with colleagues in Brasília and in the several places we visited when doing our preparatory work for the Survey. And I am delighted to be here today in this distinguished company to launch the Survey.

2. Before discussing the challenges identified in the Survey for Brazil in the years ahead, I would first like to summarise in a few words our assessment of the current economic situation.

3. **Our assessment of the recent economic developments is by and large positive and we remain cautiously optimistic about Brazil's outlook.**

- 2004 was a good year for Brazil. The economic recovery is now well under way, following a few years of unimpressive growth. The economy has bounced back more strongly than anticipated: GDP is expected to have risen by 5 per cent in 2004 -- the fastest expansion in 10 years. By maintaining a prudent policy stance, the administration has done an impressive job in restoring confidence, which had faltered in the run-up to the presidential election in 2002. Domestic demand has since picked up, consumers and businesses are more confident, and private investment is recovering. These cautious policies are now bearing fruit and the near term outlook is promising.
- Crucial to the recovery has been renewed resilience to external shocks. The external sector has been Brazil's Achilles heel for many years, but the economy delivered record trade and current account surpluses in 2004 without serious domestic imbalances. This has been achieved through robust export growth, rather than a compression of imports, making the external adjustment an on-going process. The maintenance of a freely floating exchange rate has been essential. So has been the gradual reduction in trade barriers over time.
- It is also important to note that this strong performance would probably not have been possible without sound macroeconomic institutions. Good policies hardly ever deliver strong performance

when institutions are weak. This perception seems to already be entrenched in Brazilian society, making the strengthening of institutions an on-going process. Of particular importance in the macro area are the inflation targeting framework for monetary policymaking and the Fiscal Responsibility legislation, which have become the main institutional pillars for on-going macroeconomic adjustment. These institutions have been put to the test but withstood the succession of adverse shocks the economy has faced in the past few years. The authorities should be praised for their continued resolve in defending and strengthening these institutions.

4. To continue to build on these achievements, we consider the consolidation of macroeconomic stabilisation to be of paramount importance in the years to come.

- On the fiscal side, consolidation has been commendable but is yet to deliver an appreciable reduction in public indebtedness over a durable period of time. Sizeable primary surpluses -- of at least 4¼ per cent of GDP -- will remain necessary over the medium term to securely place the public debt on a downward trajectory in relation to GDP. An increase in the primary surplus target -- not only in 2004 on the back of higher-than-projected growth but over the medium term -- would be welcome to allow for a faster reduction in the public debt ratio. Lower public indebtedness would also contribute to making the fiscal stance less pro-cyclical over time, reducing the need for tightening in bad times and mitigating pressures for loosening in good times.
- Public debt management will need to remain prudent. A sustained reduction in the public debt ratio is of paramount importance. And, in the process, debt management should continue to focus on attenuating rollover risks in “bad” times and on reducing the government’s exposure to foreign exchange and interest rate volatility in “good” times. In doing so, the debt dynamics would become less vulnerable to changes in market sentiment, allaying concern among market participants over the sustainability of Brazil’s debt dynamics.
- At the same time, monetary policy will need to continue to respond swiftly to inflationary pressures. The Brazilian authorities should be praised for setting up a full-fledged institutional framework for inflation targeting following the floating of the real in 1999. The policy regime is working well. The central bank is perceived as being *de facto* independent, although autonomy is not ensured by law. Giving it *de jure* operational autonomy would contribute to boosting confidence in the institutional set-up. It is also important to acknowledge that the ultimate goal of inflation targeting is to deliver low, stable inflation over the longer term.

5. **Against this background, I would like to elaborate on the three main challenges identified in the Survey which need to be addressed. These are: *i*) improving the quality of fiscal consolidation, *ii*) enhancing the investment climate, and *iii*) strengthening social policies.** In doing so, it is important to bear in mind that these challenges are interrelated. They require a comprehensive set of measures in order to boost the economy's resilience to shocks, paving the way for sustainable growth in the years to come and for a faster catch-up in relative living standards.

6. **The first challenge is to improve the quality of on-going fiscal consolidation.** Fiscal adjustment has been achieved over the years predominantly by hiking taxes and cutting back public investment. As a result, Brazil now has a high tax ratio, much higher than in countries with comparable income levels. This is detrimental not only to growth but also to the labour market, encouraging informality. At the same time, it is hard to retrench current spending because of downward rigidities in the budget. Revenue earmarking is widespread and mandated expenditure levels have been created over the years. Also, reform of the social security regime for civil servants has lagged behind that of the private-sector regime, placing a heavy burden on the budget. Ensuring that the social security system is financially sustainable over time is a pre-requisite for making room in the budget for higher spending on more pro-poor social assistance programmes. It will also increase Brazil's preparedness to cope in the years to come with the spending pressures associated with a fairly rapidly ageing population. The upshot is that, by tackling these problems, the need for fiscal consolidation can be reconciled with that of alleviating Brazil's high tax burden in the years to come and channelling budgetary resources to meet society's economic and social priorities. The experience of OECD countries suggests that fiscal consolidation is more likely to be successful when based on the retrenchment of spending rather than investment cuts and revenue hikes.

7. **A second challenge is to improve the investment climate.** The new bankruptcy law is an important step forward to encourage the creation of credit to the private sector and to reduce intermediation costs. Interest spreads have come down but remain extremely high in Brazil. At the same time, efforts have been made to reduce regulatory uncertainty in network industries, such as in the electricity sector, which also weighs on investment. These reforms are well thought out but implementation will be their ultimate test. In the case of electricity, for example, a new model is now in place. But the risk of regulatory failure should not be underestimated, given the enhanced role of government in long-term planning. Private investment in water and sanitation continues to be constrained by a lack of clarity over the assignment of regulatory powers across different levels of government. This has held back much-needed investment. Brazil's experience with regulatory reform in the telecom sector shows how a well designed and implemented regulatory framework can create incentives for investment. New legislation on public-private

partnerships, if carried out in a fiscally sound manner, could also encourage private investment in a host of infrastructure projects.

8. **Finally, a third challenge is to strengthen social policies.** There seems to be widespread agreement within the government and beyond that social disparities do not allow for the benefits of sustained growth to be evenly spread among different social groups. Much has been done in this area over the last decade or so, with unquestionable improvements in key social indicators. An example is the increase in school enrolment over time, owing to sound policies and political resolve. The government continues to have an important role to play in this area, ensuring that social outcomes are commensurate with Brazil's already high levels of spending on social programmes, including pensions. To this end, public social spending will need to be more pro-poor, and scarce budgetary resources will need to be allocated to the programmes that are deemed to be most cost-effective and conducive to the accumulation of human capital. Public spending on pensions accounts for a higher share of GDP in Brazil than in the average OECD country, despite Brazil's younger population. But spending on means-tested programmes -- such as income transfers for the care of children, and elderly and disabled persons -- amounts to a relatively small share of public social spending, well below the OECD average. For public social policies to bear fruit, it is essential that efforts be focused on continuity, through an incremental strengthening of existing programmes and improvements in service delivery. It is important to strengthen the social policies that will allow for the pursuit of the government's social agenda while maintaining fiscal discipline and galvanising support for reform, always bearing in mind that sustained growth is necessary for poverty to be alleviated.

9. **To sum up, I would like to underscore this Survey's general assessment.** Brazil is currently reaping the benefits of macroeconomic consolidation, underpinned by a prudent policy stance and the strengthening of institutions for macroeconomic policymaking. External adjustment has been far-reaching and is set to continue, reducing vulnerabilities and boosting the economy's resilience to shocks in the years to come. Macroeconomic adjustment has been costly but is bearing fruit, as the conditions for sustained growth are by and large in place. This positive outlook is nevertheless not without risks, but provides the government with an invaluable opportunity to make headway into structural reform and for addressing policy areas where progress has so far proved difficult to achieve. We wish the authorities every success in seizing this opportunity and building on these achievements in the years to come.