**Does History Repeat? Some Worrying Parallels between Lula Da Silva and Ramsay MacDonald**[1]

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Lula da Silva's 2002 election as President of Brazil marks a watershed in Brazilian political history. At the personal level, it is the first time that a man of the people, born in extreme poverty, has become President of the Republic. At the system level, it is the first time a workers' party – the Partido dos Trabalhadores or PT - has taken control of Brazil's executive.

Lula formally took office in January 2003, amidst high expectations and with much of the nation looking for a change of direction in economic and social policy. But nine months into the President's term, those expectations are eroding. With Brazil now mired in economic recession and unemployment climbing to record levels, there is increasing dissatisfaction with the new government's economic strategy. Whereas the government has pushed progressive new microeconomic policies, such as the "zero hunger" income transfer program, it has simultaneously pursued a highly orthodox macroeconomic policy aimed at gaining favor with international financial markets. This policy has involved fiscal austerity (large budget surpluses) and high interest rates. The result has been stagnation that is undermining the President's standing and creating political divisions within the Workers Party.

[1] The views expressed in this article are those of the author and not those of the Open Society Institute.

**The Ramsay MacDonald parallel**

Lula's situation has an eerie resemblance to that of British Labor Party Prime Minister Ramsay MacDonald in 1929. In that year, the British Labor Party won the general election for the first time ever, and MacDonald established Britain's first Labor government. And like the PT in today's Brazilian congress, Labor lacked an overall majority in parliament.

In addition to these political parallels, there are also strong economic parallels. Like Lula, MacDonald inherited a dismal economic situation. Britain was mired in a ten year long stagnation that had begun shortly after World War I, and the pound sterling was vulnerable to speculative attack because of Britain's adherence to the gold standard – a problem that was exacerbated by adherence at an over-valued parity. Finally, the dominant economic policy view of the day was the "Treasury View," which maintained that government budget deficits crowd out private investment spending on a one-for-one basis. This view encouraged fiscal austerity, and in many regards it is the intellectual forerunner of the thinking on fiscal policy and balanced budgets that now holds sway with the IMF.

Philip Snowden was Labor's Chancellor of the Exchequer – the equivalent of US Treasury Secretary. By every account, Snowden was committed to Labor's core social principles, being a life-long Christian Socialist. In part because of a desire to maintain the good graces of financial markets, Snowden was persuaded by the Treasury view. As a result, he refused to engage in needed Keynesian-styled fiscal expansion, and he even proposed cutting social services and unemployment pay. British economic conditions worsened with the onset of the Great Depression. The Labor Party in turn split over the issue of fiscal austerity, and lost office in 1931. Thereafter, Labor remained in the political wilderness for fourteen years, not regaining power until Clement Atlee's historic victory in 1945.

**The problem with Brazil's economic policy**

Both the British Labor Party's failure in 1931 and Lula's predicament today reflect the primacy of macroeconomic policy. If governments get macroeconomic policy wrong, then they will fail no matter how sound their other policies. Monetary policy is an especially important component of macroeconomic policy since it sets domestic interest rates. These rates influence business investment spending and economic growth, and they also influence the exchange rate and the trade deficit. Lastly, they also affect the amount of interest government must pay to service its debt, which in turn influences the budget deficit and the amount available for discretionary policy spending. The net result is that flawed monetary policy will cripple growth, cripple fiscal policy, and ultimately undermine the possibilities for economic change and progress.

Lula's Brazil is beset by high interest rates. Though rates have been lowered from a peak of twenty-six and one-half percent to twenty-two percent, they remain at levels that will crush growth. These high rates are the result of a policy driven by fears of a currency run that could trigger renewed financial crisis. This policy has purchased temporary financial stability, but it has done so at the expense of growth. Even worse, the policy is founded on a contradiction, since Brazil will confront a return of financial instability absent the restoration of economic growth.

The underlying contradiction in policy can be understood through assessment of the debt-to-GDP ratio, which is a critical indicator of financial stability. The evolution of the debt-to-GDP ratio depends on the growth of the debt, and on the growth of GDP. The growth of the debt in turn depends on the interest payments government must make, and on the primary budget deficit (i.e. the deficit before interest payments). To placate financial markets, Brazil has chosen a path of high interest rates and primary budget surplus. High interest rates have increased debt growth, and they have also combined with budget surpluses to lower economic growth. The net result is that the debt-to-GDP ratio looks set to continue rising, so that Brazil now confronts the prospect of no growth and financial instability just around the corner.

The bottom line is that high interest rates and large budget surpluses are a deadly economic cocktail. A comparison of Brazil's situation with that of the US is revealing. US short-term interest rates are at a forty year low of one percent, and the overall budget deficit is 4.5 percent of GDP. Yet, even with this expansionary policy configuration, it is still proving tough for the US to shake its recession. In contrast, Brazil is fighting a recession with contractionary policies, which is tantamount to economic suicide. Instead, Brazil must adopt expansionary policies similar to those in the US. It needs lower interest rates for long run financial stability, and it needs a lower primary budget surplus to restore growth. Absent this, the weight of recession will defeat President Lula.

**Policies for escaping Brazil's debt trap**

The US can lower interest rates because it has no foreign currency debt, and because it has low inflation. Brazil's situation is more complicated since it has large foreign currency denominated debts, and its economy is more inflation prone. Lula's fear is that if he lowers interest rates and reduces the budget surplus, this will trigger an exchange rate crisis that causes imported inflation and an explosion in the burden of foreign currency debts. These concerns are real, but they can be handled.

Escaping Brazil’s debt trap requires a two pronged financial strategy. The first prong is a domestic strategy that lowers domestic interest rates and restores growth. The second prong is an external strategy that retains investor confidence and lowers external interest rates.

Regarding the domestic strategy, the Bank of Brazil must lower the short-term domestic interest rate so as to reduce the government’s debt service burden and ensure sustainability of its debt. Lower interest rates will also stimulate investment and growth, which will increase tax revenues. If there is a threat of inflation, the government should use regulatory policies that restrict the ability of banks to create new credit that finances consumer spending. Such a policy can ensure continued investment spending which is needed for economic growth, while restricting total spending that may be inflationary.

Side-by-side, the government must reduce its primary budget surplus to jump start economic growth. Running budget surpluses in times of recession is economic suicide. Given the large savings on debt service that will come from lower interest rates, it may even be possible for the government to increase non-interest spending while lowering the overall budget deficit.

This domestic economic strategy must be accompanied by an external financial strategy aimed at reducing the interest rate foreign lenders charge Brazil. The credibility that Lula’s administration has built-up in its first nine months can provide a platform for this external strategy. The government’s commitment to responsible policies has begun the process of building market confidence, but at this stage additional measures are needed. One measure would be to create an IMF-funded debt stabilization fund committed to ensuring a floor price to Brazilian bonds. With this fund in place, the price of Brazilian bonds would rise, and interest rates charged to Brazil would fall.

The critical feature of this proposed policy is that it has Brazil focusing on the bond market rather than the exchange rate. Exchange rate weakness is just a symptom of the problem; the underlying problem is confidence in Brazilian financial assets. Defending the exchange rate does nothing to build confidence. It just exchanges borrowed foreign currency, on which Brazil must pay an exorbitant interest rate, for domestic currency that yields no interest.

**Preventing a repeat of history**

Like Ramsay MacDonald's British Labor government of 1929, the Workers Party government of President Lula da Silva has opted for policies of fiscal and monetary austerity aimed at currying favor with financial markets. And like Britain in 1929, Brazil is now experiencing recession and high unemployment. The policies of austerity have succeeded in buying short-term financial stability, but they have killed growth and created the prospect of future financial instability.

The current strength of Brazilian financial markets offers an opportune moment to initiate a smooth transition from policies of austerity to policies of responsible economic expansion. This calls for lower domestic interest rates and a reduced primary budget surplus. President Lula da Silva's government has shown itself to be financially responsible, and US interest rates stand at one percent so flight capital has nowhere to flee to. Now is the time to make the policy shift. Failure to do so risks having Brazil's first Workers’ Party government repeat the tragic experience of Britain’s first Labor Party government.