

PRESIDENT LULA'S UNCERTAIN PATH

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It is fascinating to observe the drama playing out in Brazil of a life-long, left-leaning labor leader adopting mainstream economic measures that he had long opposed now that he is president of this important country. This reflects a sentiment common in Latin America and elsewhere, “Es otra cosa con guitarra.” (Loosely translated: It’s different when you must perform.) Luis Inácio “Lula” da Silva ran for president from the left three times before he was elected in his fourth try, but this time he shifted gradually to the center during his campaign and then, when he took office, endorsed measures that are important elements of the Washington Consensus, a policy prescription that is commonly derided by Latin America’s intellectual left. Lula had better succeed in his presidency, because if he fails his old allies will never let him forget this policy change.

Brazil, under Lula, agreed with the IMF to raise the country’s primary fiscal surplus (i.e., before taking interest payments into account) from 3.75 to 4.25 percent of GDP. This is designed to keep Brazil’s debt from growing further, but also has the obvious effect of limiting the government’s discretionary spending, including for social programs. “Gruel before jam” is how the *Economist* described this. The Central Bank has twice raised the country’s reference interest rate, the Selic, since Lula assumed office. The Selic rate is now 26.5 percent, and this is high both in nominal and real terms. The main motive was to stem the growth in inflation. The inflation target for this year is 8.5 percent, but few market watchers expect it to be this low. On a recent visit to Sao Paulo, analysts from one important Brazilian bank told me that this—containing the growth of inflation—might be Lula’s main challenge. Union wage bargaining becomes intense in April, and it will be hard to restrain large nominal wage increases in the face of rising inflation.

Lula’s reform agenda puts social security and tax reform at the top of his agenda, particularly reform of Brazil’s public sector pension system. Lula’s party, the Labor Party (PT) opposed such reform when it was proposed by President Fernando Henrique Cardoso, and the ironic argument that it stands a better chance of success now than before is precisely because it

is being pushed by a PT president. This difficult reform proposal is coming early in the Lula administration when the president’s prestige is high. The government has proposed a modest Zero Hunger program, one that will not bust the budget, and it is seen as a harbinger for what may come later when the budget permits. This builds on programs instituted by Lula’s predecessor, President Cardoso. Social programs like this were once seen as the bread and butter issues of a Lula presidency. They might still be—but not now. Unlike supply-side diehards in the United States, Lula does not believe he has the luxury of declaring that budget deficits don’t matter.

President Lula (as he is called in Brazil) demonstrated that he understood he could not ignore the natural conservatism of world money market players when he selected people for economic positions in his cabinet and in the Central Bank. The minister of finance, Antônio Palocci, is a member of the PT, but one reason for his appointment was that he was seen as “safe” by business and financial interests both in Brazil and elsewhere. As the *Economist* pointed out, Palocci, immediately after his appointment, traveled to the United States to urge the big banks to keep open their credit lines to Brazil. Lula’s choice to head Brazil’s Central Bank was Henrique de Campos Meirelles, president of BankBoston and FleetBoston’s Global Bank. Lula did not slight the PT in his cabinet appointments (18 of 29 cabinet appointments came from the PT), but it is clear that special care was taken in selecting those responsible for making macroeconomic policy decisions.

Lula won the presidency because he promised change, not just in his speeches, but also because of his very background—a poor boy with little formal education who rose to prominence by his energy and wits and has long demonstrated his sympathy for the downtrodden in his work, history, and outlook. His public popularity actually increased sharply after he won the election, and it became clear that he would be given a long honeymoon to demonstrate that he would make a difference to the average Brazilian. Just how long this honeymoon will last is unknown, but surely not more than a year.

Yet, during this year, he will be hobbled by the budgetary stringency imposed by the need not to grow Brazil's debt, especially the foreign currency debt or that tied to short-term interest rates. He may not succeed fully in either his tax or pension reform proposals, and this could tarnish his image as an agent of change. The enormous inequality of incomes and opportunities in Brazil cannot be altered in a year—or four or even eight years in office. Lawlessness, crime, and drug use are all growing, and after a year or so in office, this growth will likely be attributed to Lula's inability to deliver desired economic and social benefits.

Tensions are deep in the society. They exist between the political parties, the established elites and the new economic and social managers appointed by Lula, and between the hard liners in the PT and the pragmatists who are advocating mainstream economic policies for now. Almost 30 percent of the PT deputies in the Congress are from the far left. Yet, a great majority of the population wants Lula to succeed, as was clear in the election and subsequent opinion polls. Many financial and business people with whom I spoke when in Sao Paulo volunteered the sentiment that Brazil, if it is to have a prosperous future, must relieve the deep poverty and reduce the vast income inequality that exists. Lip service? Perhaps. But also, I think, a sign that they want Lula to succeed because if he doesn't, who knows what comes next.

This is the central theme of a survey of Brazil in the *Economist* of February 23, 2003, that carried the title "Make or break." Or as the author of the survey put it, it is possible to foresee two drastic outcomes: a "dream" scenario in which Lula succeeds in carrying out basic societal reforms; or a "nightmare" scenario in which the future is growing crime and rising poverty. A crucial requirement of the dream scenario is a growing GDP, one that provides more resources for the budget, helps create jobs, and reduces poverty. If one tries to understand why the left-leaning labor leader chose to start his administration with mainstream economic measures, this is the answer: Brazil cannot prosper, cannot get outside support, cannot attract investment, unless the government is seen as being responsible in handling economic fundamentals. Few observers expect GDP growth to exceed 1 to 2 percent this year, but current policies are designed to establish a foundation for more robust growth in the years ahead. Lula's task is not easy. He must retain his credentials as an agent of social change even as his economic measures put off that change until at least next year, and he must mollify widely disparate groups in society, those who have benefited from the system and those who have had to survive from the dregs that remained.

The U.S. government has played this transformation quite professionally, something one might not have anticipated given the indifference toward Brazil that prevailed earlier.

Much of the earlier relationship consisted of slugging it out on specific trade issues—Brazil's policy on restricting U.S. investment and imports in the computer industry, for example, and U.S. agricultural subsidies and import restrictions on key Brazilian products. Those of us in Washington who follow U.S. policy toward Brazil used to joke that official visitors from each country came with a list of trade complaints and that mindset framed the bilateral interaction. Knowledge of Brazil in the U.S. Congress was scant and few congressional visits to Brazil took place. There were even some offensive anti-Lula congressional pronouncements during the campaign. This surface knowledge was surprising because the U.S. business community had long since discovered Brazil, which was the largest destination for U.S. direct investment in Latin America. It was hard to fathom this official inattention to a country of 175 million people with an extensive industrial complex.

When Lula was elected, the administration welcomed his ascension to the presidency, and Lula visited with President Bush in Washington. The emissary that the Bush administration sent to Lula's inauguration was a cabinet-level official, Robert Zoellick, the U.S. trade representative; this was not bad, but not optimal because it tended to frame the relationship largely in trade terms at a time when much more is at stake. Many Latin American countries are going through difficult times in retaining their democratic institutions, and here was the largest of all the regional countries peacefully and democratically choosing a new president. Trade is important, but the U.S.-Brazilian relationship should extend more deeply into political, social, and global issues befitting the two largest countries in the Western Hemisphere.

Just a word on trade issues. Brazil—including Lula—has been ambiguous about its support of the Free Trade Area of the Americas (FTAA). Nevertheless, the reality is that Brazil is participating in the deliberations and jointly chairs the overall negotiation process with the United States. Brazil's final decisions about the FTAA are uncertain, but then so are those of the United States.

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