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Lula and the Continuity of Neoliberalism in Brazil: Strategic Choice, Economic Imperative or Political Schizophrenia?

Introduction

This article offers a political-economy interpretation of Lula's election to the Brazilian presidency in 2002, and an assessment of his administration. Lula's election in October 2002 was greeted with delight by his left-wing supporters in Brazil and abroad. For them, Lula's remarkable trajectory, including childhood poverty and hard work as a lathe operator in São Paulo's industrial belt, his contribution to the renewal of Brazil's trade unions and his leadership role in the Workers' Party (PT), his principled opposition to the élite pacts that have always shaped Brazilian political life, and his unquestionable integrity, showed that his election would open a new stage in the history of Latin America's largest country.[1] Paradoxically, however, his new allies on the political Right *also* warmly greeted Lula's victory. For them, the PT seemed to have finally achieved political 'maturity', which is always deserving of applause.

[1] The history of the PT is reviewed by Branford and Kucinski 1995 and 2003.

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More importantly, they expected the new administration to join the neoliberal consensus that has ruled Brazil since the early 1990s,[2] dealing a terminal blow to the powerful Brazilian Left.

It is important to address this paradox in order to understand the current government's power base, objectives and margin for manoeuvre. Even if the new administration fails to deliver the policy changes and welfare improvements originally expected by many of Lula's supporters, it is worthwhile assessing what has been achieved, why and how, and what economic and social improvements are realistically possible in one of the world's most unequal societies. Brazil has a vast territory and abundant natural resources, a developed industrial base, enormous productive potential and a relatively organised and experienced working class: if significant improvements in social welfare cannot be achieved there, it would be difficult to claim that they are feasible in other poor countries.

It is impossible to assess the new administration from all of these angles in a short essay. This article reviews the social, political and economic processes underpinning Lula's election, and the strategic choices of his administration, in six sections. The first reviews the social forces supporting the new administration, summarised under the term 'losers' alliance'. The second explains the political and economic rationale of Lula's commitment to neoliberalism. The third analyses the trajectory of the Brazilian economy during the last fifteen years, in order to assess the material basis of the neoliberal transition, the economic constraints faced by the new government and the scope for alternative policies. The fourth and fifth review the administration's record in 2003–4, and its economic and political achievements. The sixth section summarises the article and briefly outlines the most likely scenarios for the second half of Lula's administration.

I. The losers' alliance

Lula was elected by a *losers' alliance*: a loose coalition of social groups having in common only the experience of *losses* under neoliberalism.[3] This was not a Gramscian historical bloc. The 'losers' alliance' was not a strategic alliance, it did not have a hegemonic power project, and it never challenged the state

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[2] This period encompasses the administrations of José Sarney (1985–90), Fernando Collor (1990–2), Itamar Franco (1992–4) and Fernando Henrique Cardoso (1994–2002).

[3] See Morais and Saad-Filho 2003 and Saad-Filho 2003.

(see below). The alliance was purely tactical; these groups were essentially attempting to limit the costs of neoliberalism, either by marginally changing the priorities of economic policy or by simply shifting its costs onto others. However, there was no agreement about how this should be done or what alternative policies should be implemented. The 'losers' had very modest and possibly mutually incompatible objectives, centred on a relative improvement of their economic and social position and an increase of their political influence.

The loser's alliance included four main groups. First, the unionised urban and rural working class, especially the skilled and semi-skilled manual and office workers, the lower ranks of the civil service, sections of the professional middle class and many informal workers. These groups have been the backbone of the Brazilian Left (and the main source of support for the PT) since the disintegration of the military régime, in the early 1980s. They have also lost out most heavily under neoliberalism. They were penalised by heavy job cuts, the stagnation or decline of real wages, the dilution of employment rights and the contraction of public and social services that accompanied the neoliberal transition.

Second, Lula was supported by large segments of the unorganised and unskilled working class, including many informal and unemployed workers of the metropolitan peripheries. Some of these groups had been reluctant to engage with the PT, partly for ideological reasons (especially their attachment to clientelistic and populist political practices), and partly because of the relative scarcity of channels connecting them to the PT. (In contrast, multiple and overlapping channels linked the PT to the formal-sector workers, for example, trade unions, community associations, social movements and the 'base communities' of the Catholic church.) In 2002, these large but mainly unorganised groups supported Lula because of his perceived rejection of neoliberalism and because of the PT's political pact with several evangelical churches, which are increasingly influential among this segment of the working class.

Third, several prominent capitalists also supported Lula, especially among the traditional manufacturing élite of the Southeast. They were disappointed by the failure of the neoliberal growth strategy associated with President Fernando Henrique Cardoso. Many of these capitalists were exhausted by the long stagnation of the Brazilian economy, the onslaught of transnational firms and the relentless pressure of cheap imports, especially after the hasty trade liberalisation in the early 1990s. Some magnates were also concerned with the negative social implications of neoliberalism, especially the perceived deterioration of the distribution of income and its presumed security implications: violent crime, random shootings, kidnappings, the growing power of heavily armed drug-trafficking gangs, and so on. These capitalists hoped that Lula would combine economic 'responsibility' with a more pro-active strategy to tackle Brazil's social problems. Their preferred economic policy was nationalist and expansionary. It was based on the reduction of the debt burden of productive capital, minimisation of exchange-rate volatility, rationalisation of the tax system, expansion of state procurement and development finance, and marginal income distribution. Typically, Globo, a reactionary and heavily indebted media empire, ditched the official presidential candidate early on and supported Lula, hoping that his 'nationalist' administration would help the corporation to stave off bankruptcy.

Fourth, several notorious right-wing oligarchs, landowners and influential local politicians from the poorest regions of Brazil also supported Lula. Their unexpected political conversion was not due to pressure from below; rather, it was the outcome of a shrewd political calculation. Since the early 1990s, these oligarchs and their *protégés* were being squeezed out of their influential positions in Brasília by the encroachment of a new cohort of upper- and middle-managers of state institutions appointed by the financial interests associated with neoliberalism. In contrast with the previous generation of lawyers, engineers and talentless political appointees from the poorest regions of the country, the new managers are economists, financiers and professional administrators, mainly from the rich Southeast, and carefully trained in the neoliberal arts in the best international universities. The traditional oligarchy also resented the rationing of 'development' funds imposed by the fiscal austerity measures in place since 1990, which badly eroded their political influence. Finally, they felt betrayed by a 'dirty tricks' campaign allegedly inspired by president Cardoso and his party's presidential candidate, José Serra.[4] By switching their support to the PT, these oligarchs attempted to defeat the neoliberal interests associated with Cardoso. They also anticipated

[4] In March 2002, Maranhão state governor Roseana Sarney (daughter of former president José Sarney, and supported by oligarchic interests of Centre and Northeast) was far ahead of José Serra in the opinion polls. She was disgraced when Federal Police broke into her husband's office and found a large hoard of cash that would allegedly be used in her campaign. Her downfall turned Serra into the only viable right-of-centre candidate. However, the use of the Federal Police and live media coverage of the search pointed to the government's hand behind the affair.

that Lula would depend heavily on their support in Congress and in the state governments, and that the PT would be more sensitive than the neoliberals would to the plight of poorer regions – both of which would maximise the oligarchs' political power and influence.

Two important groups resisted Lula's advances, in spite of the PT's effort to broaden the coalition as much as possible. Unsurprisingly, most of the élite – including the large and medium capitalists, financiers, exporters, traders, the media, most big landowners and local political chiefs, their intellectual and political proxies and the top civil servants – refused to support Lula under any circumstances. However, their resistance against the PT was much less vociferous in 2002 than in previous elections, especially in 1989, when Lula was narrowly defeated by a brutal campaign of intimidation, coercion and sheer economic pressure.

The other reluctant group was the urban middle class. Although it is relatively small, internally divided and politically unstable, this group is also highly influential because of its ideological ascendancy over the working class and its privileged access to the media and the organised social movements. Although there is a significant left-wing constituency among the urban middle class, important segments remain attached to clientelistic politics, right-wing ideology and landowner interests (especially the rapidly growing agribusiness interests in São Paulo, the South and the Centre-West). This class suffered badly under neoliberalism. 'Good jobs' in the private and public sectors contracted drastically, higher education no longer guarantees sufficient income to satisfy their aspirations, and young adults can rarely replicate the social and economic achievements of their parents. This group as a whole yearned for expansionary economic policies; however, many were reluctant to ditch the neoliberal-globalist ideology that they had fully incorporated only recently. They were proud of their new international credit cards, glad to have access to imported consumer goods and full of memories of recent trips abroad (which, until the 1980s, were possible only for a tiny minority). They were also frightened by the 'radical' image of the PT.[5] Their dilemma was exacerbated by the continuing turmoil in neighbouring Argentina and Venezuela – the

Unsurprisingly, Roseana's vengeful father supported Lula. In turn, the PT helped him to be elected Speaker of the Senate.

5 In 1999, just after the devaluation of the real (see Morais, Coelho and Saad-Filho 1999 and Saad-Filho and Morais 2002), the president of the Central Bank, Francisco Lopes, defended in the Brazilian Congress the liberalisation of the capital account of the balance of payments, and rejected demands for emergency controls on capital flows. He claimed that controls

former collapsing because of the dismal failure of its extreme neoliberal experience, while the latter was forever unable to achieve political stability as it charted new political waters. Under intense pressure from all sides, the urban middle class splintered across the political spectrum.

II. Lula's neoliberal shift

The social, political and economic features of Lula's administration were determined by the alliances underpinning his election, described in the previous section, the material changes imposed by neoliberalism, reviewed in Section III, and the PT's reaction to the 2002 exchange rate crisis, explained below.

In mid-2002, the emerging losers' alliance was already sufficiently strong to give Lula a comfortable lead in the opinion polls. However, Lula's radical image deeply worried the Brazilian and international financiers and the neoliberal élite. They feared the loss of political and economic leverage in an administration led by the PT, and they were especially concerned that the new administration might default or compulsorily reschedule the domestic public debt and Brazil's foreign debt. Because of these concerns, several financial institutions refused to buy government securities maturing after 31 December 2002 (the last day of Cardoso's presidency).[6]

The resources released by the brokers' refusal to purchase government securities were transferred either to the foreign-exchange market (devaluing the *real*) or to the open market.[7] In 2002, US$9.1 billion were transferred abroad

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> would have negative consequences, they would deny any possibility of Brazil becoming a first-class nation in the world economy. They would also mean, in practice . . . that one would no longer have an international credit card. Any foreign payment would require the purchase of dollars in the parallel market . . . it would involve arbitrary decisions by state authorities, deciding who could have dollars, and who could not. We already had this experience in Brazil. The Ministry of Foreign Affairs would provide a special passport, giving that individual the right to purchase dollars for a trip abroad. If your passport did not have the right colour, no dollars would be available [in the official currency market]. This is a régime of complete arbitrariness. (Senado Federal 1999.)

Lopes's discourse targeted the Brazilian upper and middle classes, that would be most directly affected by any restrictions on capital flows.

[6] This was not the only worry of the financial market operators. The political bankruptcy of neoliberalism in Brazil was so profound that all other presidential candidates – including Serra – were studiously ambiguous about their preferred economic strategy.

[7] The open market trades long-term Treasury and Central Bank securities held by the Central Bank and the private financial institutions. These securities are traded

in this way, devaluing the *real* from R$2.32 to the dollar in March to R$3.42 in July, and R$3.80 in October (inflation was only 4 per cent during the entire period). The country's net international reserves tumbled, from US$28.8 billion in March to only US$16.3 billion in December. The devaluation of the currency and the brokers' loud complaints about the 'lack of policy clarity' after the elections led to the downgrading of Brazilian bonds and foreign-debt certificates abroad which, in turn, triggered the recall of short-term loans and commercial credit lines by foreign banks. Half of the country's commercial credit lines were lost in a few weeks. The Brazilian balance of payments was on the verge of collapse.

At the same time, the proportion of the stock of public securities traded in the open market increased from 0.7 per cent in February to 2.5 per cent in April, 5.3 per cent in July and 12.4 per cent in December. The Central Bank increased its open market operations to try to prevent these funds reaching the foreign exchange market, leading to a catastrophic devaluation of the *real*. In September, the stock of highly liquid securities in the open market reached 5.3 per cent of GDP, exceeding the monetary base and the Central Bank's international reserves.

There is no question that the Cardoso administration was complicit in the meltdown of the Brazilian balance of payments, the evaporation of the government's capacity to sell medium- and long-term securities and the Central Bank's loss of control over the open market. In mid-2002, the Brazilian economy tottered on the brink of collapse.[8] Media pressure on the government and the presidential candidates was intense, fuelling speculation even further. Lula's poll leadership wobbled badly and his competitors sensed an opportunity. It was claimed that whoever managed to overtake Lula at this critical juncture would have strong chances of being elected, because he (there

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though contracts to repurchase them by a certain date, usually within one month. The macro-economic function of the open market is to allow the Central Bank to fine-tune the liquidity of the economy. The number of transactions in the open market is high, but the volume of securities in this market is usually tiny – only a small fraction of the stock held by the financial system.

[8] Left critics of Lula's pact with finance have claimed that the Brazilian economy was in relatively good shape in 2002, and the PT's conversion to neoliberalism could not be blamed on the economic crisis (see Borges Neto 2004 and Paulani 2003 and 2004). This criticism is misguided. It is surely right to claim that the neoliberal shift of the PT predated the crisis, and was largely independent from it. It is, however, a serious mistake to conclude that the crisis itself was entirely irrelevant – as if it had been merely a smokescreen.

were no female candidates) would secure the growing anti-Lula vote and the accompanying campaign funds, just as Fernando Collor did in 1989. However, Lula was determined to stabilise his position and win his fourth presidential election. On 22 June, he issued a 'Letter to the Brazilian People' stating that his government would respect contracts (that is, service the domestic and foreign debts on schedule) and enforce the economic programme agreed with the IMF.

This shrewd move was sufficient to disarm the media, prevent a further deterioration of the economy and secure Lula's leadership in the opinion polls, but it was not enough for the neoliberal coalition. Realising that Lula was poised to win, the neoliberal camp now demanded *institutional* guarantees of the continuity of neoliberalism, especially an independent Central Bank committed to a 'responsible' monetary policy and a new IMF agreement spanning well into the new administration. Lula acquiesced, and the wheels turned extraordinarily rapidly in Brasília and Washington. The new IMF agreement was signed in record time, on 4 September 2002. It involved a loan of US$30 billion, of which only US$6 billion would be available immediately. The rest would be available to the new government, if its policies were approved by the Fund. Lula's consent opened to the PT the doors of financial institutions and conservative governments around the world.

Lula's pact with neoliberalism virtually ensured his election, and he duly won both rounds of the vote by a large margin. However, his concessions imposed narrow limits for the new administration. They implied that his government would follow Cardoso's neoliberal economic policies – but, it was promised, with more competence, honesty, creativity and sensitivity to the need for compensatory (targeted) social policies. During the campaign, little was said about the blatant contradiction between Lula's commitment to the neoliberal agenda and the expectations of most of his voters. Most of the 'losers' were bound to be disappointed.

The 2002 economic crisis, and its political resolution – Lula's complete capitulation to neoliberalism – illustrate the growing power of finance in Brazil.[9] Finance can influence decisively not only economic policy, but also the democratic process in the country. The outcome of the crisis also implies

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9 The conversion of Lula and the PT to neoliberalism did not begin in 2002. It started after Lula's defeat in 1989, with the subsequent decision of the party leadership to shift the PT to the 'middle ground'. The transformation of the PT into a mainstream political party is reviewed in Saad-Filho and Morais 2005.

that the Lula administration is limited in three important ways. First, Lula was elected by an unstable coalition of incompatible social and political forces attempting to shed the stagnationist bias of the neoliberal policies imposed in 1990. Beyond this, the 'losers' have only a limited range of short-term objectives in common, and their alliance is unable to offer consistent support to the government. Second, the capitulation of the PT leadership to the power of finance enserfed the government to the interests that the PT had hoped to defeat since its foundation, more than two decades ago. Finally, the losers' alliance – and the forces supporting the new administration in Congress and at State level – does *not* generally aim to shift policy away from neoliberalism. The disparity between Lula's impressive victory,[10] the distribution of seats in Congress, where the PT and its dependable allies hold less than one-third of the seats,[11] and the Left's negligible influence on the judiciary shows that radical changes are not unambiguously popular, and they may be unenforceable. In sum, although Lula's election created the *expectation* of changes, the President does not have a *mandate* for radical change, and he was not unambiguously committed to specific outcomes or even processes of change.

III. The economic stranglehold of neoliberalism

Sections I and II explained the most important political constraints upon the new Brazilian administration. This section argues that the economic constraints are no less binding. For neoliberalism is neither simply an ideology nor one viewpoint contending with others in a democratic debate. The 'reforms' have given rise to a *material basis* for the reproduction of neoliberalism through the transformations that they have wrought on the Brazilian economy and society. Three aspects of these transformations are especially important.

First, the reforms dismantled the 'division of labour' between domestic, foreign and state-owned capital established during the period of import-substituting industrialisation (ISI, between 1930–80), and the corresponding

[10] Lula received 40m votes (46.4 per cent) in the first round of the elections, and 53m (61.3 per cent) in the second round. Serra, his nearest rival, was beaten by 20m votes in both rounds.

[11] Lula's centre-left alliance, including PT, PSB, PL, PCdoB, PPS, PV and PDT, elected 177 deputies (34.5 per cent of the house) and 25 senators (30.9 per cent). The centrist and right-wing PMDB, PTB and PP joined the coalition in 2003, while the PDT left. The government can now count, at least notionally, on 368 deputies (71.7 per cent) and 48 senators (59.3 per cent).

social structures and patterns of employment. During ISI, domestic capital tended to produce non-durable consumer goods and capital goods, while transnational companies (TNCs) produced durable consumer goods. State-owned enterprises (SOEs) provided infrastructure and basic goods and services (steel, electricity, telecommunications, water and sanitation, oil extraction and refining, air, road, rail and port links and so on). Finally, state-owned banks played an essential role in the provision of long-term credit, especially for economic diversification and industrial development. The neoliberal reforms included the privatisation of most productive and financial SOEs, and they promoted the alliance between foreign and domestic capital at firm level within most value chains (including the denationalisation of industry and infrastructure). While ISI encouraged the diversification and domestic integration of manufacturing production, import liberalisation and the ongoing process of international integration of Brazilian capital have fostered the production of a narrower range of relatively unsophisticated goods. They have hollowed out the Brazilian manufacturing base, and made the economy structurally more dependent on foreign trade, investment and technology.

The destruction of strategically important production chains established under ISI was associated with the widespread use of subcontracting in manufacturing and services, and the sharp reduction of the number of stable and relatively well-paid blue-collar jobs. Although the productivity of the remaining firms has increased, industry has been starved of development funds, the manufacturing base has contracted,[12] unemployment has mounted, and the informal economy has expanded significantly.[13] These were not simply the inevitable outcomes of a technically neutral process of economic 'rationalisation'. Quite the contrary: they are the economic consequences of a profound transformation in the Brazilian political economy. The country's productive structure has been converted in order to service the short-term imperatives of *global* accumulation, rather than the short-term requirements of *national* accumulation, as was the case under ISI (the long-term interests of the poor majority were neglected in both cases).

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[12] The share of manufacturing in Brazil's GDP has declined from 33 per cent in 1980 to around 20 per cent. In contrast, in South Korea, this share has remained around 30 per cent during this entire period (see World Bank 2003).

[13] Pochmann 1999 assesses the impact of the neoliberal reforms on the Brazilian labour markets. Privatisation is reviewed by Goncalves 1999, and the new relationship between Brazilian and foreign capital is analysed by Coutinho et al. 1999, Laplane and Sarti 1999 and Saad-Filho and Morais 2002.

Second, the state has deliberately dismantled its institutional capacity for macro-economic planning and micro-economic intervention through mass privatisations, downsizing, SOE and agency closures and large-scale subcontracting at ministerial level. These processes were accelerated by a brutal staff cull imposed by president Collor in 1990,[14] and two waves of 'voluntary' redundancies in 1998 and 2003. Lack of managerial and institutional capacity would make it very difficult for the Lula administration to implement alternative economic policies, even were the necessary legal and financial resources available.

Third, Brazilian finance has been profoundly transformed in two important respects. On the one hand, the financial system has become closely bound up with global finance through extensive privatisations, mergers, acquisitions and strategic alliances between domestic and foreign institutions.[15] On the other hand, and even more significantly, the institutional and regulatory reforms imposed during the neoliberal transition have extended the control by the financial system over the three main sources of money capital in the economy: *domestic credit*, the *public debt* and *foreign capital*. This critically important aspect of neoliberalism has been largely neglected in the literature. However, it has played a central role in the restructuring of Brazilian economy and society, and it has severely limited the policy choices available to the new administration. In what follows, the implications of the extension of the power of finance are analysed in further detail.

Financial-sector control over domestic credit has been extended through the privatisation of most of the Brazilian financial system, except two federal commercial banks, Banco do Brasil and Caixa Econômica Federal, and the state development bank, BNDES (Banco Nacional de Desenvolvimento Econômico e Social). Although they are relatively large,[16] the state-owned commercial banks are legally required to operate under market rules. Compliance is carefully monitored by the Central Bank, the media and the financial markets, allegedly in order to avoid corruption or the populist use

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14 Collor's attempt to dismiss 100,000 civil servants and close dozens of state agencies and departments was never fully completed, and it was partly reversed several years later. However, it disorganised the state apparatus, demoralised the civil servants and greatly facilitated the reorganisation of the state along neoliberal lines by the Cardoso administration.

15 See Paula 2002, Paula and Alves Jr. 2002 and Studart 1999a and 1999b.

16 Banco do Brasil and Caixa Econômica Federal are the largest banks in the country. In 2001, they controlled, respectively, 27.4 and 16.6 per cent of the assets of the ten largest banks in Brazil (Valor Econômico 2002, p. 96).

of their resources. These are surely valid concerns. However, they imply that these institutions have been neutralised from the point of view of industrial and financial policy objectives, and are effectively private rather than public concerns. In addition to this, in 1999, the government started implementing the Basle rules as part of the IMF agreement. Although these rules helped to strengthen the financial system, they have also induced the banks to increase their holdings of public securities, potentially reducing the availability of loans to the private sector. These regulatory changes have also contributed to the concentration and centralisation of capital in the financial sector. The number of banks declined by more than half during the last decade and, in the late 1990s, up to 40 per cent of the assets of the banking sector belonged to foreign institutions.[17]

The leverage of the financial sector over the public finances has increased sharply, especially because of five policy and regulatory changes. First, the 1988 Constitution bars the monetisation of primary fiscal deficits, effectively allowing the financial institutions to limit the state expenditures unilaterally, through their (un)willingness to purchase new public securities. Second, the Fiscal Responsibility Act (2000) imposes stringent financial constraints upon all levels of the public administration. For example, the Act mandates the federal, state and municipal governments to pass annual budget laws including primary surpluses large enough to service their existing debt. Failure to achieve these targets in any bi-monthly period triggers automatic expenditure cuts, including the suspension of service provision and payments, *except* debt service and civil-service wages and pensions. In practice, the former have been protected more often than the latter. In other words, under the pretext of ensuring fiscal rectitude, the financial institutions have been granted privileged access to the tax revenues, at the expense of the users of public services, civil servants, pensioners and the non-financial creditors of the state.[18] Third, permanently high interest rates since the 1992 liberalisation of the capital account of the balance of payments have inflated dramatically the stock of public securities owned by private financial institutions.[19] Fourth,

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[17] See Penido and Prates 2001, 2003.

[18] Public investment declined from 1.11 per cent of GDP in 1994 to 0.92 per cent in 1998, and 0.75 per cent in 2003. Investment in 2002 was even lower (0.42 per cent of GDP), because of the expenditure cuts due to the exchange rate crisis (Governo do Brasil, Sistema Integrado de Administracao Financeira, SIAFI).

[19] Saad-Filho and Morais (2000) show that the growth of the domestic public debt between 1991–9 is mostly due to the accumulation of interest rather than primary fiscal deficits.

the exchange-rate risk has been nationalised through the sale of public securities indexed to the dollar, especially in periods of exchange-rate instability. In particular, the state absorbed the cost of the January 1999 exchange-rate crisis (approximately 5.6 per cent of GDP).[20] Although this helped to avoid an economic depression in the wake of the devaluation of the *real*, it also contributed to the rapid growth of the public debt and the shortening of the maturity of this debt – most bills are very short-term, normally maturing in 24 to 36 months. Later efforts to control this debt have contributed to the destabilisation of the entire economy (see Section IV).

Finally, financial-system control over the flow of foreign resources has increased significantly in recent years, especially after the gradual liberalisation of foreign currency deposits and the capital account of the balance of payments. A small number of banks control most of these transactions, as well as foreign trade credit (foreign institutions are allowed to offer trade credit only in partnership with a domestic bank).

These regulatory and institutional changes were accompanied by fiscal, monetary and exchange-rate policy shifts towards a neoliberal policy compact. Under ISI (especially in its last period, 1968–80), fiscal policies were generally activist, while monetary and exchange-rate policies were accommodating.[21] After the neoliberal transition, fiscal policy became increasingly contractionary (see above), while monetary policy developed a more activist role, which was sometimes supported by the overvaluation of the currency. This policy combination was especially prominent in 1994–8, during the *real* stabilisation programme.[22] Finally, after the 1999 currency crisis, a new policy framework was imposed by the Cardoso administration (and continued by Lula). It was based on the managed fluctuation of the *real*, large fiscal surpluses and high domestic interest rates. Essentially, given the maximum fiscal surplus achievable, the interest rates were determined by the overlapping objectives of demand control (to achieve the government's inflation targets), exchange-rate stability, attraction of foreign capital to finance the balance of payments and maintaining the solvency of the state (generating sufficient demand for public securities).

The substitution of interest-rate manipulation for fiscal policy as the most important macro-economic tool replicates in Brazil the shift in other neoliberal

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[20] See Saad-Filho and Morais 2002, p. 48.

[21] See Fiori 1992, Lessa and Fiori 1991 and Studart 1995.

[22] This period is reviewed by Amann and Baer 2000, Bresser-Pereira 2003 and Saad-Filho and Mollo 2002.

economic areas, especially the United Kingdom (since 1976), the United States (since 1979) and the Eurozone (since, at least, 1992).[23] However, monetary policy is critically important in Brazil for two additional reasons. On the one hand, most industrial and financial institutions, including the pension funds, hold vast quantities of public securities, whose valorisation is determined by the level of the interest rates. Under normal circumstances, lower interest rates should stimulate private consumption, investment and economic growth. However, in Brazil, this expansionary effect is partly offset by the contraction of the pool of investible funds, due to the slower growth rate of the stock of government debt. In extreme circumstances, for example, if the federal government defaulted on its domestic debt, the economy would face a devastating crisis – liquidity would disappear, and a large part of the existing stock of money capital would be destroyed.[24] On the other hand, if the holders of public securities switch their assets into foreign currency (as some did in 2002), the Brazilian *real* would collapse. This risk must weigh heavily upon every macro-economic policy decision, and it compels the economic authorities to remain in the straight and narrow path of neoliberalism.

Brazilian fiscal policy has been limited to accommodating, through adjustments in the fiscal surplus, the macro-economic disequilibria created by neoliberalism. Alternatively, it can be argued that the main objective of fiscal policy is to fund the administration of neoliberal policies by the state. In essence, fiscal policy supports the transfer of tax revenues to the holders of public securities, and finances the compensatory social programmes that legitimate neoliberalism and limit some of its perverse effects. The developmental role of fiscal policy, which figured prominently during ISI, has been almost completely abandoned, and the fiscal surpluses have become part and parcel of the reproduction of neoliberalism in Brazil. For this reason, Lula has been compelled to *intensify* the fiscal restrictions imposed by Cardoso, even though they have limited his capacity to deliver economic stability and sustained employment growth and welfare gains to the 'losers' (see Section IV).

Finally, the floating exchange-rate régime has minimised the Central Bank's influence upon the value of the *real*, in spite of its importance for the level

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[23] See Arestis and Sawyer 1998 and 2005.

[24] In 1990, the Collor administration partly froze financial assets, including the domestic debt, in an attempt to eliminate high inflation. The economy collapsed, with GDP contracting 4.3 per cent during the year. The stabilisation plan became economically and politically unsustainable, and had to be abandoned. High inflation rapidly resumed.

of employment, real wages, industrial development and macroeconomic stability in Brazil. The institutional and policy changes explained in this section facilitated the transfer of control over the most important levers of accumulation in Brazil to a small number of unaccountable institutions, controlled by domestic and international finance. They control a large share of the private-sector loans, hold the vast majority of the public securities, command large amounts of foreign currency, dominate the foreign-exchange and foreign-assets markets[25] and mediate the flows of foreign investment into the country (especially investment by Brazilian flight capital).[26] They have amassed enormous political influence, and they can determine (and, potentially, destabilise) state policy and social welfare, as was demonstrated in the politically induced exchange-rate crisis in 2002 (see Section II).

IV. 'Left neoliberal' economic policy

Although the PT presents itself as a left-wing party, Lula leads a centre-left administration supported by a centrist coalition in Congress and answerable to a conservative judiciary, and his government has been implementing a neoliberal programme normally associated with the political Right. The fractured – one might even say schizophrenic – nature of the Lula administration is due to the political alliances underpinning his election (explained in Section I), the policy choices made at the highest level of government (described in Section II) and the constraints imposed by the neoliberal reforms (outlined in Section III). These political and economic constraints have obliterated the social-democratic aspirations of the PT, destroyed the party's *élan* and impaired its unity. They have also created severe difficulties for the PT's supporting mass organisations, especially the largest federation of trade unions in Brazil (Central Única dos Trabalhadores, CUT) and, to a lesser extent, the landless peasants movement (Movimento dos Trabalhadores Rurais Sem Terra, MST). Many members are finding it difficult to accept that their urgent needs and long-term aspirations

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[25] The only exception is the foreign-exchange hedge contracts, in which the state-owned banks play a key role.

[26] The significance of investment by Brazilian flight capital can be gauged by the share of FDI originating in Caribbean tax havens, which increased from 20.2 per cent in 2000 to 29.5 per cent in 2003 (see *Notas à Imprensa do Banco Central do Brasil – Setor Externo*, June 2001, June 2002 and March 2003). There is no similar data for portfolio investment, but it is generally assumed that the participation of Brazilian capital is even larger.

should be contained in the name of political and economic 'stability', precisely when – they think – the PT and its allied organisations are finally in a position to implement their historical programme.

This section reviews the economic policies of the new administration in 2003–4, and their outcomes. It will be shown that, while most financial and balance of payments indicators have improved, the production, income and employment data deteriorated in 2003. Their recovery in 2004 is likely to be limited, and the prospects for the near future are not especially good.

The first significant economic policy decision of the Lula administration was to increase unilaterally the primary fiscal surplus target agreed with the IMF from 3.75 per cent of GDP to 4.25 per cent. The surplus actually achieved in 2003 was 4.32 per cent of GDP, leading to complaints that the government 'must learn to spend money'. Subsequently, the government increased the surplus target further, to 4.5 per cent in 2004. These initiatives served two purposes. On the one hand, they signalled the government's firm commitment to neoliberalism. On the other hand, they reduce the pressure for politically damaging interest-rate increases in order to contain inflation, especially the bubble induced by the 2002 currency crisis. In spite of Finance Minister Antonio Palocci's supportive fiscal policy, Central Bank chairman Henrique Meirelles raised base rates from 25.0 to 26.5 per cent in the first three months of the new administration,[27] and only reduced them after inflation had been subdued (see below).

In addition to its unambiguously neoliberal macro-economic management, the new administration has implemented four important policy initiatives. First, it rammed through Congress a wide-ranging reform of public-sector pensions that had eluded F.H. Cardoso for a whole decade. The government's bill was virtually undistinguishable from the one that the PT had previously defeated, but this time it passed by a large majority. The bill faced opposition from three sources: civil-service trade unions controlled by PT activists, that called a long but fruitless strike against the reform; a small number of PT deputies and senators, that refused to support a bill that they had previously defeated (and were punished for echoing their party's criticisms of Cardoso's bill); and Cardoso supporters seeking to embarrass the government by rejecting

[27] Meirelles is a former president of the US-based BankBoston, and had been elected Federal Deputy by F.H. Cardoso's party, PSDB. He is rumoured to have been number seven in a list of financiers approached by the PT to take over the Central Bank. The others had rejected the offer.

a bill that was very similar to the one that *they* had failed to approve under the previous administration. These political gyrations created confusion, demoralised the PT and its left-wing activists and offered an excellent opportunity for political cartoonists to exercise their skills.

Second, the new administration approved in Congress a neoliberal tax reform, also inspired by one of Cardoso's initiatives. The reform preserved the high taxation required to service the public-sector debt (Brazilian taxes are equivalent to 36 per cent of GDP, which is unusually high for a middle-income country), but with higher indirect taxes and rebates for financial transactions. The reform also reduced the fiscal autonomy of the municipal and state governments, allegedly in order to quell the expensive 'tax wars' between them.[28]

Third, the government approved a constitutional amendment separating the regulation of the Central Bank from the regulation of the financial system as a whole. This may seem to be arcane but, in fact, it has simplified enormously the legal process of granting independence to the Central Bank.[29]

Fourth, the administration has proposed a reform of labour law that aims to offset, at least in part, the high tax rates required by the public debt service. Under the guise of promoting free association and free negotiations between the workers and their employers, the reform bill will curtail existing rights and undermine the financial position of many trade unions. The government is probably also hoping that this will put pressure on the right-wing labour confederations and facilitate the encroachment of unions linked to the PT into these fiefdoms.[30]

The government's contractionary macro-economic policies were costly. Persistently high interest rates choked inflation (annual inflation rates peaked at 17.2 per cent in May 2003, fell to 5.1 per cent in May 2004, and tended to rise slightly subsequently).[31] Even though the base rates declined to 16 per

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[28] This is only part of the truth: the federal government also wanted to reduce the policy autonomy of the subnational levels of the public administration.

[29] In mid-2004, in response to a corruption scandal touching on the president of the Central Bank, Lula upgraded this post to Minister of State – thus awarding Meirelles immunity from prosecution. This was not only in order to reward a new friend, but also to protect the government from politically-motivated police investigations that threatened to undermine the administration and destabilise the economy. Conveniently, this measure has also removed another potential difficulty in the road to Central Bank independence.

[30] The relationship between the trade-union bureaucracy and the PT is perceptively examined by Oliveira 2003.

[31] Inflation rates measured by IPCA, see *Conjuntura Econômica*.

cent in April 2004 (rising again to 16.25 per cent per cent in September), real interest rates continued to hover around 10 per cent – among the highest rates in the world.[32] Manufacturing output fell one per cent in 2003, and GDP declined 0.2 per cent during the year – the first economic contraction in eleven years. The recession was tempered only by the strong expansion of agriculture, which grew 5 per cent.

The income and employment results in 2003 were also disappointing.[33] Open unemployment in the six largest metropolitan areas in the country[34] increased from 11.7 per cent of the labour force, in December 2002, to an all-time high of 12.3 per cent one year later. In the São Paulo metropolitan area, total unemployment (including open and hidden unemployment and the discouraged workers) reached 20 per cent. Labour income in the six metropolitan areas (including the earnings of the wage workers, underemployed and informal sector workers) declined 9.9 per cent in 2003 (–18.4 per cent since 2001), while wage income fell 5.1 per cent (–13.7 per cent since 2001).[35] The deterioration of the workers' earnings while the financial and export sectors reported rising profits probably implies that the concentration of income has increased in the first year of the PT administration.

In 2004, the economy performed more strongly (see below). Incomes increased and many jobs were created, but the unemployment rate initially *rose* marginally – probably because of the return of many discouraged workers to the labour market – but it later declined to 11.2 per cent, in July. The main sources of growth, predicted to reach 4.0–4.5 per cent in December, were exports (especially agribusiness) and the mild recovery of the domestic market, fuelled by the export sector and the good performance of manufacturing. Strong improvements in the formal labour market contributed to an increase in average worker income, which has finally returned to the level of late 2002.

The balance of payments and the financial indicators improved steadily, for four reasons. First, the partial recovery of the world economy from the collapse of the dot.com bubble increased the availability of capital in the

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32 The real interest rates are the base rates minus the financial markets' inflation expectations (see BCB 2004).

33 Data source: Instituto Brasileiro de Geografia e Estatística, <www.sidra.ibge.gov.br>.

34 São Paulo, Rio de Janeiro, Belo Horizonte, Porto Alegre, Salvador and Fortaleza.

35 Some groups of unionised skilled workers were able to bypass this declining trend of wages. For example, the heavily-unionised metal and bank workers were able to negotiate real wage increases in 2003. Their success owes nothing to the federal government; it was entirely due to the strength of these categories of workers.

international financial markets, helping to relieve the Brazilian balance-of-payments constraint. Second, the new administration has established its 'credibility' with domestic and international finance that, at least, helped to avoid further turbulence. Third, inflation declined, as was explained above. Finally, the cumulative devaluation of the Brazilian *real*, from R$1.16 per dollar in January 1999 to a peak of R$3.80 in October 2002, helped to boost the country's trade performance. Exports increased 50 per cent between 1999 and 2003, to US$73 billion, while imports have remained stable around US$50 billion. In 2001, Brazil had its first trade surplus in seven years and, in 2003, the first current account surplus in eleven years. The inflows of portfolio capital increased strongly, from *minus* US$4.7 billion in 2002 to *plus* US$5.1 billion in 2003 (however, the foreign direct investment inflows have declined steadily, from a peak of US$32.8 billion in 2000 to only US$10.1 billion in 2003). These improvements of the balance of payments supported a limited recovery of the foreign currency reserves (up US$8.7 billion since the 2002 crisis to US$25.0 billion in mid-2004), and contributed to the decline of the domestic real interest rates (see above). The Bovespa index of the São Paulo stock exchange reacted strongly to these good news, gaining 127 per cent in 2003 (but remaining stable in 2004), and J.P. Morgan's EMBI+ Brazilian risk index declined from over 2000 to only 480 points during 2003, but later rose to 600 points).

The steady hand of the Brazilian authorities may not have been the most important reason for these performance improvements. In 2003, the financial indicators performed strongly even in countries whose policies are presumably undeserving of 'credibility', such as Venezuela (the Caracas stock exchange rose by 135 per cent).[36] Moreover, permanently high interest rates, steady capital inflows and the Central Bank's relative neglect of the exchange rate contributed to the appreciation (and subsequent stabilisation) of the *real* around R$2.90 per dollar since late 2003.[37] The revaluation of the *real* has contributed not only to inflation control (as would be expected) but also to the improvement of the public-sector accounts, because it has reduced the demand for public securities indexed to the dollar.[38] In spite of this, and the

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[36] Calvo et al. 1993 argue that capital flows to Latin America are determined primarily by the level of US interest rates, rather than the domestic policies in the recipient countries.

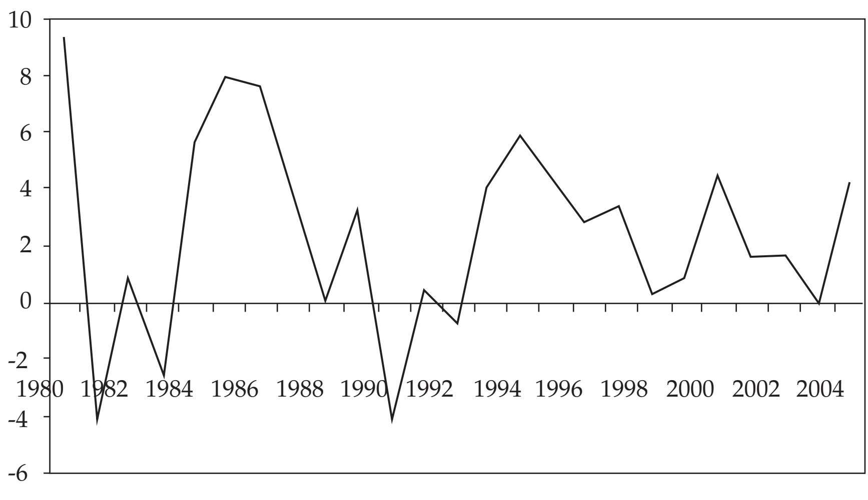
[37] This is not only a Brazilian phenomenon; the currencies of other troubled middle-income countries, such as Argentina, Turkey and Venezuela, also appreciated in 2003.

[38] However, the revaluation may make it difficult to achieve further improvements in the trade and current accounts in the medium term.

record primary fiscal surplus achieved in 2003, high interest rates and the growing stock of the public debt (rising from 48.8 per cent of GDP in 2000 to 55.5 per cent in 2002 and 58.2 per cent in 2003) led interest payments on the domestic debt to reach and all-time high of 9.5 per cent of GDP in 2003.

The growth spurt in 2004 has been presented as the 'proof' that the neoliberal strategy of the PT administration was fundamentally sound. After the sacrifices of 2003, and with the 'recovery' of the fundamentals (inflation and exchange-rate stabilisation, confidence in the government, export growth, and so on), the economy is allegedly poised for a recovery of investment and a long period of growth. Maybe. But another interpretation is possible. The Brazilian economy may have simply rebounded from the recession of 2003, under relatively favourable domestic and external circumstances. There is no evidence that this is the beginning of a cycle of prosperity. The Brazilian economy has had a disappointing performance for over twenty years, with occasional growth spurts (see Figure I), which were not sustained either because of external constraints (as in 1986, 1996 and 2000) or because of domestic instability (as in 2002). In the meantime, the economic recovery has helped the PT in the 2004 municipal elections (see below).

Figure I: Brazil – GDP growth rates, 1980–2004 (%)



Source: IBGE (GDP growth in 2004 estimated at 4.25 per cent)

V. Policy schizophrenia

For all its weaknesses, self-doubt and vulnerabilities – and perhaps *because* of them – the current administration seems to be able to impose neoliberal policies more consistently and successfully than any other government, however right-wing or ideologically committed to neoliberal interests. It seems that Brazilian neoliberalism has achieved the perfect coup: after the corrupt maverick (Fernando Collor) and the aristocratic ex-Marxist sociologist (F.H. Cardoso), it is now the former trade-union leader's turn to impose the policies favoured by the financial interests and the new élite consensus. There *really* seems to be no alternative to neoliberalism.

The schizophrenic character of Lula's administration allows it to systematically wrong-foot the opposition from the Left as well as the Right. The government has shown that it can incorporate virtually *any* policy initiative of the right-wing opposition, including fiscal orthodoxy, privatisation, the concession of privileges for finance or the rich and neoliberal reform of pensions, labour law, the financial system and social security. At the same time, the administration has also been able to occupy the political space of the Left, through its popular appeal, the capture or paralysis of the most important social movements in the country (including, in particular, CUT and, to a lesser extent, the MST),[39] and through the government's activist foreign policy.

The administration's much-publicised foreign-policy successes were predicated on its spotless track record in the domestic sphere. In their negotiations at the WTO, UNCTAD, MERCOSUR and FTAA, Brazilian diplomats have been instructed to defend the interests of the country's main exporters (including, obviously, both domestic and foreign capitalists), rather than simply bowing to demands that the country should accept the trade barriers currently imposed by the US and the EU.[40] The Brazilian negotiators have only been able to stand their ground because the government's adherence to neoliberalism at home has minimised the ability of the US and the EU to object to Brazil's foreign-policy stance. In addition to these commercial-policy

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[39] Brazilian social movements, largely under PT control, managed to frustrate many neoliberal reform initiatives since the mid-1980s. Lula's election and his determination to follow neoliberal policies have thrown these movements into confusion. In the words of Oliveira 2004, p. 7, the PT government has 'anesthesised the popular demands, and effectively kidnapped Brazilian civil society'.

[40] Gentili 2004 reviews the Brazilian strategy of confrontation followed by negotiations at the WTO and the FTAA.

clashes with the world's most powerful economies, Brazil has been garnering support for the holy grail of its diplomacy in the postwar era, a permanent seat in the UN Security Council. The country has also been pursuing South-South commercial deals with South Africa, India, China and other 'non-traditional' partners, as part of Brazil's export drive and, simultaneously, to enhance its international standing. So far, these initiatives have achieved only limited success (except in the case of China), but they offer a vast strategic potential for Brazilian capital and for foreign firms based in Brazil. Lula has embraced these foreign-policy initiatives wholeheartedly. In addition to promoting Brazil's narrow commercial interests, Lula has been seeking to take over Nelson Mandela's mantle, partly in order to enhance the profile of Brazil's aspirations and partly to offset his meagre achievements at home with high-profile triumphs abroad.[41]

The tensions between Brazilian foreign and domestic policy are part of the schizophrenic nature of the current administration. They have, in common, the prominent role played by the President, and his undeniable charm. These tensions also imply that the Lula administration is fully committed to the 'market mechanisms' advocated by the neoliberal orthodoxy, both at home and abroad. The government's strategic option includes the attempt to gain 'credibility' by respecting the existing rules and contracts and reducing Brazil's external vulnerability through structurally high trade surpluses. This strategy avoids the difficult problems of confronting the US and the ruling international system on the domestic arena, and it opens the possibility of increasing Brazil's international influence and expanding its foreign markets. This interpretation of the foreign-policy orientation of the Lula administration bypasses the misguided opposition between the claim that nothing has changed with Lula and the opposing claim that Lula's foreign policy is inspired by genuinely leftist principles. In reality, Brazil's foreign policy is part of the overall strategy of the PT leadership that has avoided politically damaging confrontations with neoliberalism and the US government both at home and abroad, while seeking to expand the spaces available to improve the outcomes of the government's neoliberal policies.

At home, the PT has been attempting to stabilise its position by claiming to its disaffected left-wing supporters that it is the lesser evil and, therefore,

41 These demands and opportunities explain Brazil's ready acceptance of a leading role in the UN military mission in Haiti, in spite of the bitter experience of the Brazilian contribution to the US-led occupation of the Dominican Republic in 1965.

that it must receive their support regardless of its actual record in office. After all, the PT is firmly established throughout the country, electorally viable, organically connected to social movements, and sensitive to the plight of the poor in a way that no right-wing party could claim to be. Moreover, the President himself regularly rants against unemployment and touchingly deplores the poverty of many Brazilians which once afflicted his own family. No left-wing political party can hope to beat the PT at this game.[42]

Under favourable economic circumstances, the PT's image as both government *and* opposition can confound the Left, deprive the Right of a credible platform and ensure a comfortable majority coalition in Congress, as well as Lula's re-election in 2006. However, this strategy could also backfire. For example, if the economy performs poorly during the next two years, if the government is racked by scandals or if Lula's credibility wanes because he is unable to deliver the changes expected by most of his supporters, the administration could become paralysed by its internal contradictions. The 'loser's alliance' would unravel and the PT could suffer a crushing defeat in the next presidential elections.

Securing support for the administration could also become difficult if the living standards of the 'losers' decline further – especially the formal and informal workers (many lower-ranking civil servants may have already been lost since they have been heavily penalised by the government's pensions reform and its unwillingness to offer them significant improvements in pay and conditions).[43] In spite of Brazil's improving economic performance, especially in the export sector, the manufacturing élite has also been disappointed by the administration's failure to live up to its commitments to support domestic industry. The government has produced an inane industrial policy review, including few clear priorities, no performance monitoring instruments and insufficient funding. High interest rates continue to hinder private investment, and the stringent fiscal targets limit the scope for public investment, which is essential to relieve the severe infrastructure constraints in Brazil, especially in the areas of transport and electricity generation. Although the state development bank, BNDES, has extended additional loans to Brazilian

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[42] For parallel examples in different contexts, see Cockburn's (2004) critique of the automatic support of the Left for the Democratic Party in the United States and Watkins's (2004) rejection of the appeal of 'New Labour' to the Left in the United Kingdom.

[43] The wages of most civil servants have been virtually frozen since 1994 (exceptions include the military, the Inland Revenue and the Treasury Department).

firms, the Ministry of Finance has challenged this 'discrimination' against foreign companies. The government's most significant industrial-policy initiative is the domestic production of two deep-water oil platforms for the state oil company, Petrobras, and the renewal of the company's tanker fleet. This will help to revitalise the construction, metal and shipbuilding industries, especially in the politically important state of Rio de Janeiro.

The conflicting expectations of the groups in the losers' alliance, as well as opposition pressure and the schizophrenic character of Lula's administration have created a state of permanent fluidity and political tension in Brazil. These conflicts boiled over, for the first time, in the so-called 'Waldomirogate' scandal in early 2004, and again when Central Bank chairman Meirelles was accused of tax evasion in the middle of the year.[44]

These simmering tensions can also be explained in another way. Lula's election and the neoliberal about-turn of the PT have shown how difficult it is to 'vote away' neoliberalism or, more generally, how difficult it is to shift economic policy by constitutional means. The disconnection between political and economic democracy, expressed by the inability of the majority to influence economic policy to any significant degree, is the most important challenge to the Brazilian constitutional order since the restoration of democracy in the mid-1980s.

The 2004 local elections

Brazilian mayors and local councillors are elected every four years, half-way through the mandate of the President, federal deputies and senators, state governors and state representatives. The outcome of these elections helps to assess the political strength of the federal and local governments and it signals, albeit imprecisely, the prospects of the various contenders for the next electoral cycle.[45] The 2004 elections took place on 3 October in Brazil's

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[44] The Meirelles scandal was outlined above. Waldomiro Diniz, a high-ranking advisor of Lula's Chief of Staff, José Dirceu, has admitted taking bribes and channelling funds from gambling mobs to PT candidates. Although this is a relatively minor scandal by Brazilian standards, press hostility, public dejection (the 'incorruptible' image of the PT was shattered), and the government's ineptitude handling the scandal turned 'Waldomirogate' into a defining moment for the administration. José Dirceu has not been accused of any wrongdoing; however, he is the leader of the government's 'left wing'. The damage to his reputation has increased the influence of the 'right wing' Ministry of Finance (*even though* Diniz used to advise Finance Minister Palocci before the election!).

[45] Historically, there is only a weak correlation between local and national election

5,600 municipalities. There was also a second-round mayoral election on 31 October in 44 municipalities with more than 200,000 registered voters, where the first-round winner failed to obtain 50 per cent of the valid votes.

The first round results were presented by the PT as a vindication for the Lula administration, since the Party received 17.2 million votes (18.1 per cent) and, for the first time, the largest share of the national mayoral vote (up from fourth place in 2000). However, this triumphalist view is superficial, and it hides the most important aspects of the picture.

The PT elected 400 mayors in the first round, well short of its target of 800, and its performance in the larger cities was mostly disappointing – in other words, the PT grew in small towns that are politically less influential and that will play only a minor role in deciding the outcome of the 2006 presidential elections.

The second round of the local elections was especially unfavourable for the PT. The PT participated in 21 run-offs, but it lost most of them. The most important defeats of the PT were, first, in São Paulo, the largest city in Brazil, and where Lula campaigned so intensely that he was fined by the Electoral Court and, second, in Porto Alegre, the base of the World Social Forum and a city administered by the PT for sixteen years. In both cities, the incumbent PT mayors lost badly. The PT won only in one large city, Fortaleza, but the new mayor is a left-wing dissident who ran against the wishes of the Party leadership and criticised the federal administration heavily during her campaign. The PT won only in three other important cities (Nova Iguaçu, Niterói and Vitória), and it lost heavily throughout São Paulo state, the richest and most populous state in Brazil and the cradle of the party. Although PT allies obtained localised victories, the outcome of the second round was clearly unfavourable to the PT and the Lula administration. The Party has spread itself thinly, and lost its most important strongholds. This bodes ill for Lula's re-election bid in 2006 because the Party will lack strong and prestigious local administrations supporting its national campaign.[46]

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results, because of the different determinants of voters' choices – local interests in the former, and broader political concerns, in the latter.

[46] This does not, of course, imply that Lula is bound to lose the 2006 elections. The incumbent president is naturally the favourite, and Lula's charisma has not dissipated yet. Moreover, the right-wing opposition lacks any credible presidential candidate, and it continues to suffer from political fragmentation and infighting. The Left will probably not play a significant role in these elections, although the campaign may contribute to the organisation of left-wing political movements.

Finally, the PT Left performed poorly, in spite of its remarkable victory in Fortaleza. This is, in part, because of its reluctance to criticise the federal government and, in part, because the PT leadership refused on principle to support all left-wing candidates and starved them of resources. It is also noticeable that the 'professional' political campaigns currently favoured by the PT have failed to enthuse the Party activists, weakening significantly the capacity of the PT to mobilise support among the working class. This may also become a source of problems for Lula in 2006.

VI. Conclusion

Brazil's economic performance in 2003–4 was mixed. Employment and incomes fell and the domestic public debt increased, but the financial and balance of payments indicators improved (nevertheless, they remain highly vulnerable to adverse developments in the US, Europe and Japan, and to 'market sentiment' at home). Even under the best possible circumstances, the prospects for Brazil's long-term development remain poor. The country's infrastructure bears the weight of two decades of underinvestment. The privatisation, denationalisation and deregulation of infrastructure provision and of several basic industries, including telecommunications, rail and air transport, the petrochemical and steel industries, mining (except Petrobras), finance (except Banco do Brasil, Caixa Econômica Federal and BNDES) and large chunks of the electricity supply, water, sanitation and road networks, limit the capacity of the state to lead a process of rapid and co-ordinated economic recovery. Moreover, the state's industrial policy institutions have been largely disabled, and the federal government is financially exhausted due to the costs of the domestic debt, widespread resistance against further tax increases and the creeping informalisation of the economy. The openness of the capital account has made the balance of payments structurally vulnerable, and the prospects for the exchange rate are also uncertain.

Neoliberalism has also transformed the Brazilian industrial base substantially. Brazilian capital is much more closely integrated with foreign capital than at any time since 1930, and the manufacturing sector has been disarticulated and largely integrated into competing transnational value chains (even where they serve primarily the domestic market). Finally, the institutional and policy changes imposed by neoliberalism have transferred control of the most important levers of accumulation to a relatively small number of financial institutions. They command most private-sector loans, own the vast majority of the public securities, control large amounts of foreign currency and mediate the flows of foreign investment into the country. They have amassed enormous political influence and can destabilise state policy and social welfare, as was shown in mid-2002.

Balance of payments fragility and the fiscal crisis of the state are the most important constraints to growth in Brazil, but they cannot be addressed adequately through the neoliberal strategy adopted by the Lula administration. In spite of this, abandoning neoliberalism for an alternative (democratic) economic strategy, including controls on international capital movements, limitations on the foreign and domestic public debt service and an aggressive policy of employment generation, income distribution and integration of the manufacturing base, would not be cheap, simple or rapid.[47] Powerful economic interests would flatly reject this policy shift, and the strategy may founder because of administrative shortcomings or obstruction in Congress or in the courts, or it may be spurned by the voters because of short-term macro-economic instability or media pressure. The domestic constraints to an economic policy shift will weaken significantly only if there is a significant deterioration of the international economy. If the grip of the international financial markets on the periphery weakens, or if the Brazilian economy collapses because of a balance of payments crisis, capital controls may become inevitable, and mass pressure could more easily force the redistribution of income and wealth (especially land) as part of a new development strategy centred on the domestic market.

In the worst possible ('Argentinian') scenario, this policy shift would be imposed upon a reluctant government by a severe economic crisis, after increasingly frantic attempts to 'make neoliberalism work'. This may yet come to pass. In the meantime, the government's faltering popularity has reduced its margin for manoeuvre and exhausted the 'losers' tolerance with the PT's amateurish handling of the state. The decline of government capacity to accommodate conflicting demands within the losers' alliance increases the likelihood of a complex political re-alignment taking place in the near future, potentially affecting the administration's parliamentary base and its sources of mass support.

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[47] Alternative economic strategies for Brazil are reviewed in the special issue of *Análise Econômica* 2003 and by Sicsú, Oreiro and Paula 2003.

In this sense, the outcome of the 2004 elections is worrying for the administration. The growth of the PT and its allied parties in the small and middle-sized cities was largely due to the advantages of power at the federal level, which is not unexpected in Brazil. This has nothing to do with the rise of an autonomous working-class movement in the political sphere, or even with the spread of 'citizenship', which is allegedly one of the PT's key political objectives. The PT lost especially heavily in the large cities, both in terms of the number of its elected mayors and councillors and in terms of the alarming loss of the vote of the middle class. In São Paulo, the loss of this important social group was not compensated by the spread of PT votes among the poor periphery of the city. The loss of support for the PT among the middle class may indicate that the Party will have difficulties replicating the 'losers' alliance' in 2006. It may also be symptomatic of the loss of a social group that has been enormously influential in shaping the political ideology of the PT and that plays a key role in the connection between the working-class poor, the social movements and their political expression within the state.

While the PT struggles to stabilise its sources of support and the administration attempts to make neoliberalism deliver according to its promises, the Brazilian Left has very different concerns: building the foundations of a new political movement that will offer concrete and realistic alternatives for the expansion of economic and political democracy in the country. This will take many years. Neoliberalism has eroded the social, economic and political roots of the working class and demolished its traditional forms of political expression and organisation. It is not yet possible to anticipate the precise form of this new left movement or estimate its potential success, but its construction will be the most exciting political project in Brazil for a generation.

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