Challenges Facing Foreign Investors in Brazil: A Risk Analysis

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Abstract

Brazil has embarked on a new phase in its journey towards a mature society. Brazil's new president, Luis Inacio da Silva ("Lula") introduced a new social, economic, and political agenda for Brazil, strongly emphasizing social issues. Over the past twelve years, Brazil moved from an autarchic model to an open market model. Accordingly, Brazil's market has become more sophisticated, more competitive, and its rules and guidelines more predictable and transparent. Brazil's state-led growth model has been replaced by a market driven economic model, with privatization, trade, and investment liberalization policies leading to a new chapter in the Brazilian economy. Brazil, however, still struggles with a number of social and economic problems. This paper elaborates on the main challenges facing foreign investors in the Brazilian economy.

I. Introduction

In November 2002, Brazil elected the first left-wing president in decades, Luis Inacio da Silva, "Lula", a former steel worker (Mendes, 2002). Lula, the first factory worker to ever become president in Brazil, was elected by 53 million Brazilians, an unprecedented 62% of Brazilian voters. Lula's election was a strong indication that Brazil's political institutions have matured (Atuch, Daminai, and Kenia, 2003).

Lula's victory was a result of his political strategy to shift to the center-left, engaging a coalition of political parties (Martins, 2002). Lula also avoided being linked to extremists in his own party by moving to the center-left. This new Lula or "Lula Light" as he was labelled, was a response to his understanding of the need for a different political approach. Lula stated many times that the Labor Party (PT) had changed and that Brazil had changed. The "Ribeirao Preto Manifesto" of 2002 laid out the new PT, one PT more interested in developing domestic synergies than domestic antagonisms (www.pt.org.br). In the "Letter to the Brazilian People" Lula stated that if elected he would not embark in economic, political, or social adventures. Lula was distancing himself from his own party (Lamounier, 2002; Moraes, 2002).

The "Old PT" and its extremist's positions were no longer to be Lula's political platform. For instance, the "Old PT" used to defend policies like defaulting on Brazil's external debt, and the state control of the country's financial sector. In 2003, Lula is calling George W. Bush an important ally of Brazil, courting Brazilian political parties, and prescribing a conservative approach to economic policy making (Anderson, 2002).

Lula' victory is also a sign that segments of the PT have undergone a political "DNA mutation" in the past decade (Costa, 2003). Three presidential campaign losses, taught the PT the need to change and adjust to a shifting political, social, and economical landscape. In the past decade, the PT elected mayors, governors and a president. The PT's managerial expertise is expanding. In addition, its experience with other parties has made the PT more pragmatic politically, moving away from radicalism (Caixeta, 2003).

Lula understands that fiscal discipline, controlled inflation, and honoring Brazil's external commitments are a prerequisite for Brazil's sustainable development. Contrary to Cardoso's government, however, Lula will pay heed to Brazil's acute social maladies. His social and economic background gives him strong ties to the poor and legitimacy to champion social causes. But Lula's ambitious social goals and programs are largely dependent on a stable economy.

Cardoso's economic, political, and social legacies are an important factor imposing limitations and degrees of freedom for Lula's maneuvering during his first year in office. This paper

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addresses Cardoso's legacies, their impacts on Lula's agendas, and discusses opportunities and challenges permeating Lula's government.

II. Social Indicators: Lula's Main Challenge

Lula's main campaign platform was directed towards addressing Brazil's acute social problems. After taking office, Lula promised to wage war on hunger and unemployment. His "Zero Hunger" program stresses one of his government's main goals, to have Brazilians experiencing famine, eating three meals a day (www.pt.org.br).

Brazil has developed acute social disparities over the past decades. Although Brazil is a wealthy country, a large share of its population lives below the poverty line, giving the country one of the worst social indicators in Latin America. For instance, 34% of Brazilians live below the poverty line, compared to 19% in Costa Rica, and 15% in Mexico and Chile (World Bank, 2003).

The country's chronic wealth distribution issues have gotten worse over time. In 1960, the richest 10% controlled 39.6% of the wealth. In 1999, the richest 10% controlled 46.8% of the country's wealth. In contrast, the poorest 10% controlled 1.9% of the country's wealth in 1960 and in 1999 the poorest 10% controlled only 1.2% of the country's wealth (Kleber, 2002).

Brazil's lack of attention to wealth distribution is related to its lack of attention and emphasis on making education a priority. Contrary to a number of South East Asian countries, Brazil has never focused its attention or resources on its educational system. While the numbers look good at first glance with 97% of Brazilian children enrolled in school in the year 2002, on average Brazilian children stay in school for only 7 years, compared to at least 12 years for American children. This truncated schooling has led to some of the highest illiteracy rates, about 14.6%, in the Latin American (IBGE, 2001; 2002).

In 2002, 33% of the Brazilian population, 54 million people, were labelled as poor, 14%, 8 million people, were extremely poor, and 8% of the Brazilian population, one million people, were experiencing famine. Famine is an acute problem in the Northeast and North regions of Brazil (Martins, 2002).

Another dimension of Brazil's acute social maladies is Brazil's high infant mortality rate. The infant mortality rate has however been steadily declining over the past few decades. In 2002 it was 32.7 per 1,000 births, compared to 7 per 1,000 births in the U.S. and about 10 in Chile. On the other hand, Brazil's life expectancy remains one of the lowest in Latin America. This can be attributed in part, to Brazil's lack of investment in health care and prevention (Castro, 2002; Lewis, 2002).

Table 1

Brazil and Mexico – Social Indicators, 2001

Social Indicators	Brazil	Mexico
Population (millions)	172.6	99.4
Population Growth (%)	1.3	1.5
Life Expectancy at Birth (years)	68.8	73
Fertility Rates (births per woman)	2.2	2.6
Infant Mortality (per 1,000 life births)	32.7	29.2
Urban Population (% total population)	81.7	74.6
Illiteracy Rates (males)	14.6	6.4
Illiteracy Rates (females)	14.2	10.2
Improved Sanitation Facilities, urban (% with access)	85	87
Improved Water Source (% with access)	87	86
Fixed Lines and Mobile Telephones (per 1,000)	318	267
Personal Computers (per 1,000)	44	50.6
Number of Internet Users (% total population)	2.89%	2.71%

Source: Compiled by the author from World Bank, World Development Indicators Database, 2002.

The slow growth of the Brazilian economy over the past two decades has resulted in an increasing unemployment rate. Every year, 1.5 million people join the Brazilian labor market and the economy must grow by at least 5% per year in order to absorb them. However, in the 1980's, the economy only expanded at an average of 2.6%. The 1990's were even worse, with the economy expanding at an average of 1.8%. The small growth rate of the 1980's and 1990's led to an average unemployment rate of 5.6% in the 1980's and 6.1% in the 1990's. In November 2002, the unemployment rate reached 10.9% (Almeida and Santos, 2002).

The 1990s also saw a dramatic increase in urban violence. The number of murders in Brazil increased from 25,000 in 1990, to about 60,000 in 2001. Brazilian crime rates reached 53 per 100,000 people; compared to Chile's 6 murders per 100,000, and Argentina's 12 murders per 100,000 people (Filho, 2003).

Table 1 provides an overview of some social-economic indicators for Brazil in 2001.

III. Economic Indicators

The Brazilian economy has undergone substantial changes in the past five decades. In the 1950s, the country embarked on an intense import substitution industrialization strategy (ISI), resulting in dramatic impacts on the Brazilian economy, society, and business environment.

In the past five decades, the Brazilian economy evolved from an agrarian based economy to a manufacturing service oriented economy. For instance, the share of the agricultural sector declined from 25% of the Brazilian GDP in the 1950's, to less than 10% of the Brazilian GDP in the early 2000's (Baer, 2002). The last five decades also saw the Brazilian economy move from a strong state oriented growth model, to a market driven economic model. The buzz of the 1950's, ISI, was replaced in the 1990's and early 2000's by market oriented reforms such as trade liberalization and privatization (Haddad, 2001).

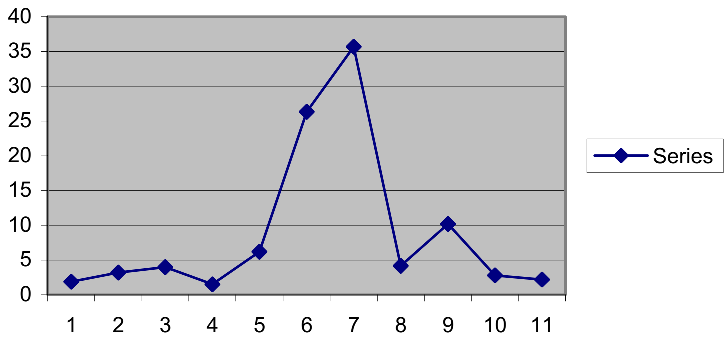
In 1990, during the Fernando Collor administration, Brazil unleashed a package of bold market oriented reforms, encompassing a privatization program and trade liberalization measures. The Brazilian economy had been protected from foreign competition for decades, which created a number of distortions and lack of incentives for domestic companies to innovate and improve the quality of their products (Gouvea, 1995).

The market oriented reforms forced Brazilian companies to become more efficient, which largely benefited consumers. In addition, Brazilian consumers are now exposed to a larger variety of products and services with different levels of quality and prices. Brazilian companies were also able to engage in global procurement strategies, acquiring parts and components from the most competitive suppliers around the globe (Junior and Ferreira, 1999).

Contrary to previous programs, this time privatization was included into the framework of a deregulation project. Thus, the government would no longer act as an entrepreneur, but rather as a rule maker and promoter of growth and development (Baer, 2002; Gouvea, 1994).

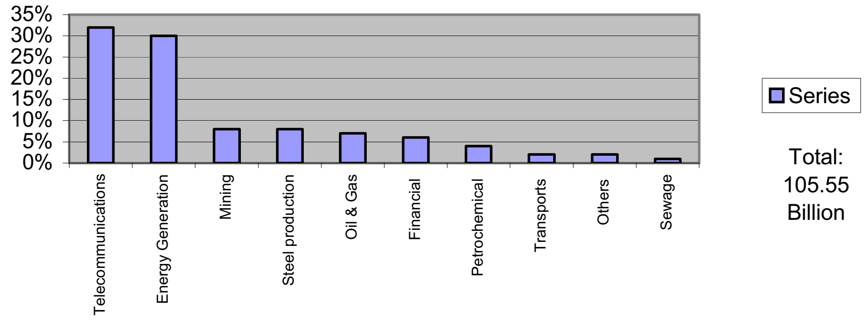
In the period of 1990-2002, the Brazilian privatization program generated USD 105.55 billion in revenues. State companies generated USD 34 billion and federal ones – USD 71 billion (BNDES, 2003). Figure 1 shows the evolution of Brazil's privatization revenues for the period of 1991-2002. The early years of privatization were largely concentrated in the manufacturing sector, such as steel mills. In the second half of the 1990's, the service sector became the main focus of attention. Figure 2 illustrates the relative share of the different sectors that were the focus of the Brazilian privatization program in the period of 1991-2002.

The second half of the 1990's marked a departure from the first phase of privatization, which was heavily based on industrial sectors. The second phase was aimed at the privatization of the Brazilian infrastructure and service industry controlled by the state. Figure 2 illustrates the growing importance of these newly privatized sectors.



Source: BNDES, 2003.

Fig. 1. Brazil Privatization Program, Total Revenues, 1991-2002 (USD billions)

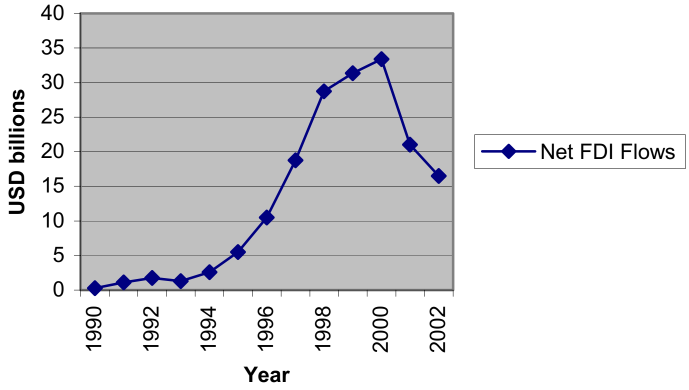


Source: BNDES, 2003.

Fig. 2. Brazilian Privatization Program, Relative Share of Total Revenues by Main Sectors

Brazil's market oriented reforms, as introduced in 1990's, had a dramatic impact on attracting foreign direct investment (FDI) to the Brazilian economy (Baer and Rangel, 2001). In the late 1990's, Brazil was ranked 5th among the world's largest recipients of FDI flows and ranked 8th in the world for its volume of stock of FDI at USD 156.8 billion. Brazil increased its share of global FDI from 0.7% in the early 1990's, to about 4.5% by early 2000. In the late 1990's, Brazil was second only to China among emerging economies for its stock of FDI (United Nations, 2002).

Figure 3 shows the evolution of FDI for the 1990-2002 period. The flow of FDI increased from USD 0.28 billion in 1990 to USD 33.4 billion in 2000, and then declined to USD 16.5 in 2002 (Banco Central, 2003). The decline in FDI is a reflection of the global economic recession and a reflection of macroeconomic instabilities in the Brazilian economy, compounded by the Argentine economic and political crisis of 2001-2002.



Source: Brasilia: Brazilian Central Bank, 2002. Note: Figures for 2002 are a forecast.

Fig. 3. Net Foreign Direct Investment, Flows 1990-2002, USD billions

In the 1990's, FDI targeted the Brazilian service industry. The privatization of sectors of the Brazilian service industry received the lion's share of FDI flowing to the Brazilian economy. For instance, in the period of 1994-2001, the share of foreign banks in the Brazilian market increased from 8.4% to 33.7%. In 2000, 69% of all FDI flows were concentrated in the service sector, or non-tradables with emphasis on infrastructure and financial services, compared to a 30.77% share in 1995.

Table 2 offers an overview of the key economic indicators of Brazil, comparing these to Mexican economic indicators.

As shown in Table 2, in 2001 Brasil had the second largest economy in Latin America? With GDP of USD 502.5 billion. The service industry accounted for 56% of the Brazilian GDP, followed by industry with 35% and agriculture with 8%.

Table 2

Economic Indicators for Brazil and Mexico

Economic Indicator	Brazil	México
GDP (USD billions)	502.5	617.8
GDP % Growth Last 5 Years	1.5	4.4
Real Interest Rate	11.8	3.5
Inflation GDP Deflator (annual %)	7.4	5.5
Share of Sectors/GDP:		
Agriculture	8	4.4
Industry	35.8	26.8
Service	56.2	68.9
Exports (USD billions)	61.7	171.2
Exports Growth Rate, 1994-2001 (%)	5.6	12.5
Exports of Goods and Services/GDP	13.4	27.6
Imports of Goods and Services/GDP	14.4	30
High Tech. Exports/Manufactured Exports	18.6	22.4
Present Value of External Debt (USD billions)	223.8	157
Total Debt Service (% of Exports of Goods and Services)	90.7	30.2

Source: Compiled by the author from World Bank, World Development Indicator Database, 2002.

The Brazilian economy is still not as open as the Chilean or Mexican economies as measured by the share of imports and exports in the country's GDP. In addition, Brazilian export performance has been less than stellar for the past two decades. Between 1980 and 2000, global trade expanded by 12-15% yearly. On the contrary, Brazilian exports in the same period expanded by only 8.6%. In 2001, Mexico exported USD 171 billion, compared to Brazil's USD 61 billion. Brazil's share of high tech exports over total exports is also well below Mexico's. The Brazilian economy shows a very high degree of external fragility as measured by the size of its external debt, USD 223.8 billion, one of the world's highest, and by the total external debt service ratio, about 90.7%, also the highest in our sample of countries. By 2001, Brazil's small export volume and high level of external debt aggravated the country's global standing.

IV. The Cardoso Years

The Cardoso administration, 1994-2002, saw substantial changes taking place in Brazil. His legacy is a multifaceted one, encompassing substantial impacts on the Brazilian economy and political and social scenarios. Cardoso's legacies will largely constrain and format Lula's first few years in government. The following paragraphs will offer an overview of Cardoso's main legacies in three specific areas: economical, political, and social.

A. The Brazilian Economy

During his first tenure in government, Cardoso benefited from market oriented reforms put in place initially by Fernando Collor de Mello's administration, and also by the Real Plan, designed during the Itamar Franco presidency when Cardoso was Minister of Finance (Netto, 2002a, b).

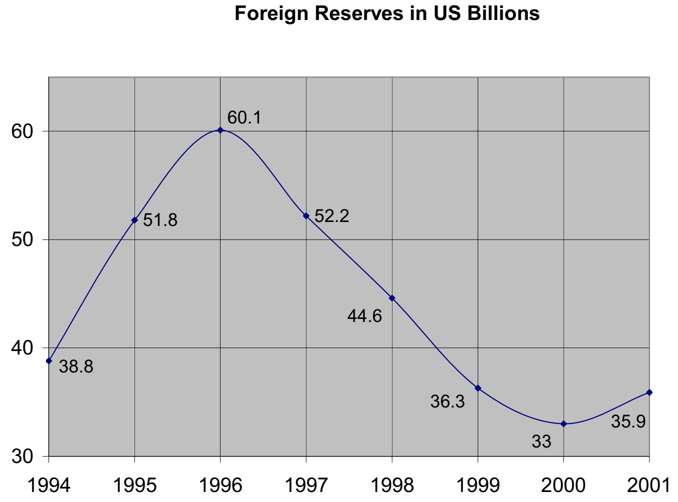
Cardoso's presidential campaign bid stressed his desire and will to put an end to Brazil's unequal society. A stable and growing economy was a precondition for Cardoso to accomplish his goals. In this sense, one of his major platforms was to put an end to Brazil's long inflationary process. For instance, in 1993, Brazil's annual inflation rate had reached 2,708% and therefore controlling the hyperinflationary process was becoming central to the stabilization of the Brazilian economy (Pereira, 2002).

The Real Plan was Cardoso's answer to Brazil's inflationary problems. The Real Plan, designed during Cardoso's years as finance minister during the Itamar Franco presidency, was fully implemented during his first tenure in government.

The Real Plan was based on fiscal adjustment and the de-indexation of the Brazilian economy. The Real Plan can be divided into two phases: a) the 1994-1998 period, and b) the 1998-2002 period.

During the first phase of the Real Plan, a new currency, the Real was introduced. The Real Plan succeeded in lowering inflation rates. By 1996, inflation rates had fallen to 9.3%, similar to those experienced in the early 1950's. During this period, the Real Plan relied on a high Real/US dollar exchange rate to keep domestic prices in check (Nassif, 2002).

The high exchange rate policy pursued by the Cardoso administration, however, resulted in an increasing deterioration of the Brazilian foreign sector. In order to keep the exchange rate policy in place, Brazilian policy makers resorted to high interest rates and massive interventions by the Central Bank to defend the value of the currency. By the first half of 1999, nominal interest rates had reached 45%. Brazil also sustained substantial losses in foreign reserves as a result of this exchange rate policy. Figure 4 illustrates the substantial losses in foreign reserves during the period from 1994 to 2001. By late 1998, the prolonged use of high exchange rate strategies started to impose a heavy burden on the economy. For instance, high interest rates raised the cost of doing business domestically and increased the public debt considerably. On the external side, Brazilian goods became pricier and less competitive in international markets. The increasing vulnerability of the Brazilian economy led the country to resort to a USD 41 billion loan from the IMF (Netto, 2002c).



Source: Brazilian Central Bank, 2003.

Fig. 4. Brazilian Foreign Reserves, 1994-2001

Fernando Henrique Cardoso's re-election marked the second phase of the Real Plan. The needed adjustment of Brazil's exchange rate policy came only after Cardoso was re-elected; the Real was devaluated. The following two years were marked by low economic growth rates and increasing unemployment. During this period, Brazilian policy makers became frequent visitors in Washington D.C. Brazil's increasing external vulnerability forced the country to follow IMF economic directives (Netto, 2001). In September 2001, Brazil was granted another stand-by loan of USD 15.7 billion and in August 2002, the IMF issued another stand-by loan of USD 30 billion.

The Cardoso economic team tried to explain Brazil's poor economic performance during his tenure in government by blaming the global economic troubles. The Brazilian economy, however, did not experience high levels of globalization. For instance, according to Foreign Policy magazine's Globalization Index, by 2002 Brazil was ranked number 57th in the world, out of a sample of 62 countries (Foreign Policy, 2003). Thus, Brazil showed a very low level of its economy being exposed to globalization trends. As a matter of fact, according to the Foreign Policy 2003 Globalization Index, other Latin American economies such as Chile and Mexico, showed higher levels of exposure to globalization trends than Brazil. Chile ranked number 31st, and Mexico ranked 49th.

It is also interesting to compare the Chinese and Brazilian economies' performances during the 1990s. China and Brazil offer a good comparison for how two emerging economies expanded during the 1990's. China expanded its GDP from USD 387 billion in 1990, to USD 1.1 trillion in 2001, a 199% nominal increase. Brazil, during the same period, expanded its GDP from USD 465 billion to USD 504 billion (World Bank, 2003). The Cardoso administration's economic record is thus, marked by dramatic successes and dramatic failures:

Inflation and Interest Rates: Contrary to Cardoso's allegations, the Real Plan was not able to bring price stability to the Brazilian economy**.** In the period between July 1994 and December 2002, the accumulated rate of inflation was 137.93%. During the same period, the prices of several products and services increased dramatically. For instance: a) Housing Rental: 385%; b) Phone Services: 433.2%; c) Propane kitchen gas: 540%, d) electricity: 255.9%. These numbers point to a substantial failure of the Real Plan in protecting Brazilians' purchasing power. In 2002 alone, cooking oil increased by 73%, refined sugar 66%, black beans by 61%, and loaves of bread by 37%. Transportation prices increased by 21.4% in Sao Paulo during the same time period. These price hikes affected mostly those at the lower levels of income in the Brazilian society (Almeida, 2003).

The increasing vulnerability of the Brazilian economy in 2002, coupled by political instability during the fall election of 2002, further pressured the Brazilian currency.

In 2002, the real was devalued by 52% and interest rates were hiked to 25% annually, further pressuring Brazilian domestic prices (Banco Central, 2003).

High levels of interest rates ballooned Brazil's domestic debt. Brazil's government debt soared from 30% of Brazil's GDP in 1994, to 62% of Brazil's GDP in July 2002. At the same time, the share of the Brazilian state in the economy expanded from 25% in 1992 to about 34% in 2002, defeating Cardoso's bid to lower the levels of state participation and intervention in the Brazilian economy. Thus, despite Cardoso's bold privatization program, increasing government debt and taxes drastically expanded the share of the state in the Brazilian economy (Netto, 2002c).

During the Cardoso years Brazilians faced high levels of real interest rates and high levels of taxes, leading to very low levels of economic growth.

Economic Growth: The Cardoso administration showed very low levels of economic growth and development. During the first four years of the Cardoso tenure, the Brazilian economy expanded by an average of 2.6%. During his second tenure, the economy expanded by an average of 2.2%. These growth rates are lower than rates by the Brazilian economy during the 1980s and early 1990s, an average of 3.5%. It is important to remember that the 1980s were known as the "lost decade" in terms of economic growth, until the Cardoso years. Another side of the low levels of economic growth is its impact on Brazil's per capita income growth. The Brazilian per capita income growth expanded by only 0.6%, on average, during the Cardoso years.

Exports: The other legacy of the Cardoso administration has been the lack of attention paid to Brazil's exporting sector (Markwald, 2001). The Real Plan combined with a lack of explicit policies to foster exports led to low growth rates during the FHC tenure in power (Puga and Markwald, 2002). As a result, Brazil became extremely dependent on foreign direct investment and portfolio investments, thereby increasing Brazil's vulnerability to external forces. In 1994, Brazil exported USD 43 billion. In 2002, Brazil exported USD 60.4 billion, well below Cardoso's goal of an export volume of USD 100 billion. The low levels of exports reduced Brazil's share of total global exports. In 2002, Brazil accounted for only 0.9% of total global exports, well below Mexico's share (SECEX/DECEX, 2003).

The low growth of Brazilian exports during the Cardoso years, along with the mounting external debt increased Brazil's dependency on foreign direct investment, portfolio investment, and on IMF emergency package loans. In 2002, the ratio of external debt/exports was close to 4, when the acceptable and recommended ratio should not exceed 2. Foreign debt service accounted for 2/3 of Brazil's exporting revenues, when the recommended level should be around 1/3 of Brazil's total exports (Netto, 2002b).

B. Brazilian Society and Political Environment

The Cardoso years had a definite impact on the Brazilian society and political system. Brazil's poor economic performance during the Cardoso years had substantial impacts on the Brazilian society.

Political Environment: The Cardoso years promoted substantial changes in the Brazilian political environment. Cardoso consolidated Brazil's young democracy, and solidified the relationship between the Brazilian society and the state (Cooper and Frasca, 2003).

Cardoso's relationship with Brazil's political parties showed a mixed record. He was able to pass the 2000 Fiscal Responsibility Law, forcing states and municipalities to follow strict fiscal policies. This was a vital measure to keep Brazil's primary budget surplus in check. On the other hand, Cardoso was not able to secure support for the pension and tax reforms. The failure to secure these vital reforms largely compromised the performance of the Brazilian economy during his tenure in government (Cruvinel, T. (2002).

Cardoso's re-election, altering the Brazilian Constitution, was a feat not even attempted during the military dictatorship years (Martins, 2002; Lamounier, 2002). His re-election move compromised his ability to handle legislative and executive relationships. It is argued that "corridor negotiations" further compromised the future of the Brazilian economy and society by postponing the introduction of needed measures, such as the earlier devaluation of the Brazilian currency.

Unemployment: Unemployment rates increased considerably during the period of 1994-2002. In 1995, Brazil's unemployment rate was around 6.1%. In 2002, unemployment rates had risen to 7.5%. In the city of Sao Paulo, unemployment rates were close to 19% by the end of 2002. Workers in the state of Sao Paulo would take 22 weeks to find a new job in the early 1990s. By 2002, workers were taking 50 weeks on average to find a new job (Almeida and Santos, 2002).

Law & Order: The Cardoso years will also be remembered by the increasing urban violence. Homicides increased by 37% between 1992 and 1999. Organized crime became more active and violent in the same period of time. In 1994, the country saw 30,000 homicides; by 2001, this number had increased to 60,000 (Filho, 2003).

The Cardoso years were also plagued by allegations of corruption involving several members of his government. Several politicians were also accused of connections to organized crime. According to Transparency International's Corruption Perception Index, Brazil's level of corruption increased during the Cardoso years. In 1995, Brazil was ranked 40th in the world; in 2002, Brazil was ranked 44th (www.transparency.org). .

Health Care: On the health care side, the Cardoso administration took firm steps to fight AIDs. The AIDs epidemic peaked in 1998. In 2002, the number of cases was below 1994 levels. On the other hand, the lack of long-term planning for the health care of Brazilians resulted in a number of epidemics such as the 2002 Dengue fever that deeply affected the Brazilian society and economy. Lula will have to pay heed to basic health care and implement measures to stop other outbreaks. The Dengue fever epidemic was a clear result of lack of attention and resources allocated to health care (Otavio, 2002).

Education: On the education front, Cardoso, a former professor, made some inroads and improvements (Pereira, 2002). By 2002, most Brazilian children were enrolled in schools around the country. Brazilian children, however, stay at school on average for eight years compared to an average of 12 years in the U.S. The Cardoso administration also made inroads in combating children working conditions. Programs were set in place to recruit more children to schools around the country.

The educational sector, however, was also the subject of severe budget cuts. For instance, salaries of federal professors were frozen for more than five years. Another side of Cardoso's policies had been the lack of attention paid to wiring public schools across the nation to the worldwide network. Several programs designed to foster the penetration of the internet were postponed or cancelled by the government. For instance the National Information Technology Program (Proinfo) was launched in the mid-1990s. At that time the Cardoso government committed to acquire 100,000 thousand computers to Brazilian public schools. By 2001, only 30,000 computers had been installed in Brazilian public schools. Moreover, out of 188 thousand Brazil's public schools, 116 thousand did not even have access to a phone line (Gouvea and Kassicieh, 2001).

Agrarian Reforms: The Cardoso administration made important strides in fostering Brazil's agrarian reform. By 2002, more than 250,000 families had won land titles to more than 15 million acres of productive land. The Landless Movement (MST), an important social movement in Brazil, became increasingly more active during the Cardoso years, promoting a number of property invasions and armed confrontations leading to a number of casualties (Malin, 2002; www.mst.org.br). The Cardoso administration failed to relocate families to Brazil's farming frontiers, creating social tension in a number of traditional agribusiness areas. The MST is an important social movement in Brazil (Malin, 2002).

V. Lula's Challenges & Opportunities

Cardoso's legacies impose a heavy burden on Lula's government, shaping and constraining Lula's agenda. The following paragraphs will elaborate on some of the challenges and opportunities permeating the Lula administration.

A. Economy

In contrast to initial expectations, Lula adopted a conservative approach to economic policy making. Lula fulfilled his campaign promises of not embracing radical economic reforms, such as the ones proposed by his party, the PT, in the late 1980s and early 1990s, calming domestic and international markets (Caixeta, 2003).

Lula's government will be largely constrained by domestic and international forces. For instance, in 2003 the global economy is experiencing a drastic downturn. The U.S. economy, the European economy and the Japanese economy are all experiencing low rates of economic growth simultaneously. Brazil is directly affected by such global economic slowdown.

Brazil's ability to see a substantial inflow of foreign direct investment and portfolio investments is therefore compromised (Dias, 2002). For instance, the net flow of private capital from developed countries to Latin America is expected to drop from USD 62 billion in 2000 to USD 35 billion in 2003. Private investors are expected to invest USD 13 billion in the Brazilian economy in 2003, a far cry from the late 1990s' foreign investment levels. In addition, high prices of oil in 2003 as a result of conflicts in Iraq, and terrorism, are also slowing down economic growth recovery in the U.S., Europe, and Japan (Romero, 2003).

As a result of such an adverse international environment, during his first year, it is expected that Lula's economic strategy will be one based mostly on promoting domestic growth and development. This strategy, however, will be based on promoting sectors with high capacities for job creation and low import dependency.

Lula is proposing a post-neoliberal model, in opposition to Cardoso's neoliberal economic model i.e., an economic model that puts social issues at the center of economic debates. The PT is also calling this transition a shift from a traditional monetary approach to a "Popular Capitalism."

This nationalistic approach to managing the Brazilian economy has always been one of the PT's main characteristics. Still, the PT understands it has to learn to manage a capitalist economy (Attuch, Grinbaum, and Leite, 2002).

Lula will have to address short-term and mid-term economic issues. Lula's short-term economic reforms are related to Brazil's complex system of state value added taxes and Brazil's pension fund system (Amaral and Barelli, 2003). These reforms are essential for Brazil's long-term economic stability. Trimming Brazil's public servants' pension funds is also an important step toward economic stability. The pension system deficit accounts for 4% of Brazil's GDP. Brazil's retirement system has been called "Robin Hood in Reverse". The growing deficit drains an average of USD 2 billion per year (Cooper and Frasca, 2003).

Brazil's public debt is a major issue, multilateral agencies demand higher budget surpluses in order to lower the Brazilian risk. Budget cuts, leading to budget surpluses, would control inflation which could lead to lower interest rates, leading to more effective control of Brazil's domestic debt. Such efforts, however, could lead to lower investment levels in social programs and infrastructure, compromising Lula's economic and social programs.

The PT will need to address microeconomic issues as well as macroeconomic issues regardless of ideology. Low levels of economic growth and unequal distribution of income are pressing issues. The increasing size of the informal economy is also a pressing problem (Giambiagi, 2003).

In 2002, the volume of credit as a percentage of Brazil's GDP was about 25%. Lula will need to make credit more available to small and medium size companies (Scheinkman, 2003). Economic growth is also related to gains in productivity that are closely related to Brazil's tax system, credit availability and lower levels of interest rates. The Lula administration will also use the state apparatus to strengthen Brazil's offering of domestic credit and loans. For instance, the BNDES is expected to have a more proactive role in supporting and providing funds for strategic sectors in the Brazilian economy.

Brazil's public domestic debt is putting pressure on domestic interest rates. For instance, in spring 2003, nominal interest rates were at the 26.5% level annually, one of the highest in the world (Banco Central, 2003). High interest rates are negatively affecting the economy and the dynamic of Brazil's domestic debt. In 2002, Brazil's net public debt was close to 60% of Brazil's GDP or USD 250 billion and Brazil's net foreign debt, private and public, approached USD 165 billion. In 2003, Brazil will need USD 35 billion in foreign resources in order to finance its deficit in the current account and external debt.

In 2003, Lula's economic team announced a target of 4.25% primary budget surplus (revenues minus expenses, not taking into account debt service expenses), a level beyond that stipulated by the IMF, 3.75%. Lula is sending a strong indication that Brazil is serious about cutting its public debt. The rise in primary surplus is also a result of the dramatic increase in taxes from 28% of Brazil's GDP in 1995 to 35% of Brazil's GDP in 2002, allowing for a 4% surplus. The maintenance of a primary budget surplus in 2003 will be assured by higher fuel prices, lower wage increases for federal employees, and cuts in a number of social programs, such as health and education. It is expected that social expenditures will be reduced from 2.4% of Brazil's GDP in 2002, to 2.2% in 2003. In addition, the recently created Ministry of Cities will face an 85% budget cut this year, and the recently created Ministry of National Integration will face a 90% budget cut in 2003 as well.

There is an expectation that inflation will remain high in the first semester of 2003, resulting in low levels of economic growth and high interest rates.

Lula however, is not going to continue Fernando Collor de Mello's market oriented reforms, embraced by the Cardoso administration (Sardemberg, 2003). On the contrary, Lula is proposing a different paradigm of economic development, one that will bring the interventionist role of the State back into the economy:

a) **Privatization:** In relation to privatization of state owned enterprises, Lula has stated that Petrobras and Banco do Brasil will no longer be privatized. In addition, Lula has stated that several state banks are no longer on the privatization list. Lula's decision to not privatize state banks may however, jeopardize efforts to control the state's expenditures and budgets. It is to be expected, that privatization will be slowed down considerably during Lula's tenure in government.
b) **Domestic Sectors:** Lula's economic team will be strongly supporting sectors with definite backward and forward linkages to the "Social and Economic Infrastructures." Thus sectors linked to the Social Infrastructure such as housing, urban sanitation, and urban development will receive priority by the administration. Moreover, sectors linked to the Economic Infrastructure, such as transport, energy generation, and telecommunications will also be in the center of Lula's economic attention.

Lula's nationalist capitalism allied with Brazil's external vulnerability, is leading Lula to engage in promoting industries which do not show strong dependency on imported inputs. Thus, it is expected that the food industry, clothing, civil construction, and the service sector will be emphasized. In addition, these sectors are also labor intensive in nature.

The Brazilian National Development Bank (BNDEs) is going to be used to provide funds for strategic sectors of the Brazilian economy. In addition, in contrast to the Cardoso years, BNDEs will fund small and medium size Brazilian domestic firms. During the Cardoso years, BNDEs funded the operations of a number of multinationals doing business in Brazil.

c) **Industrial Policy**: The PT is again discussing the establishment of an industrial policy in Brazil. In 1990, Fernando Collor de Mello established the Industrial Chambers, aimed at devising long-term growth strategies for industries deemed essential for Brazil's long-term growth and development. Industries, such as biotechnology, were then targeted by the Collor administration (Erber, 2002). The "purchasing power of the Brazilian state" was then thought of being as capable of developing these industries. In 2003, for instance, Lula is using the state oil company Petrobras' buying power to procure and boost Brazil's oil industry.
d) **Export Promotion:** In contrast to Cardoso, Lula understands that export promotion is Brazil's ticket out of its current economic stagnation (Silva, 2002). In this direction, Lula appointed a former executive of one of Brazil's leading exporting companies to be in charge of formatting Brazil's new approach to export promotion. Lula is also putting in place a new agency in charge of export promotion, and it is promising to eliminate a number of domestic taxes that make Brazilian exports less competitive in global markets. Moreover, Lula is also promising to revamp Brazil's dated export infrastructure, a substantial component of doing business in Brazil. Mexico offers a good example for Brazil. In 2002, Mexico's GNP was larger than Brazil's, and exports were an important feature of Mexico's rise in output. Mexico's integration into Nafta guarantees that its GNP will continue to be larger than Brazil's for the next coming years (Zellner, 2002).

Another shift in course has been Lula's emphasis on promoting trade relations with countries like China and India, besides making efforts to solidify Brazil's Latin American trade ties. Thus, Lula is pursuing a South-South agenda in addition to pursuing traditional South-North trade ties with Brazil's main trading partners, the U.S. and the E.U.

In 2002, Brazil had a trade surplus of USD 12 billion, with total exports reaching USD 60 billion, a 3.3% increase over 2001 levels, and with a USD 11 billion decrease in imports. These numbers pale when compared to the likes of Mexico, showing how much Brazil has to do in terms of promoting exports (SECEX/DECEX, 2003).

Lula is also engaging two agencies SECEX and APEX with the promotion of exports. In addition, CAMEX (Camara de Comercio Exterior) e Siscomex (Sistema Infromatizado de Registro das Importacoes e Importacoes), will suffer some transformation and transparency.

e) **Indigenous Technology Development:** Indigenous technology development is another important issue for Lula's government. In 2001, Brazil filed for 110 patents, compared to 87,607 patents in the U.S., 5,371 in Taiwan, and 3,538 in S.Korea. Only 0.1% of the Brazilian population is involved in scientific research, compared to 0.4% in S.Korea and 0.8% in the U.S. Moreover, in 2001, only 31% of Brazilian firms were investing in technology (Aubert, 2002; Soares, 2002).

B. Political Issues

The PT has traditionally been an opposition party (Cavalcanti, 2003). The PT's role in the Brazilian political scene has been mostly through its representatives in the Brazilian senate or lower house, in addition to state level representatives. This isolation from the executive side of Brazilian politics allowed the PT to follow a radical path for awhile. Only recently, the PT has elected mayors, governors and a president.

Cardoso was criticized by the PT for his "corridor negotiations." The PT perceived itself as the only political party in Brazil immune to the political bargaining process inherent of pluralistic societies. The shift from opposition to the political party in charge will send shock waves throughout the PT (Dirceu, 2002).

It is expected that members of the PT will remain reluctant to engage in political negotiations (Silva, 2002). It is entirely possible to expect and argue that we may see a rupture of the PT, with more radical members of the PT leaving to create their own party. Lula's government will have to exercise "Realpolitik" and engage in political concessions and negotiations with other parties. The next few months and years will show how effectively the PT can build political bridges (Lima, Oyama, and Lima, 2002).

The Lula government will also suffer pressure from traditional supporters such as public servants and the Landless Movement (MST). Public servants will lobby for wage increases and the MST for a faster allocation of land plots to 85,000 thousand landless families. In 2003 these demands will put additional pressure on a tight budget. The pension fund reform is also the object of a heavy lobby by public servants. Lula has little room to maneuver in order to satisfy these constituents. It is expected that additional ruptures in the PT network will occur.

The lower house will be presided over by the PT and the Congress by the PMDB. Without a formal alliance with the PMDB, the PT will be short 100 votes to approve a number of constitutional reforms. Without the PMDB the PT is counting on 213 lower house representatives, a shortage of 256 for a majority. In the Senate, out of 81 senators the PT has 30 allies. The PT will have to engage in a number of negotiations to accomplish what it wants. After 13 years trying to reach the presidency and alienating a number of traditional parties in the process, Lula is now in a position where he will have to compromise with parties that were the object of his sharpest criticisms.

Lula's government is also opening up more exposure for women in Brazil's political system. For instance, Lula appointed three women ministers and one secretariat. The PT also saw six women elected for the senate, and fifteen women elected to the lower house.

C . Social Issues: The Zero Hunger Program

Lula's government will have a strong social bias. Cardoso's lack of attention to pressing social issues resulted in the aggravation of a number of Brazil's main social indicators (Barros, 2001). Brazil is still facing very high levels of poverty and famine for an emerging economy. Lula is promising a government with a strong commitment toward addressing Brazil's main social issues. Lula's flagship program is the Zero Hunger program (Mendes, 2003).

During his inaugural speech, Lula stated that "If, by the end of my term, all Brazilians are able to eat breakfast, lunch, and dinner, I will have fulfilled my life's mission." Lula has equated his efforts to end poverty, to a war on poverty, an effort to offer every Brazilian three meals a day (www.pt.org.br).

The Zero Hunger program is a partnership between the Brazilian government, private sector, charity groups, and NGOs. The program aims at easing hunger for about 50 million Brazilians and famine for about 12 million, or 0.7% of the Brazilian population. The program will be heavily directed toward the people of the Northeast where 49% of the program's targets live, and only produce 10% of the grains the program needs**.**

Lula will benefit from some of Cardoso's programs to address social issues. The Cardoso administration introduced programs such as the Solidarity Community, Fundef, and Pab (Scholz, 2002). These programs however, did not accomplish as much as it was expected at the onset of their introduction. In any event, Lula can benefit from some of the information available and manpower used to establish such programs. To sum it up, the lack of health care and nutritional help, in addition to better schooling and sanitation are also urgent needs that must be addressed by Lula.

It is important to note that Lula's government created a "Social Assistance Ministry" and a Secretariat of Economic and Social Development. The large number of social technocracy and social bureaucracy may result in an overlapping of functions and may slow and compromise Lula's efforts to eliminate hunger in Brazil.

The Zero Hunger program will give a boost to a number of economic sectors in Brazil. For instance, Brazil's agricultural output will have to expand. This increase will create additional demand for seeds, fertilizers, and equipment, in addition to pesticides.

D. Foreign Policy

During the Cardoso years, Brazil's insertion in the global economy shaped Brazil's domestic policies. Lula is developing a different paradigm, whereas Brazil's domestic economic goals will dictate the format of Brazil's insertion in the global economy (Baumann and Franco, 2001; Brandao, 2001).

Lula is giving top priority to Brazil's relationship with Latin American countries. He feels that Brazil needs to develop a stronger Latin American identity. Contrary to Cardoso, Lula is pursuing a South American and a Latin American leadership goal (Giambiagi and Markwald, 2002; Rittner, 2003).

In this fashion, Lula, contrary to Cardoso, is giving priority to the Mercosur region, where Lula perceives that Brazil and its neighbors show high levels of economic synergy that were neglected during the Cardoso administration (Kramer, 2003; Lewis, 2002). Lula is also reviving the idea of establishing a plan for the creation of a common currency now that the Argentine peso and the Brazilian Real are converging (Giambiagi, 1997). Lula is definitely championing the revival of Mercosur and the case for an enlarged Mercosur.

Lula, however, has his eyes turned not only to the Mercosur region but also to the rest of Latin America. In 2003, for instance, Lula pursued a proactive agenda in the Venezuelan crisis. The creation of the "Friends of Venezuela Group" initiative was Lula's first major international initiative. Lula is also pursuing closer ties with Colombia and Mexico as well.

Lula is pursuing a South-South diplomatic and economic effort. In addition to Mercosur, Lula is pursuing closer diplomatic and economic ties to countries like India, China, Russia and South Africa. During the Cardoso years, very little effort was made to diversify Brazil's main export markets and economic relations. Cardoso's main efforts were directed towards Brazil's main traditional markets. Lula also sees the possibility of Brazil engaging in technology transfer agreements with countries like China, and India which currently develop research in a number of fields that are deemed important to Brazil.

Lula's trip to Washington D.C. soon after the election also points to a very important change in the PT's approach to foreign policy. After his visit to Washington D.C., Lula is calling the U.S. a vital partner for Brazil, a remarkable shift from the foreign policy advocated by the PT in its earlier days. In 2003, the PT is again showing its pragmatic approach to managing Brazil's foreign policy agenda. In 2002 the U.S. market accounted for 25.5% of Brazilian exports, followed by the European Union with 25.1%; the Brazilian private sector expects Lula to devise an agenda that fosters Brazil's trade with its top two trading partners (SECEX/DECEX, 2003).

The Free Trade Agreement for the Americas proposal scheduled to take effect in 2005 is a major step for the Brazilian economy (Hrinak, 2003; Ryff, 2003). Lula has not refuted the idea of Brazil joining the FTAA. However, trade reciprocity is at the forefront of negotiations between Brazil and the U.S.

The U.S. wants an open Latin American market for manufacturing products and services such as banking services, insurance, telecommunications, sewage, tourism, health care, and education. The U.S. also wants Latin American countries to implement American IPR guidelines and laws that include patents in the biotechnology field, and government procurement policies (Gouvea, 2002a, 2002c).

On the Brazilian side, the assessment of welfare losses and benefits resulting from the FTAA are a priority on Lula's government agenda. Increasing access to the U.S. market, the elimination of U.S. non-tariff barriers on Brazilian products, and resolution of pending issues such as environment, labor, services, patents and investment are vital issues for Brazil. It is clear for Lula that if the U.S. and Brazil do not achieve a mutually beneficial outcome the FTAA will not be an appealing proposition (Rattner, 2002). Brazilian policymakers are particularly concerned about the U.S. opening its markets to Brazil's agricultural products. In 2002, Brazilian exports accounted for only 1.5% of U.S. total imports. The Lula government would like to see Brazilian exports accounting for a larger share of the U.S. market.

Final Remarks

The Lula government is facing a daunting task: to introduce social and economic democracy in Brazil. The last decade saw an increasing and accelerated deterioration of Brazil's economic and social indicators. Lula will not have too many degrees of freedom to address these issues; the country is anxiously waiting for substantial reforms. During his presidential bid campaign, Lula's slogan was "Lula Now!" months later, Brazilians are beginning to ask "What is Lula now?" Brazil's very high levels of poverty and crime are an explosive combination, stressing the Brazilian social fabric.

The naïve romantic view that the PT is the only political party that can save Brazil from its social and economic maladies will soon be confronted with reality. On the other hand, the fear that the PT will not be able to handle Brazil's socio-political and economical complexities will also be put to the test.

The conflicting goals of Lula's government, an increase in social aid and programs and budget controls are bound to conflict. Lula keeps making big spending pleas such as an end to famine in the country, better pay and raises for public servants, an industrial policy, more resources to Brazil's educational system, and more resources to Brazil's health care system.

The Brazilian economy is facing a number of challenges and constrains that will shape Lula's social goals. Externally, the global economic recession aggravated by the Iraq conflict and terrorism is leading to lower levels of global economic growth and development. As a result, Brazil can expect to see lower levels of international investment. In addition, lower levels of global economic growth will also result in lower levels of Brazilian export growth. These external constraints will have dramatic impacts on Brazil's financial needs to cover its current account deficit.

Domestically, extremely high levels of interest rates and a depreciated currency add additional pressure to Brazil's ballooning domestic debt. The revival of inflation will force Lula's policy makers to keep a tight approach to economic expansion. The approval of the pension fund and the tax reforms are vital for the stabilization of the Brazilian economy. This stabilization is crucial for Lula's social programs. In order to improve the welfare of millions of Brazilians, Lula will have to create jobs and increase purchasing power. A policy of handouts will be short-lived and not very effective.

The PT will have to renounce its idea that only a larger and interventionist state can address Brazil's social and economic maladies. If the Lula government promotes an abundance of subsidies and protectionism, instead of promoting higher levels of productivity and competitiveness, the Brazilian economy will suffer. Instead of a state driven economy, Brazil needs to promote free enterprise and the creation and strengthening of Brazil's private sector. Otherwise, Lula's government runs the risk of seeing foreign investors searching for more open and dynamic markets.

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