The Political Economy of Crisis: What Remains of Brazil’s Development Model?

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Abstract

This paper examines Brazil’s ongoing economic and political crisis and addresses two key questions. First, to what extent was the crisis a result of inherent flaws in the development model that had underpinned previous successes? Second, can the crisis be finally overcome, even in the absence of fundamental reforms? Regarding the first, the paper argues that Brazil’s development model, whatever its virtues, left unaddressed serious structural impediments to sustained inclusive growth. Once the global economic environment deteriorated and the domestic political environment fractured, these flaws brutally revealed themselves. Thanks to buoyant global demand and improved economic management, the Brazilian economy is now in the midst of a modest recovery. Yet it would be hard to pretend that this will prove sustainable in the absence of critical reforms in such areas as export diversification, human capital formation and public sector pensions. Without such reforms Brazil will not be able to embark on a path of sustainable, inclusive growth.

Introduction: A brief history of crisis

In August 2016 President Rousseff was impeached amid noisy scenes in the Brazilian Congress. This event marked the most dramatic twist so far in a long running economic and political crisis. The crisis has combined the steepest recession since World War 2 alongside popular protest, wide-ranging corruption scandals and a collapse in investment. Brazil’s star has fallen to an extent inconceivable just seven short years before. Then, an image of Rio’s famous Christ the Redeemer statue appearing to blast off from the top of the Corcovado Mountain had graced the cover of The Economist magazine. Foreign investment was pouring in, growth was accelerating and poverty was in sharp decline. Rio itself was set to host two of the World’s major sporting events, the FIFA World Cup and the Olympic Games. The arrival of Brazil as a serious, economically dynamic international power finally seemed at hand. Its emergence was genuinely welcomed on the world stage given long standing international affection for Brazil’s sporting and cultural achievements and the country’s studied non-interventionist posture (Reid, 2015).

Brazil’s successes began to attract the attention of international scholars anxious to determine the roots of such an apparently effective development strategy. In particular, curiosity surrounded aspects of Brazil’s policy regime that might be successfully emulated elsewhere. Interest centered on Brazil’s standout accomplishment: the reconciliation of robust growth with a frontal assault on poverty and inequality. In terms of Brazil’s own history, this achievement was remarkable. Brazil was, of course, no stranger to economic boom periods; the 19th century (another era of rampant globalization) had witnessed
several. In more recent times (the late 1960s and early 1970s), Brazil had surprised the world with a bull run of strong growth and rocketing inward FDI.

During these episodes, however, the fruits of economic expansion had been narrowly channeled towards richer groups, accentuating further the skewness of an already uneven income distribution. In the 2000s, though, the benefits of growth were being far more widely felt thanks to policy innovations — among them the feted *Bolsa Familia* — and structural changes in labor markets. The Brazilian experience appeared to offer an empirical shot in the arm to those who believed that globalization could be squared with social inclusion. Not surprisingly, Lula, Brazil’s President between 2003 and 2010, became widely celebrated among the international social democratic elite. His place in this pantheon was cemented as he rubbed shoulders with Al Gore, George Soros, Tony Blair and others at Davos summits.

Still, even at the height of these *mirum annis*, more seasoned observers were urging caution. Both within Brazil and outside there was always concern that, whatever the structural changes following economic stabilization in the mid-1990s, the country remained over dependent on commodity exports and, by extension, China’s appetite for these. Second, there was open acknowledgement that in many key areas, progress on vital, though politically contentious reforms had stalled. In the fields of tax reform, investment in infrastructure, educational provision and public health, too little real headway was being made. As Amann & Baer pointed out in 2006¹, the root cause of many of the difficulties in these areas could be traced to a reluctance to grapple with serious fiscal reform. In particular, there was a failure to tackle issues such as excessive public sector worker pension entitlements and constitutionally mandated transfers from the federal to sub-national governments. All of this meant that the authorities’ scope for discretionary spending was chronically limited. Without the necessary fiscal room for maneuver there was little scope for structural reformulation of the economy. This would prove critical once the commodities boom ended.

Less evident at the time, but very much tied to the political impasse surrounding key reforms, was the ticking time bomb of institutionalized political corruption. At the turn of the decade worrying signs began to emerge that Lula’s legislative successes were lubricated by elaborate payments schemes. These schemes, collectively termed the Mensalão, took advantage of pliable legislators, weak party discipline and an, as yet, underdeveloped constellation of monitoring and enforcement mechanisms. When revealed, the scandal did taint the credibility of the administration. Yet it remained so popular that the political damage proved containable. Far less obvious, indeed well hidden from public view, was another set of corruption schemes. These took advantage of the unhealthily close relationship between big business and major political parties. Only once Lula’s successor,

¹ Amann & Baer (2006)
Dilma Rousseff, was into her second term, was the scale and import of this corruption exposed to the harsh light of day.

The election of Dilma Rousseff, Lula’s hand-picked successor in October 2010 promised to usher in another successful chapter in Brazil’s development story. Yet within two years the favorable international tailwinds that had assisted Brazil’s rise had reversed direction and were starting to impede progress. By 2012 Dilma’s administration was having to grapple with the macroeconomic implications of sharply declining commodity prices. While never rapid under her predecessor, the pace of structural reforms slowed under the new President; indeed a certain lassitude began to characterize her legislative program.

By 2013 disquiet stemming from the chasm between elevated popular expectations and actual progress on the ground spilled over into social unrest. Rio, São Paulo and other cities witnessed violent street demonstrations triggered by sharp rises in bus fares. The juxtaposition of sub-standard basic services against public munificence for FIFA 2014 further fueled anger on the streets.

Rising levels of public protest were, by 2013-14, accompanied by a sharp economic reversal. Previously robust growth was now replaced by contracting output, rising unemployment and a worrying uptick in inflationary pressure. This deteriorating picture was completed by a sharp rise in the operational and primary fiscal deficits and an accompanying rise in the debt to GDP ratio. Further quarter on quarter contractions in GDP were experienced well into 2016, producing Brazil’s most enduring recession since World War II. Attempting to engineer a return to pre-recession levels of growth was always going to be an exceptionally tough challenge in the light of depressed global commodity prices and enduring structural bottlenecks. However, the capacity of the authorities to make real progress here became increasingly hampered by the eruption of a scandal even bigger in scale than the Mensalão.

The *Lava Jato* scandal, which surfaced in 2014, implicated several members of Congress and the administration in a corrupt kickback scheme involving contracts issued by Brazil’s leading oil producer, Petrobrás. The scandal, combined with a sharpening recession, undermined the authority of the administration. Eventually, the President herself succumbed and was impeached in August 2016\(^2\). Dilma’s replacement, Michel Temer, amid record low popularity ratings, embarked on a course of cautious market liberalization. By the end of 2017 the economy had begun to show modest signs of recovery. Still, the outlook remained clouded by uncertainties surrounding the October 2018 presidential election.

The course of events discussed above illustrate the rapid and apparently systemic nature of the crisis which has befallen one of the world’s preeminent emerging market economies. The purpose of this paper is to address two questions, the answers to which may have important ramifications for other middle income economies seeking to close the gap with

\(^2\) The direct cause of the impeachment centered on charges that the President had been manipulating public sector accounts data.
their richer counterparts. The questions are as follows. First, to what extent was the crisis a result of inherent flaws in the development model that had underpinned previous successes? Second, can the crisis be finally overcome, even in the absence of fundamental reforms?

**Brazil’s achievements**

From the current standpoint, it is sometimes easy to forget just how striking Brazil’s achievements have been since the successful stabilization of the economy in the mid-1990s. Baer (2013), Reid (2014), and Roett (2011) number among the many studies which highlight the remarkable transformation of the economic and social landscape over the last twenty years. As Chart 1 illustrates, one of the fundamental dimensions of success was the realization (up to 2014) of significant year on year increases in income per capita.

**Chart 1: Income Per Capita in Brazil, 1980-2016 (constant US$ 2005)**

![Chart 1: Income Per Capita in Brazil, 1980-2016 (constant US$ 2005)](image)

Source: Compiled by author from World Bank data

The record on growth here contrasts markedly with the 1980s (the lost decade) and the start of the 1990s when incomes fell, then stagnated. As might be expected, poorer income groups fared disproportionately worse during this era while, during earlier boom periods they had failed to fully capture the potential gains from surging growth (Baer, 2014). Once growth resumed in earnest from 1993 onwards, however, its benefits were much more widely felt. As Chart 2 indicates below, over the course of the last decade and into the first two years of this, those in the bottom three deciles of the income distribution (together with the richest decile) tended to gain most from the surge in growth.
The inclusive nature of the growth realized over the course of the 2000s and into the current decade is further reflected in Chart 3 which indicates strong reductions in income inequalities. The significance of this achievement cannot be overstated: during previous epochs of economic expansion little was realized in terms of evening out Brazil’s notoriously skewed income distribution.

**Chart 3: The Evolution of the Gini Coefficient in Brazil, 1995-2014**

Source: Compiled by the author from data supplied by IPEA
The sense that Brazil was undergoing a fundamental (and positive) economic transformation is further reinforced when one examines the evolution of other important economic indicators. Thus, throughout this period Brazil witnessed surging exports (especially mineral and agricultural exports), sharp rises in inward and outward foreign direct investment (FDI) and a relatively enviable record on the maintenance of price stability (inflation remained in single digits despite the quickening pace of economic activity) (ECLAC, 2014).

The successful assault on poverty together with rapid growth and intensifying international economic relationships dramatically elevated Brazil’s long subdued global profile (Burges, 2017). Thus Brazil under President Lula became an increasingly important actor on the international stage. In the realm of global economic governance Brazil turned more assertive, helping to found the BRICs Development Bank (now termed the New Development Bank). Through its seat on the G20 Brazil argued forcefully for better international exchange rate coordination. Brazil’s global economic influence was extended further by the establishment of foreign branches of the BNDES national development bank, the signing of cooperation agreements with several African states and a sharp expansion of the stock of foreign assets held by Brazilian corporations (ibid.). In short, by the turn of the present decade, Brazil had emerged as a major global economic power.

Elements of a development model

As mentioned in the introduction, Brazil’s economic and social successes in the 2000s prompted curiosity from policymakers and academics working in the development field worldwide. In particular, interest centered on the constellation of policies, institutional features and conjunctural factors which provided the foundations for inclusive growth. Amann & Barrientos (2016) argued that these policies, features and factors could, in combination, be said to comprise a “Development Model”. Furthermore, elements of this model could potentially be replicated in other country contexts, notably in Sub-Saharan Africa. But what exactly comprised its main features?

First, according to Amann & Barrientos (ibid.) the most fundamental, if not salient feature of the model was its blending of consensus and conjuncture. Many of the most important policy innovations facilitating the progress made were, at the time of their creation, politically contentious (Alston et. al 2016). Thus, for example, the containment of inflation via de-indexation, fiscal adjustment and the adoption of an exchange rate peg required measures which impinged on powerful vested interests and involved real opportunity costs (ibid.). Yet, the administrations of Itamar Franco (1992-1994) and Fernando Henrique Cardoso (1995-2001) proved able to expend political capital and forge the necessary consensus to overcome obstacles and secure the necessary reforms.
For Alston et al., fundamental to this process was an accompanying shift in collective beliefs as to the most appropriate ways to tackle what appeared to be an immovable obstacle (hyperinflation). Under Cardoso’s successor, President Lula (2002-2010) a significant popular mandate together with (as we now know) an institutionalized bribery scheme, manufactured the consensus necessary to enact groundbreaking social legislation. This notably included the Bolsa Familia conditional cash transfer (CCT) program.

However, as Amann & Barrientos (2016) argue, the ability to forge a consensus and adopt a coherent policy platform is not a sufficient condition for success. As the authors stress, certain conjunctural features need to be in place - notably a benign international economic environment. Regarding this, in Brazil’s case, a key platform upon which the inclusive growth strategy was built centered on buoyant international commodities prices. Thanks to deindustrialization in the 1980s and 1990s Brazil had become far more reliant on exports of Natural Resource-Based (NRB) products such as iron ore, soya and meat (Kingstone, 2012). Once prices and demand for these began to accelerate (in part thanks to China\(^3\)), significant impetus was imparted to Brazil’s growth.

The positive results here were magnified by spectacular productivity gains in the NRB sectors, notably agriculture (see Chart 4). These were associated with rapid technical progress (Figueiredo, 2016). The new-found competitiveness of the NRB sector forms a second feature of the model. Thus, it would be simplistic to characterize Brazil’s success as merely a reflexive reaction to high commodities prices; instead, real underlying structural change subtly altered Brazil’s place in the international division of labor, enabling it to add value to its staple exports and take full advantage of improving global market conditions.

**Chart 4: Global Agricultural Productivity Trends 1961-2010**

\(^3\) Which came to account for the second most important destination for Brazil’s exports
A third critical feature of the model was its centeredness on inclusive growth. As noted earlier, previous growth episodes had not seen the benefits widely dispersed. In Brazil, from the mid-1990s onwards this picture changed as the poorest sections of the population collectively enjoyed the largest relative gains. The vital question, of course, revolves around why in the contemporary era growth proved so inclusive when it had not done before. Some of the answers here are strongly connected with other features of the model. Specifically, Amann & Barrientos (ibid.) along with Alston et. al (2016) identify improvements in the fiscal capacity of the state not only to raise revenues but to target them in a pro-poor manner. This constitutes a fourth feature of the model and acknowledges the effectiveness (if not exactly efficiency) with which Brazil’s indirect tax-orientated fiscal regime was able to siphon off the resources necessary to tackle poverty.

In this connection, a fifth feature of the model (and undoubtedly the most celebrated in the literature) centers on the rise of inclusive and productivist social policy initiatives, notably the Bolsa Familia conditional cash transfer program launched in 2004. While certainly not the first such policy (predecessor initiatives had been launched during the Cardoso administration in the 1990s) the Bolsa proved surprisingly effective, reaching all of its target population within two years and being run at modest expense (less than 1% of GDP).

Popular fixation with the Bolsa should not obscure the fact that it was not by any means the principal driver of declining poverty and inequality. Over the past five years a growing body of empirical evidence points to other more significant influences. Ferreira (2014) identifies what may be considered a sixth feature of the model; growing inclusivity in the labor market. He argues that the key influence behind declining inequality was the increased ability of people (especially from disadvantaged groups such as women and people of color) to participate in the labor market. This was especially true in rural areas. Taken together, with a sharply tightening labor market up to 2012 the effect of this was to raise wages for the bottom three deciles of the population at a faster rate than for the middle and upper earners (ibid.).

The final feature of the model – macroeconomic stabilization – enabled the poor to lock in these gains instead of seeing them eroded away by inflation. As already mentioned, the achievement of macroeconomic stabilization was itself the product of the model’s most fundamental feature; the achievement of political consensus around contentious reform programs. Once the basis for consensus began to fragment, further progress would be impeded; at the same time the achievements made would be placed in jeopardy.

**Brazil enters crisis**

The reversal of fortune experienced by Brazil in the early part of this decade was rapid indeed. As Chart 5 indicates below, having emerged from the 2008 international financial
crisis virtually unscathed, Brazil enjoyed robust growth from the early part of 2009 right up to the end of 2011. The pace of expansion slowed rapidly in the following two years while by the start of 2014 Brazil had slipped into a sharp recession. Only by 2016 were signs of recovery evident. However, growth remains weak. According to Central Bank forecasts, GDP is expected to expand by no more than 0.9% for the full year in 2017.

Almost as perturbing was the return of significant inflationary pressure. For 2015 average consumer price inflation slipped into double digits, reaching 10.68%. This was well above the central target of 6.5% established by the monetary policy committee of the Brazilian Central Bank. Perhaps undesirably, given the sharp contraction in aggregate demand, the surge in inflation forced the authorities to tighten fiscal policy while raising interest rates. The base rate reached 14.25%, amongst the highest for all emerging market economies. Painful though this measure was, it soon contributed to a sharp fall in consumer price inflation which the Central Bank expects to reach 3.2% for 2017 as a whole. This allowed the authorities to lower base rates to 8.25% by late 2017.

The sharp recession unsurprisingly undermined labour markets. By Nov 2015, unemployment reached 7.5% having risen for the seventh consecutive month and having attained a level much above the record low of 4.3% achieved in December 2013. By October 2017, despite signs of recovery in demand, the unemployment rate had risen to 12.2%. These developments have inevitably had implications for the poorest in society: the number of Brazilians below the extreme poverty line rose between 2012 and 2013 (from 10.08m to 10.45m), the first time a rise had been registered since 2003.

Chart 5: Brazil – Quarterly GDP growth (%), 2008-17*

*Quarterly variation in GDP at market prices compared with same quarter in previous year

Source: Elaborated by the author from data supplied by IPEA
All of the above may simply suggest the symptoms of a recession, perhaps cyclical in nature which would inevitably pass of its own accord. However, it can be reasonably argued that the recession was but one dimension of a broader, more systemic crisis afflicting the political economy of Brazil. Evidence to support this is not hard to find. Among the most obvious and earliest manifestations of broader social disquiet at the economic and political trajectory of Brazil under President Rousseff were the globally publicised riots of 2013. These started in Rio de Janeiro and initially centred on sharp rises in bus fares; they soon spread to other cities and further violent demonstrations occurred in the run up to the 2014 World Cup which Brazil of course hosted.

The advent of recession virtually coincided with the start of President Dilma Rousseff’s first administration. Very soon it became apparent that policy makers were struggling to articulate a coherent strategy to deal with it, either through short term fiscal and monetary measures or through enacting longer term structural reforms. The absence of concerted action further dented the credibility of the administration in the eyes of investors; it also began to deplete its stock of political capital among its mass popular support base and allies in Congress. The weakening of authority only intensified following the emergence of the Lava Jato and related corruption scandals in 2014.

By the beginning of 2016, a combination of prolonged recession and intensifying corruption allegations had weakened this authority even more. Further, the broad centrist consensus upon which such critical reforms as the Real Plan and the Bolsa Familia had been built, looked in severe danger of breaking down altogether. During the course of 2016 rival pro and anti-government mass demonstrations filled the streets of Rio de Janeiro, São Paulo and other major cities. The hollowing out of the centre ground and the rise of populist rhetoric had strong echoes of similar processes playing out across the US and Europe.

As polarisation of the political landscape continued, an impeachment trial was launched against the President. In August 2016 this ultimately proved successful; in the meantime, however, the capacity of the Executive or Congress to tackle the causes of recession was severely degraded.

The discussion above therefore suggests that there are further, systemic dimensions to the Brazilian crisis than the advent of a common or garden recession. All of this begs an important question: were there inherent flaws in the Brazilian development model which made such a crisis an inevitability?

**A flawed model?**

It has already been suggested that a blend of political consensus and conjuncture lay at the heart of Brazil’s development model as poverty and inequality declined through the late 1990s into the 2000s. As should be evident, a conjunctural vulnerability always stemmed
from the requirement for benign global economic conditions, especially where they concerned demand for Brazil’s key commodities exports. As Chart 6 shows below, following an initial dip in the wake of the Lehman Brothers crisis in 2008-9, world commodity prices declined sharply after 2011.

Chart 6: IMF Commodity Price Index, 2000-2017

Source: IMF

For Brazil, the scale of the price adjustment represented an especially severe challenge since approximately 70% of exports were concentrated in the NRB sector. The relative and absolute importance of this sector has increased significantly following stabilization in the 1990s. The fundamental reason for this stems from the more liberal trade policies employed in this era; these have encouraged deindustrialization and a reversion to areas of natural comparative advantage. Much the same processes have been witnessed across the Southern Cone of Latin America, notably in Argentina and Chile (Castillo & Neto, 2016). As we have noted, Brazil’s development model encompassed a pro-active approach to this return to earlier patterns of specialization: agriculture, especially, has invested heavily in training and technology resulting in accelerating productivity and a movement up the value chain (Figueiredo, 2016). Nonetheless, the increasing relative dependence on NRB exports (even higher value-added ones) represented a source of vulnerability which rapidly hit home once commodity prices began to decline.

The dangers of overreliance on commodities production seemed obvious even at the height of Brazil’s boom. They surely represent a clear flaw in the model. Yet nowhere were effective systematic efforts made to alleviate this. One reason for this may lie in the sheer scale of the challenge that will need to be overcome if Brazil is to be as international competitive across a range of manufactured exports as it is, for example, in minerals. To give some idea of the scope of this it is worth taking a look at Chart 7.
As the chart indicates, in contrast to agriculture, across all productive sectors Brazilian labor productivity growth has significantly lagged behind the US and South Korea (like Brazil an economy which industrialized in the first three decades after WWII). Moreover, with a very few and celebrated exceptions, Brazilian industrial enterprises typically fail to operate at the global technological frontier and have rarely internationalized (Amann & Cantwell, 2012). These structural weaknesses have long been recognized (Giambiagi et. al . 2011). However, with a very few exceptions attempts to remedy them over the years have been sporadic and short-lived. In this less than storied tradition, the Lula and Rousseff administrations followed suit with what amounted to a rebooted import substitution industrialization (ISI) policy targeted at the oil and gas sector. This policy did end up adding to domestic capacity in shipbuilding and offshore engineering; however many such projects have become tangled in the Lava Jato scandal or have succumbed to Petrobras investment cuts triggered by falling oil prices.

Further impeding a less lop sided participation in the global division of labor has been lack of progress in alleviating long standing structural constraints around infrastructure and education. Regarding the former, Ferreira (2007) and Amann et. al. (2016) point to the potentially powerful pro-growth and pro-export effects of accelerated investment in

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4 Such as support for the bio technology and aerospace sectors
5 A good example of a short-lived but well-intentioned program being the Brazilian Quality and Productivity Program (PBQP) from the mid-1990s
6 The ISI strategy was of course employed in the industrialization of Brazil from the 1930s through to the 1980s
infrastructure. Yet, as these authors make clear, the ability of infrastructure provision to keep pace with demand has been constrained by poor regulatory design and coordination, limited access to financing, environmental considerations and shortage of technical capacity. It is also becoming increasingly clear that the corrupt processes through which certain public infrastructure projects were commissioned will have had an adverse impact on their cost-effectiveness. As a result of Lava Jato and related inquiries, many of Brazil’s major construction firms (including its largest, Odebrecht) are under investigation with senior managers in jail.

Education forms a serious constraint acting on Brazil’s competitiveness and its ability to find new niches in the global division of labor and, of course to tackle poverty. As in the case of infrastructure, adequate investment in quality education (especially at the primary and secondary levels) represents another important element missing from the Brazilian development model as it emerged in the 2000s. De Moura Castro (2018) in a detailed study illustrates the extent to which educational achievement at Brazil severely lags that of other emerging market economies, especially those in East Asia. For the author, the issue is not simply one of inadequate resources; it is also one of poor policy design, overlapping bureaucracies and unhelpful political interference. Of course, not all Brazilian education is of low quality; the country is host to a slew of world class universities. In addition, elements of its technical education system (SENAI) have proven very effective at raising skill levels to the extent that the model has been exported to Africa (Villalobos & Klasen, 2016).

Brazil remains, of course, a country characterized by a low domestic savings ratio. This feature, together with low educational attainment places the country in sharp contrast with its Asian emerging market peers. At various points in its post war development trajectory Brazil had embarked on what amounted to a “debt with growth strategy”, drawing on foreign savings to supplement those domestically available (Baer, 2014). Once access to foreign capital markets tightened, macroeconomic adjustment inevitably followed. The classic example of this occurred in the early 1980s when Brazil fell into the Latin American debt adjustment crisis7.

During the more recent growth cycle, earlier debt dependency reasserted itself, this time with a twist. Partly thanks to greater financial liberalization and the integration of greater numbers of people into the formal financial sector8, the incidence of corporate and household debt in GDP rose significantly. OECD data reveal that the stock of private sector debt increased from 108.8% of GDP in 2009 to 137.3% by 2014. The sharp rise in private sector debt levels during the post stabilization period can be contrasted with earlier growth episodes where, in a more repressive financial regulatory environment, it was the accumulation of public debt which represented the salient feature. In the new environment consumer lending – especially connected with vehicle and electrical goods purchases –

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7 Indeed in 1987 Brazil defaulted on its sovereign debt. Mexico had done the same four years earlier.
8 Another, less celebrated, element of Brazil’s inclusive growth strategy.
became an especially dynamic element in the accumulation of debt. Thus to some extent, the surge of growth experienced during the 2000s resembled consumer credit-driven booms of the type long experienced by advanced industrialized economies, notably the UK.

While during the last decade the pursuit of primary surplus targets had contained the expansion of public debt, by the start of the 2010s the authorities under President Rousseff had lessened their commitment to fiscal discipline as a more “developmentalist” agenda took shape under Finance Minister Guido Mantega. The collapse in growth after 2011 put considerable strain on revenues, further loosening fiscal policy and resulting in a surge of public sector indebtedness. The results of this episode can clearly be seen in Chart 9 below which illustrates the extent to which net public sector debt climbed at worrying rates. Attempting to disguise the true level of the deterioration in the fiscal position the President opted to engage in “Pedaladas Fiscais” (literally, “Fiscal Pedaling”). Through this (illegal) mechanism payments owed by the Federal government to the state banking system were delayed, making the primary balance appear more favorable than in fact was the case.

Chart 8: The Expansion of Net Public Sector Debt Since 2011-17 (%GDP)

![Chart](image)

Source: Elaborated by author from Banco Central do Brasil data

As noted at the start of this paper, it was the President’s sanctioning of the Pedaladas which proved ultimately her undoing. From a more general perspective, however, what the episode reveals is just how quickly one of the pillars of the Brazilian Development Model – a commitment to macroeconomic stabilization – had begun to crumble. Moreover, our brief

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9 Part of which involved, as noted, an import substitution drive in the oil and gas sectors.
examination of the debt issue makes clear the centrality of debt accumulation to the acceleration of growth during the boom years. This must surely be considered another flaw in the model.

Escaping crisis and the prospects for reform

As the previous section revealed, the Brazilian development model, successful though it has been in many respects, does indeed possess a number of flaws. These centre on long standing features of the Brazilian economy which would have been familiar to researchers and policymakers as far back as the 1950s and 1960s. Then, structuralist economists, notably Celso Furtado (Furtado, 1961), identified impediments to sustained growth centering on familiar issues such as over-exposure to the global commodity cycle, low levels of human capital formation, an inadequate domestic savings ratio and poor national economic integration (as opposed to close international integration in the case of the traditional export sectors). The fact that these structural obstacles to sustained inclusive growth still remain of relevance is a sobering fact. Yet, as China and South Korea and even India have shown, it is possible to convincingly tackle them and, in so doing, transform competitiveness and long term growth potential (Kohli, 2004).

The fact that the flaws we have identified have been recognized for so long and yet remain inadequately addressed represents, at first sight, a real puzzle. However, the puzzle becomes more comprehensible the closer one examines the issues themselves and the shifting sands of the Brazilian political landscape. Regarding the first point, it needs to be acknowledged that structural impediments to growth such as poor educational achievement and an overreliance on commodities exports are fundamental and systemic issues. They are only likely to be resolved over several electoral cycles if consistent and well thought through policies are applied. The fact that the “pay-off” to structural reforms almost always occurs beyond the lives of administrations that enact them goes a long way to explain why in many cases they are never properly pursued.

Still, it must be recognized that democratically accountable administrations in other parts of the world – and even on occasion in Brazil - have managed to seize the inter-generational challenge that structural reform can represent. As Alston et. al. (2016) have stressed, the key to success appears to be the forging of a political consensus which itself is born of broader popular consent. Under such circumstances policies such as supply side reform or macroeconomic adjustment, though costly in the short term are commonly deemed necessary to secure longer term benefits. Alston et. al. very convincingly demonstrate, in the case of Brazil that the molding of such consensus depends on the sharing of collective “beliefs”. These concern both the diagnosis of the situation and the appropriate policy response.
If one is to subscribe to this analysis, it should be evident that current circumstances are not propitious for deep reform. The broad cross party social democratic consensus that characterized the Cardoso years (1995-2002) had already begun to break down under Lula, a process that accelerated under the more divisive and partisan Rousseff. However the advent of crisis and the emergence of the Lava Jato and related scandals appear to have further undermined the foundations of consensus, creating a more polarized, febrile political environment.

Attempts to fashion a new pro-reform consensus under President Michel Temer will not only have to grapple with the political cleavage which has opened up, but also long-standing institutional features of Brazilian congressional democracy. As Power (2008) among others observes, the ability of the Executive to enact legislation, especially contentious legislation, is inhibited by the plurality of political parties, weak party discipline, the strong regional (as opposed to national) affinities of legislators and the existence of open lists.

Under these circumstances, unless the Executive enjoys a strong popular mandate and can skillfully negotiate with members of Congress, rapid legislative progress can be very difficult. In the case of President Temer, it is evident that such a popular mandate is lacking while several members of Congress (from a range of political parties including Dilma’s PT and Temer’s PMDB) are under investigation for corrupt practice. Hence, the prospects for a resumption of fundamental structural reforms appear dim. Indeed, some observers argue that, for such reform it may prove necessary to wait until the election of a new President in 2018. Assuming progress here really is so slow, can Brazil finally emerge from crisis?

Having been appointed mid-2016, President Michel Temer and Finance Minister Henrique Meirelles have prioritized the pursuit of measures designed to restore investor confidence and to bring order to public sector finances. The key elements of their recovery strategy revealed so far comprise a proposed multi-year real terms spending cap and an accelerated privatization program (*Financial Times*, May 15th, 2017). The aim of the former is to contain the expansion of public debt through adopting a clearly visible target. The latter, if met, should sequentially build up policymakers’ credibility, assisting in the process of macroeconomic stabilization. There are strong echoes of similar policy rules successfully (for a while) followed in the past; these included the targeting of the Real: US Dollar exchange rate and, more recently, the primary fiscal surplus. The second – privatization - measure effectively represents a resumption of earlier ventures with the emphasis this time on addressing some of the most chronic bottlenecks in transportation infrastructure. The initial focus centers on the sale of concessions in the highways, airports and ports sectors.

While the measures so far announced tackle important issues it cannot be pretended – and indeed no one is pretending – that they represent a solution to Brazil’s ingrained structural

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10 Amann et. al. (2014) econometrically demonstrate the especially strong growth elasticities associated with investment in this area
deficiencies. In fact, the self-imposed spending cap is likely to restrict further the scope for growth-enhancing expenditures in such areas as education and technology. The fiscal space here would in any case be under severe duress. This is because Brazil’s fiscal dynamics are characterized by a tendency for non-discretionary items of expenditure (notably debt servicing) to squeeze out discretionary items (especially investment) (Amann & Baer, 2006).

Taking all of this into account, it would be unrealistic to expect much policy-induced growth stimulus, or, for that matter, inclusive growth in the short to medium term. If one concurs with this sober assessment the question then arises as to whether Brazil will be able to emerge fully from crisis at all. There is reason to believe that, given the resilience of some elements of the development model, the answer may be a qualified ‘yes’. The explanation for this is as follows. First, as Chart 9 indicates, since 2014 the strong depreciation of the Real, allied to a reduction in domestic absorption has resulted in a turnaround in the trade balance. This will serve as a net stimulus to growth while containing the current account deficit.

**Chart 9: Evolution of the Trade Balance, 1995-2016 (US$M)**

The continued positive evolution of the trade balance will, of course, be supported by Brazil’s enduring competitive strengths as a NRB product exporter. This key leg of the development model may have an intensifying role to play in propelling growth given the current firming of commodity prices. Indeed, partly based on this, as the chart reveal, Brazil is at last no longer in a technical recession though the exit velocity is sluggish (0.7% forecast growth in 2017). A second key element of the model – inclusive and productivist social policies – is likely to remain in place notwithstanding the fiscal squeeze contemplated by the
new administration. Although qualification criteria for the Bolsa Família have been tightened up there is no suggestion that this, or other key initiatives are in danger of abolition. To this extent, once growth does resume there is every likelihood that it will prove as inclusive as it had under Lula or Rousseff. This is providing, of course, that labor markets remain as capable of absorbing people from less advantaged groups as previously (and there is no objective reason to believe otherwise).

Another key factor, the drive against corruption, should also pay dividends in the future. As Prado & Carson (2016) indicate, enforcement and monitoring mechanisms targeting corruption have multiplied considerably in recent years. Progressively, greater transparency is being brought to bear both in the political process and around tendering for public sector contracts. This may well in the longer term facilitate the more cost-effective provision of infrastructure, one of the clear deficiencies we earlier identified in Brazil’s development model.

Another deficiency earlier discussed – indebtedness – remains a worry. Yet there are reasons to believe that Brazil is not on the verge of a repeat of the debt adjustment crisis of the 1980s. First of all, compared to earlier periods relatively little debt is foreign currency denominated. For the federal government the foreign currency-denominated debt stock stands at just 2.4% of GDP. The bigger problem, in fact is domestic currency (Real) denominated debt, and here default rates have been rising (for non-personal debt the default rate rose from 3% in March 2011 to 5.9% in May 2016). However, the scope for the debt issue triggering a full-blown crisis is limited. This is because of the absence of a liabilities currency mismatch issue and a well capitalised and regulated banking system. Given the debt profile the authorities always retain the option of recapitalising the banking system with Reais if a domestic currency denominated debt crisis did emerge. Perhaps, the real problem with the extent of the debt – both public and private - is that it limits freedom to raise interest rates - if inflation is above target. Thus, Brazil runs the risk of running into fiscal dominance.

Conclusions

This paper has argued that the onset of crisis in Brazil, was to a great extent, the outcome of ingrained flaws in the country’s development model. These flaws – which center on structural bottlenecks – have long been recognized. However, the necessary political consensus to address most of them has been slow in arriving. At a time of stark political polarization, both in Congress and on the streets, the necessary policy measures seem further away than ever. Against this background it might be tempting to conclude that Brazil might not emerge from crisis for a very long time. However, certain resilient features of the model together with improvements in the global and domestic conjunctures are now propelling a modest economic recovery. In particular, the Brazilian economy is benefiting
from a combination of buoyant global demand, a steadying of investor nerves following the impeachment of President Rousseff, and the effects of lower interest rates. The broader question is whether this recovery can be sustained and, more pertinently, whether Brazil can resume the trajectory of inclusive growth it enjoyed up to 2012. Again, the answer here boils to the issue of the structural reforms which will be required to alleviate bottlenecks, raise productivity and diversify the export base. Whether these can be pursued will depend on the future political course of Brazil and, most proximately, on the outcome of October 2018’s presidential election. At the time of writing, such is the uncertainty in Brazilian politics that it is very difficult to predict the range of candidates likely to run, let alone the eventual result. So the future, though not devoid of hope or potential, remains clouded in uncertainty.
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