

## **A test of faith in Lula**

*Will the economy bounce back fast enough to silence the doubters?*

MORE than most presidents, Brazil's Luiz Inácio Lula da Silva is sustained by popular faith. Brazilians assume that he will better the lot of the poor and that his Workers' Party (PT) is nobler than the corrupt norm. That faith is now being tested. A corruption scandal last month threatened to oust José Dirceu, Lula's chief-of-staff and the man sometimes called Brazil's "prime minister". Now comes another test: Brazilians learned last week that their economy shrank 0.2% in 2003, the worst performance in 11 years. Unless it bounces back fast, the president's popularity may be shaken and his policies put in jeopardy.

Lula and his economic team promised that the tight fiscal and monetary policies of their first year in office would lead to renewed growth and more jobs in the second. The pain is tangible enough: in the year to January, average wages fell 6.2% in real terms, while unemployment in the big cities rose to 11.7%, from 11.2%. Household consumption fell a record 3.3% in 2003, while interest payments on the public debt snaffled almost 10% of GDP.

So when will the gains come? Critics see the government's macroeconomic policy as perverse. Real interest rates are among the highest of any large economy, even after last year's ten-point decline in the central bank's benchmark rate. Their laments are growing more shrill, partly because the central bank has held this steady (at 16.5%) for the past two months. Antônio Delfim Netto, a congressman friendly to the government, gave warning that the bank's obsession with hitting its inflation target (of 5.5%) could condemn the economy to mediocre growth this year.

But the economy is in better shape than it looks—and that goes, too, for the government's policies. Last year's austerity choked an inflationary burp, restored investors' confidence in Brazil and should allow interest rates to fall further. In a feisty defence of his record, the central bank's governor, Henrique Meirelles, pointed out that recovery began last July, and that growth reached an annual rate of 6% in the final quarter. Most economists still expect growth of 3-4% this year, spreading out from booming exports to domestic consumption and investment. Lula seems to realise that surrender to the growing clamour for slashed interest rates and higher spending would jeopardise such gains.

But will the gains come fast enough to ease the pressure on him? He faces local elections in October. Growth this year will produce "almost nothing" by way of new jobs, says Dirceu Bezerra of Rosenberg & Associados, a consultancy. And it remains vulnerable to outside forces, such as a rise in American interest rates, which would push up rates in Brazil.

The government, put on the defensive by revelations that one of Mr Dirceu's top aides funnelled money illegally to the PT and took some for himself, has two answers. One is to prime the economy without busting the budget. Thus the finance minister, Antônio Palocci, this week announced measures to encourage banks to lend to the depressed construction industry. He is also pressing the International Monetary Fund, which last year lent Brazil \$6.6 billion, to exempt some capital spending from the calculation of the main fiscal target. The IMF is considering this, but will not decide soon.

More important is a series of microeconomic initiatives designed to perk up private investment, especially in infrastructure. They include a reform of the bankruptcy law, rules to encourage private investment in public works and a new regime for electricity. But the government's approach to regulation has so far been inept. In January, it squeezed out the chief of the telecoms regulator, casting doubt on the independence of all regulatory bodies. The new electricity model, introduced by decree and now subject to ratification by Congress, leaves much to the discretion of the energy minister. All this hurts investment as much as high interest rates do.

The air of crisis in Brasilia could galvanise the government. Mr Dirceu, who is not accused of wrongdoing, is apparently safe for now and the government looks likely to escape a congressional inquiry into the funding scandal. Controversial measures, such as a reform of the judiciary, may languish. But the "positive agenda" of microeconomic measures could speed up. Best of all for the government, Lula's popularity has barely been dented by scandal or the economic blues. According to a poll this week, 60% of Brazilians think his performance "good" or "great". They are keeping the faith.

**The Economist on-line - acesso em 5/3/2004**