

A 'Responsible' Start

Lula's economic team, and austerity message, are playing well with the markets

By Mac Margolis

When Luiz Inacio Lula Da Silva was sworn in as Brazil's 30th president Jan. 1, many people held their breath. This bearded union man was not just Wall Street's worst nightmare. There were fears that his administration would ruin South America's biggest economy, and take the rest of the region down with it.

Instead Brazilian currency and bonds have rallied, and the prophets of imminent debt default have gone quiet. Even the long drought of international credit may be easing. Now, three weeks into office, Lula seems more like the Latin millennium bug, a political tragedy that didn't happen.

It's not that the president has changed, so much as sentiment about him has. He's begun his term much the same way he ended his campaign, preaching parsimony and political compromise. But his repeated pledges to honor Brazilian debts, fight inflation and plump up the budget surplus, if necessary, finally seem to have made a mark. "You sound like a Republican," exclaimed George W. Bush when Lula called on him last month. There are reasonable doubts whether Lula can make good on his hugely ambitious campaign agenda—paying off the "social debt" to the poor, reforming the spendthrift Constitution, resuscitating industry—and still keep creditors happy. But hardly anyone is asking anymore when he will tear off his tie, bare a Che Guevara tattoo and raise the capitalist-bashing banner of his lefty past. "Lula is off to a responsible start," says Mailson da Nobrega, a financial consultant and former Brazilian finance minister. "He's pledged not to overspend and let the Central Bank work independently. Even when he's working the crowds, he's careful to say he's not a messiah."

No one has worked harder at cementing this impression than Lula himself. When he finally got around to picking his cabinet, the sighs of relief could be heard in boardrooms around the world. Most of the 33 ministerial—jobs were awarded to Workers Party (PT) *companheiros*, but the key jobs went to ringers with made-for-market credentials. Central Bank president Henrique Meirelles, formerly head of global operations for Fleet Boston, is on a first-name basis with global CEOs and has promised a "no adventures" monetary policy. And who would guess that the new finance minister, Antonio Palocci, was once a ranking member of Liberty and Struggle, a Trotskyite cabal? One by one, debt-strapped state governors have marched up to his door to plead for bailouts. But like Pedro Malan, his miserly predecessor, Palocci has learned to respond with the most important word in national finance: "No."

That's an austerity message that investors appreciate. Last week the Institute of International Finance predicted Brazil will receive \$14 billion in private capital flows this year, double last year's tally and fully 40 percent of the estimated total for all Latin America. Says Roberto Teixeira da Costa, vice president of Banco Sul America, a So Paulo investment bank: "For now, Lula gets the benefit of the doubt."

He'll need it to improve the Brazilian economy. Last year it grew by a lackluster 1.6 percent; over the past eight years, economic growth averaged only 2.4 percent. Per capita income has not risen in a decade. Inflation has eased slightly in recent weeks, but still hovers at close to 10 percent, the worst mark since 1995.

And while a handful of banks and Brazilian blue-chip corporations—oil company Petrobras; Companhia Vale do Rio Doce, a mining combine—have lately raised dollars abroad, a few bond issues do not constitute a rally.

Promises of fiscal prudence are fine but make for thin collateral in a bearish world economy. In other words, there isn't much room for error.

So the administration's missteps are a worry. Hardly a day passes without a faux pas from one high-profile aide or another. Lula himself mucked things up in mid-January when he and 29 ministers set off for the backlands to launch a bold antihunger program. The government was forced to backpedal one day after the initiative was announced because no one could say how many Brazilians go hungry, or who qualifies for relief.

Lula inherited many blessings from former president Fernando Henrique Cardoso—rising productivity, low inflation and a sturdier economy. But Cardoso left much undone, starting with an overhaul of the 1988 Constitution, a tome stuffed with entitlements that Brazil could not afford. Cardoso whittled down many of the hand-outs—29 amendments in eight years—but not nearly enough. “The last few years of Cardoso's regime was pure crisis management,” says Winston Fritsch, a former Cardoso adviser now with Dresdner Kleinwort Wasserstein, a European investment bank. That leaves Lula with some key reform goals.

The toughest will be to downsize Brazil's cockeyed and hugely expensive social-security system. Retirement payments to former state employees, among others, account for 30 to 40 percent of all government expenditures. Last year the Brazilian taxpayers spent \$21 billion bailing out the bankrupt system. Though the vast majority of pensioners earn modest sums, the system is larded with privileges, especially for civil servants. Most retired government workers make as much as they did when they were employed. Retired judges pull down pensions 10 times greater than private-sector retirees. Few have it as cushy as those in the military, who not only retire five years earlier and earn heftier benefits (equal to their highest paychecks, plus a bonus) than most civilians, but upon death also pass along double pensions to their widows and mothers. Descendants of veterans of the war with Paraguay, which ended in 1870, still receive lifetime pensions. So do unmarried daughters of military men, who rarely get legally married for fear of losing their benefits.

Fixing this patently distorted system will not be easy. For one thing, much of the traditional support for Lula's PT comes from the civil service, whose members belong to powerful unions. Not surprisingly, the PT blocked all moves to reform social security under Cardoso. Still, the government intends to press the issue. “Everyone is going to have to give a little,” declares Jose Dirceu, Lula's strong-willed chief of staff.

Targeting the gray-headed elite is a clever political move. While Lula risks alienating his natural constituents, he has mobilized public opinion with a powerful argument: Brazil spends twice as much on pensioners as it does on all social and poverty-relief programs combined. “Government retirees are being seen for what they are,” says Nobrega, “a protect-ed caste.”

Lula's challenge will be to persuade the Brazilian Congress to pass a constitutional amendment on the pension issue. His governing coalition still lacks the supermajority (60 percent of each house) necessary to do that. So far, attempts to woo the Brazilian Democratic Movement Party, an important swing vote, have failed. Brazil's economic vitality is at stake: a study by Bear Stearns predicted that a thorough social-security reform could boost Brazilian equities by between 20 and 40 percent, and slash the premiums companies must pay on foreign loans.

If he can pull it off, Lula will have managed something remarkable. **“A leftist taking on pension reform is a little like Nixon going to communist China,”** says **Alex Kazan**, Latin American analyst for **G7 Group** consultants in Washington. **“It's a daring move that could set off a sort of shock of confidence.”** In other words, Lula's honeymoon with the markets might last. That seems an almost utopian dream in topsy-turvy Brazil. But then it wouldn't be the first time Lula has confounded the skeptics.