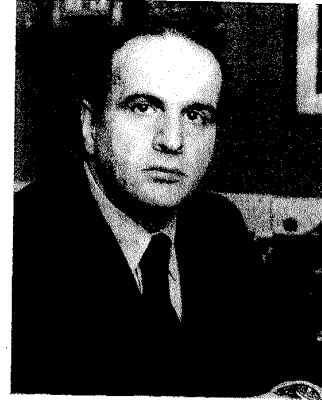


Off to a Good Start

Brazil's President Luiz Inácio Lula da Silva has achieved a lot in his first year in office. His reform agenda next year promises to be as challenging as it has been in 2003. *by Murillo de Aragão*



I wrote in this magazine a year ago, during the tense 2002 presidential elections, that whoever won would face a challenging reform agenda. I wrote that reforms were needed, "To release the immense potential of a hardworking, creative and dynamic society."

Another important point I raised last year was that the media had exaggerated the depth and extent of President Luiz Inácio Lula da Silva's leftist convictions. I also mentioned a few challenges. He and his Workers Party (PT) had to overcome the temptation of adopting heterodox, or unconventional, economic policies. Lula also had to negotiate with conservative leaders, the very individuals he had spent much of his political career opposing, to build a political base for his government in Congress.

Both these challenges have been met with flying colors. Lula has built a majority in Congress composed of parties from a variety of ideological backgrounds. He is also winning an intense battle with those members of the PT who want to accelerate economic growth by increasing public spending.

Four Challenges

There are three major reform challenges facing the government in 2004.

The first is to maintain the twin principles of economic austerity and fiscal responsibility. The second is to press ahead with a series of constitutional amendments and associated reforms. Finally, by drawing up policies that are consistent with its economic reforms, the government must promote economic and social growth.

Clearly, this is not an easy agenda to fulfill. Yet the outlook for Brazil is positive because of the considerable progress it has already made. The agenda for 2003 was carried out with great success. The country has generated a substantial trade surplus, the government has made great progress with the reforms that it had promised to carry out. It has begun a drastic reduction in interest rates, maintained its fiscal policies intact and, finally, renewed its stand-by agreement with the International Monetary Fund on favorable terms.

The government's most immediate challenge is to maintain its economic policies unchanged. In spite of his

success in stabilizing the country and creating positive expectations this year, Finance Minister Antonio Palocci is under constant attack from sectors that oppose his economic policies. On several occasions we were left with the impression that Palocci's support in the government's inner councils was not as firm as was supposed.

However, Palocci has succeeded in becoming the anchor of the Lula government, much as Armínio Fraga was during the second 1999-2002 government of President Fernando Henrique Cardoso, when he served as Central Bank president. Were Palocci to quit, the positive outlook for Brazil would suffer unless his replacement were to follow the same line of action.

Friendly Fire

Lula realizes clearly that maintaining positive economic expectations is critical for his success as president. However, part of the PT still relishes the radical rhetoric from its days as an opposition party. Thus, it is a priority for him to continue minding out for "friendly fire" and to protect Palocci and his policies.

One of the concerns investors have about Brazil is over the second phase of the Lula administration's reforms. His next steps are very important to signal that the quality of Brazil's public finances will continue improving. Even as late as mid-November, the agenda for 2004 still remains open because the government has not yet defined its priorities clearly.

Apparently, the economic team would like to promote an agenda that improves the investment climate. The financial markets would like to see further advances in fiscal policy. This would require further debates over social security reform and over tax policy. However, the legislative program for 2004 will be limited due to municipal elections due later in the year. It will become increasingly difficult to win a Congressional majority for controversial issues toward the end of the first half of 2004, as elections approach. The government will thus have to reconcile advances in the legislative agenda with the political debate and the electoral timetable.

The potential agenda for 2004 is extensive. It includes concluding passage of legislation reforming the bankruptcy

parting shot

code, legislation on regulatory agencies, on public-private partnerships and a new structure for the electric industry, a law on bio-security, Central Bank autonomy, some aspects of social security reform as well as debates on modifying labor legislation and the judicial branch.

As well as the time limits imposed by upcoming local elections, the reform agenda could also be truncated to include just a few questions because of the government's inability to advance on all these fronts simultaneously. However, to avoid frustrating expectations, the government must make an effort to maintain the same degree of political efficiency in pushing ahead with the agenda as it has demonstrated so far. Considering that the government has built a political alliance that ensures it a majority in Congress and that dialog with the opposition, even if it has sometimes been difficult, has nonetheless been fruitful, the chances of advancing with the reform agenda remain as consistent as before.

Finally, there is the question of economic growth. After this year's GDP growth rate of barely 1%, we hope that the performance of the Brazilian economy will be far better in 2004. Once the initial fears over a Lula government were swept aside, the economic team began reducing interest rates, spurring growth. The sound performance of Brazil's exports is another driver of economic growth. If we combine confidence in the government's management of the economy with lower interest rates, we expect growth next year to exceed 3%. This is particularly so, if the international economic environment remains reasonably positive.

Considering that the expectations for 2004 are generally positive, what are the risks?

There are three major risks for economic policy. The greatest is the government's ability to handle "friendly fire" from the PT's ranks and from those of its Congressional allies who oppose its economic policies and want accelerated economic growth. A second risk is that governors of states with fragile finances will exert heavy political pressure on the government to win economic support. Finally, there is a risk

that economic growth will turn out to be lower than expected and Palocci and his team could lose political backing.

As for regulatory policies, we must monitor closely the debate over the new regulatory framework for the electric industry and the new rules governing the operation of the regulatory agencies overseeing the telecom, energy and oil industries. These are important questions that will affect the climate for investment in Brazil.

As regards social policy, we will have to watch carefully how the government proceeds in designing programs and actions that reduce criminal violence in the country's big cities, an issue that directly affects all sectors of society.

Managing the militant MST landless farm workers movement is also an important issue because of its potential for destabilizing the political environment.

Right Direction

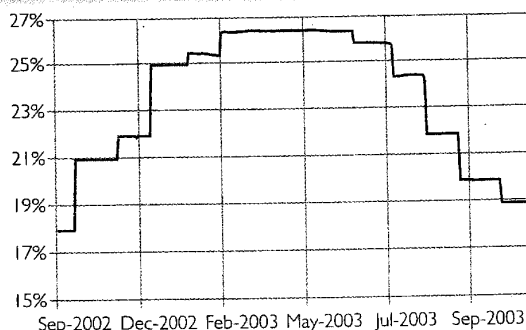
Finally, we must conclude with economic policy. Bearing in mind the positive indicators at the end of 2003 and the strong possibility that the government will succeed in fulfilling its reform agenda, it is quite probable that Brazil can indeed achieve 3% growth in 2004.

However, it remains to be seen whether the cycle of growth that should begin early in 2004 is in fact sustainable, or whether it turns out to be a flash in the pan. Brazil needs to achieve consistent economic growth over a number of years to improve its economic and social indicators. We can say with a great degree of certainty that Brazil is heading in the right direction again. Nevertheless, the strength of the cycle of economic growth that is beginning now will depend on the continuation of reforms and the effectiveness of the government's economic policies. **LF**

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Cut Rate

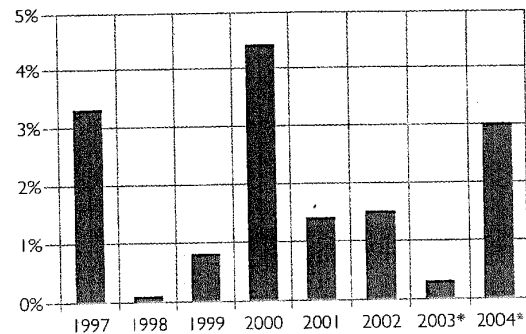
Selic - Central Bank benchmark interest rate



Source: *Economática*

Time to Start Growing

Brazil - Real GDP Growth



Source: CSFB

*Forecast