Ready to score again

By HE ANTÔNIO PALOCCI

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ANTÔNIO PALOCCI is a sanitarian and public health physician who entered politics in 1989 as Municipal Councilman for Ribeirão Preto, São Paulo state. He went on to become Member of the São Paulo State Legislative Assembly (1991-92) and São Paulo state Chairman of the Workers' Party (PT), a position he held from 1997-98. Mr Palocci was elected Federal Congressman for the state of São Paulo in 1999, and thereafter Mayor of the municipality of Ribeirão Preto from 2001-02. He was appointed Finance Minister in January 2003.

I believe British history provides numerous lessons in the field of economics. England's early success in limiting the power of the King to tax and spend, and his freedom to get into debt, is widely regarded as having been a key factor in enabling Britain to spearhead the industrial revolution. Much more recently, the UK has demonstrated the importance of fiscal discipline and good government through the turnaround in job creation, investment and economic growth it has achieved in the last decade.

Solid public accounts are also the best guarantee that the government will be able to fulfil its social obligations. Inflation is one of the greatest enemies of working people. Unfocused public spending drains valuable resources, increasing the burden on the weaker members of society and creating uncertainty. This is why the Lula administration's efforts to alleviate poverty and increase the opportunities available to the less advantaged have been built on fiscal consolidation and the principles underpinning a well-functioning market economy (such as the consistent enforcement of contracts). These policies have helped Brazil take advantage of the favourable international environment in order to buttress its external and fiscal accounts while at the same time succeeding in reducing income inequality.

One of the first reforms implemented by the Lula administration dealt with imbalances in the social security regime for public servants. That was followed by major changes to the administration of the pay-as-you-go pension scheme for private-sector workers. These changes included the appointment of a new, professional leadership and the overhauling of supporting services such as data management. Procedures for providing state benefits are also being reviewed. Reducing the social security deficit is a priority in order for the country to be able to afford innovative social programs such as the Bolsa Família, which provides an allowance to poor households containing children with good school-attendance records.

Consistent over-performance on fiscal targets has helped reduce the public debt/GDP ratio for three years in a row, following almost a decade of successive increases up to 2002. Fiscal policy and the de-facto autonomy of the Central Bank have also paved the way to lower interest rates and the development of a medium-term local currency yield curve. Together with changes in loan regulations that have strengthened debt collection, and the 2004 new bankruptcy law, these reforms are creating the bases for a solid, balanced credit expansion.

The Brazilian banking sector, which successfully weathered several international financial crises in the 1990s and early 2000s, is ready to play an important role in supporting a new cycle of investment and growth. Foreign banks are in a good position to compete with Brazilian private and public banks. Each segment accounts for about a third of the market and has contributed to the 50 per cent expansion in personal and consumer credit observed in the last several quarters. According to many in the industry, middle-market business credit is poised to be the next segment to benefit from this structural change.

New ways of financing business are also important in order to promote activities such as software production and business solutions, in which Brazil has developed a solid reputation. Many transnational companies have recognised this, choosing Brazil as one of their main global suppliers of such services. Recent clarification regarding the taxation of venture capital is bound to stimulate new endeavours in this and related areas, adding to an innovation agenda already in place, which includes new rules for universities sharing in profits from research and patents, and specific tax breaks for the software industry.

Tax policy has been systematically adjusted to reduce distortions and promote investment. In early 2003, the COFINS turnover tax was transformed into a VAT, levelling the playing field for manufacturers. This was followed by improvements in the taxation of construction companies, which have contributed to a turnaround in housing construction. Big capital outlays have benefited from the exemption or accelerated deduction of federal VAT on domestically produced or imported machinery. Importantly, no new taxes or higher tax rates were introduced in 2005. On the other hand, a cyclical surge in corporate income tax collection is being mainly saved or used to afford targeted tax cuts, such as the recent exemption of foreign investors from income taxes on investments in domestic, local currency federal public debt securities.

Fiscal and tax policies will play an increasing role in balancing economic growth in the face of strong Brazilian exports. The doubling of exports in the last five years has allowed the country to accumulate record levels of international reserves, while safely pre-paying its debts to the IMF and the Paris Club. Coupled with strong fiscal outturns, the external sector's performance has helped the National Treasury reshape the profile of the external public debt, as total debt/export ratio dropped from an historical average of close to four over the last twenty five years, to less than 1.5 by the end of 2005. Maturities have been lengthened and the investor base broadened. Last year, the Brazilian Treasury started to issue global bonds at the "Hong Kong" time, i.e. opening the book first in Asia and closing it at New York time. The practice proved successful and has been adopted by a number of other emerging market issuers. Growing confidence and familiarity with Brazilian bonds, as well as a positive outlook for the Real, are increasingly attracting international investors into domestic, local currency fixed income markets.

The floating exchange rate regime has served the country well and policy measures will continue to be taken to ensure its well functioning, while preserving the lasting competitiveness of the Brazilian business sector. Fostering productivity gains and conducting an appropriate mix of fiscal and monetary policies will be instrumental to the achievement of this goal.

The work undertaken to consolidate fiscal accounts, ensure low inflation and liberalise the economy has undoubtedly helped unleash powerful economic forces that have been translated into new jobs, better services and more investment. Three million formal jobs have been created by the private sector on a net basis in the last thirty months. A revived IPO business has meant billions of Reais raised to finance internet, railroad, energy and chemical sectors, as well as to promote the expansion abroad of industries such as cosmetics and fashion. Indeed, support from a well-regulated capital market has been vital in allowing Brazilian firms to bring out to the world marketplace unique products that embody the riches of Brazilian biodiversity and biotech research.

Manufactured items, ranging from cell phones to engines, buses and aircraft, constitute about half of Brazil's exports. Brazilian food products have met with growing demand in Asia and elsewhere, built upon high sanitary standards and research to anticipate market trends. Energy products have recently become prominent, in particular bio-fuels. Sugar-cane alcohol, for instance, would compete well with petrol even if oil prices were significantly lower than their current level. While self-sufficiency in oil production has relaxed yet another external constraint on the Brazilian economy, substitutes for diesel oil are being developed and tested in many places in the country. Because they could open a whole new market to small and large seed producers, the implications of these technologies for poverty alleviation in tropical regions have been noticed by international agencies and multilateral institutions. Brazil is helping some of these institutions to develop mechanisms to support investments in these activities in Africa and elsewhere, which could have a lasting impact on the G-8 efforts to raise the standard of living in poor regions.

Free trade is clearly another instrument for the purpose of fostering economic development and raising the standard of living. Brazil has become increasingly committed to the reduction of trade barriers, including those affecting agricultural products. Informal participation in OECD activities has increasingly focused on some of these issues, as well as those related to fostering market discipline in export finance and promoting good principles for international investment. Regular reviews of the Brazilian economy by the OECD Secretariat have underlined the openness of several services markets in Brazil, including financial services. These surveys have also highlighted the strength of the competition framework.

I believe that the continued improvement of regulations, which for the most part are well established, will help unlock new opportunities for investment in infrastructure. The Public-Private Partnership (PPP) programme is part of this strategy. Recently, R$ 4.5 billion (US$2 billion) was deposited by the National Treasury in a PPP Guarantee Fund segregated from public accounts. This fund will back public-sector long-term contractual engagements in PPP projects, stepping in whenever the risk of delayed payments arises. The Treasury is also preparing a comprehensive set of accounting rules, applicable to Federal and local PPP projects, with a view to providing full transparency to these initiatives.

In summary, it is time for Brazil to exploit its openness to foreign investment and its large and sophisticated private sector. Erratic macroeconomic performance detracted from these advantages for too long a period. Several years of consistent fiscal results, and the overcoming of the external constraint, are now changing this scenario and creating increased interest among investors. Looking ahead, the 2006 Budget Directive Law has established three-year ceilings for current expenditure at the federal level, along with guidelines aimed at limiting the need for tax increases. Moreover, society is ever more aware of the importance of keeping a lid on these expenditures in order to create room for public investment and to lower the public debt and the tax burden. I am certain that this objective, together with the commitment to further microeconomic reforms, will remain one of the main axes of Brazilian economic policy over the next few years. F

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