

The long shot for Brazil

Political support for current reforms is contingent on sustained growth, but the prospects for such growth are limited by Brazil's highly unequal distribution of income.

Having succeeded in lowering monthly inflation from 50% to around 1-3%, the Brazilian government is currently attempting the second stage of its stabilization program. One of its main tasks is to undo earlier constitutional spending commitments which, since the late 1980s, have contributed to bloating government deficits and fueled Brazil's hyper-stagflation cycles. Unfortunately, in the case of Brazil, successful reform depends on more than political goodwill.

Brazil has one of the most unequal distributions of income in the world, with the top 20% of the population earning more than 30 times the income of the bottom 20%. The effect of income distribution on growth is often debated by economists. On the one hand, income inequality helps sustain higher saving rates and could provide an incentive for investment, particularly in the early stages of development. On the other hand, persistent inequality restricts mass consumption, thus undermining domestic growth potential. Chart 1 suggests that, for emerging countries, the latter effect has been stronger than the former, so *countries with a more equal distribution also tend to grow faster*.

Chart 2 shows that, in the Brazilian case, the negative effect of income inequality on growth was muted until the early 1970s. Indeed, during the 1950s and 1960s, domestic savings (as well as large foreign loans) financed massive government investment in infrastructure and basic industries, helping propel the "Brazilian miracle". However, with the oil and debt crises of the 1970s and 1980s, growing income

inequality turned from a blessing to a curse. During the "lost decade" of the 1980s, government investment had tumbled, and with declining prospects for domestic growth, private investment went down, too. Moreover, contrary to the earlier period, higher investment since the mid-1980s has failed to reverse the declining growth trend.

Over the past three decades, Brazil exhibited an *inverse relationship between inflation and growth* (Chart 3). Since the early 1980s, the economy moved from high growth and relatively moderate inflation, to stagnation and hyperinflation. One of the main culprits was rapidly rising government spending, but this was itself more a consequence

Chart 1
Income distribution and growth in 15 emerging markets (1980-91)

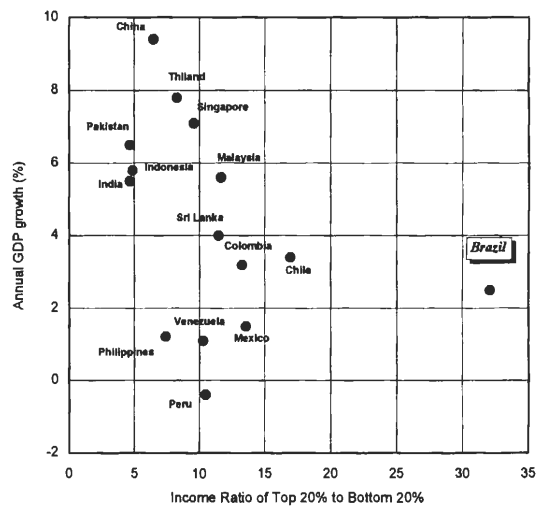


Chart 2
Brazilian Income distribution, investment and growth (%)

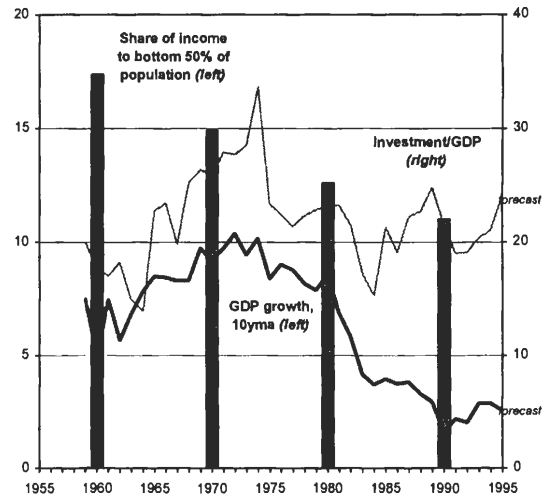
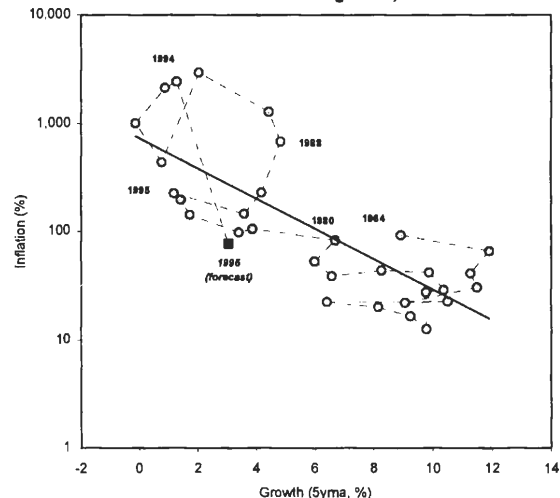


Chart 3
Brazilian Inflation and growth, 1964-95



than a cause: with stagnating national income, earnings growth was becoming increasingly determined by a redistributive tug-of-war over government revenues and spending. For example, federal-to-state transfers are in many cases channeled to municipalities created just for that purpose, while the now-faltering state banks of Rio de Janeiro (Banerj) and São Paulo (Banespa) have for years siphoned billions of dollars to various interest groups. A similar pattern is evident in federal finances. In 1991, for instance, with annual inflation running at "only" 434%, interest payments and subsidies together accounted for 63% of government spending, while corporate taxes amounted to no more than 2.8%. On balance, the consequence was rising income inequality and that is precisely why the recent "conquest" of inflation is far from assured.

To retain business and middle-class support for its program, the Cardoso government must be able to replace forgone inflationary profits (the 6 largest banks alone earned \$5.8 bn in 1993) with expectations for large and *sustainable* "growth dividends". So far, support has been cemented by the threat of social disorder (or a left-wing government) and fears of missing the globalization train; but that support could melt away -- followed by rising inflation -- with the first signs of renewed stagnation.

In the long term, the prospects for a second Brazilian "takeoff" remain constrained. Unlike the earlier experience of government-managed growth, this time the engine must be private investment which is highly sensitive to the growth of final demand. Favorable external circumstances could help the expansion of exports, but this path is inherently unstable. Moreover, government subsidies which underwrote much of Brazil's export boom are bound to decline with fiscal reform. In the final analysis, it is the home market which offers the largest potential for Brazil and that has so far remained locked by severe income inequality.

Investment Conclusions

- Support for current reforms will disintegrate unless sustainable "growth dividends" substitute for inflationary profits.
- Significant economic slowdown will likely bring higher, not lower inflation.
- The prospects for a second economic takeoff remain clouded by a highly unequal distribution of income. ☒