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Political Choice And Economic Crisis In Brazil: A Case Of Mismanagement Of Public Money

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Political Choice And Economic Crisis In Brazil: A Case Of Mismanagement Of Public Money

Presented to the Division of Economics
The City College of New York
The City University of New York

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of the Requirements for the Degree of
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Abstract

A few years ago, Brazil was the country where everybody would like to invest. Because it was one of the members of the BRIC, group of emergent countries with fast-growing economies including also Russia, India and China that gave the investors warranties that those investments would be successful.

The current situation is very different from the one pictured not too long ago. High interest rates, high inflation, undervalued currency, and international political scandals describe the very serious economic crisis the country has been facing recently, making the economic growth forecast decrease. In 2013, the variation of Gross Domestic Product (GDP) calculated for 2016 was 3.35 percent; the adjusted variation calculated 2 years later was reduced to 1.13 percent and the rate we are expecting right now is a lot lower than that since the country faces a recession.

This is an argumentative research paper in which I intend to prove that some government practices culminated in a misuse of public money and the biggest consequence was an economic crisis.

Keywords: Brazil; economy; politics; crisis; corruption.
Acknowledgements

I would like to thank God firstly, for giving me the gift of life, without which I would have no access to the things I have today; without Him I would be nothing.

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Political Choice and Economic Crisis in Brazil: a Case of Mismanagement of Public Money

“By the end of the first decade of the twenty-first century, Brazil had become one of the world’s major emerging countries” (Baer, 2014). From European colony to strong emergent economy and then to deep recession, Brazil had experienced all sources of economic scenarios in its 516 years of history. Even though the economic crisis from 2008 hit many countries, some harder than the others, seven years later the world is pretty much recovered. This situation can’t be applied to Brazil, which faced a severe recession in 2015 and forecasts say its economic health will only be restored after 2016. The government stated it was facing the consequences of the crisis, but there are many other reasons for that. Government’s bad political decisions and corruption scandals play an important role in explaining the country’s recent decline.

This paper is important for the Economics field because it approaches a recent matter that is on international news very often. Many research papers have been published since the economic crisis in Brazil started and yet, no one could forecast an accurate end to it. This paper’s goal is to prove that the biggest share of blame for this economic chaos belongs to the government, which took wrong decisions, sank in corruption, and ended up by ruing an economy that had everything to take off.

This paper is organized as follows. The Literature Review in the next section explains all the topics that will be discussed here. The second section describes the Methodology of this research, how the data were gathered and prepared and how it was examined. The following section is called Analysis and, besides presenting some new information, it also contains the examination of the data I worked with. The last section is the Conclusion, where I presented the results of this project.
Literature Review

Brazilian Economy

Brazil initially developed its economy in the 1500s, when the country used to be a Portugal’s colony. During the colonial period, Brazil was an export-oriented economy that focused its activities in different sectors at a time: sugar, precious metals (especially gold), coffee, and rubber (Baer, 2014).

Most of the infrastructure used to transport coffee to the ports was applied in the country’s early industrial growth, a period that lasted from the 1880s until just before World War I; the war years were negative in expanding the industrial sector in Brazil. The economy in the 1920s however had a very different direction as the industry had more diversification due to three factors: repair shops were reinvesting their profits to increase production capacity, foreign capital was supporting new sectors, and the government was giving special assistance to promote development.

The years following the Great Depression had dramatic consequences to Brazil as its exports were severely affected and the country had to suspend some part of the foreign debt payment and had to start a negotiation agreement. Along with that, a devaluation of the domestic currency decreased the value of imports too, and the government acted to preserve its main sector, the coffee production. As Baer (2014) says, the “growth of industrial output in the first half of the 1930s was based on a fuller utilization of existing capacity”; capacity expansion only really happened in the second half of this decade. The World War II, just like other periods of global economic downturn, such as WWI and the Great Depression, represented another period of increased output solely, not accompanied by a rise in expansion of productive capacity.

In the post-war years, the Brazilian government realized that industrialization wasn’t only a defense strategy against external events, but should be the way to modernize and increase
the growth rate of the economy. In the late 1940s, the largest share of Brazilian GDP belonged to the agriculture and the majority of the economically active population was employed in that sector. However, the country had lost its share in the world exports and the only solution to the Brazilian economy was to promote an import-substitution industrialization that took place in the 1950s. In order to finance that, a foreign exchange policy was established, along with the promotion of the Law of Similars, granting protection against foreign products to local producers that were developing domestic products with “sufficient quality and quantity”.

Brazil kept moving forward and developed some attempts at planning. The SALTE Plan was a five-year public expenditure program that intended to invest at health, food, transportation, and energy sectors from 1950 to 1954, but failed due to basically financing difficulties. The Joint Brazil-United States Economic Commission was a more ambitious plan intended to invest and develop several sectors, including infrastructure at its majority, but it also presented recommendations about the agricultural sector, technical training, diversification of exports, social inequalities, and monetary stability (Baer, 2014). Even though that plan wasn’t adopted, it led to the establishment of the National Bank of Economic Development (BNDE), which supports the development of infrastructure and industrial projects. Another big attempt of planning occurred under President Juscelino Kubitschek’s government and was called Programa de Metas (Program of Targets). This was also a non-global development plan that would last for five years and would cover the energy, transportation, food supply, basic industry, and education sectors.

In the beginning of the 1960s, the Brazilian economy had lost its dynamism and the military regime that was in control of the government agreed that they should control inflation, eliminate price distortions, modernize capital markets, create incentives to investments, attract foreign capital, and expand public investment. The solution was to tighten government expenditure and increase taxes, which resulted in the decline of the government deficit to 0.3 percent of the GDP by 1971 and the achievement of a stable inflation. Besides that, the military
government brought other positive contributions to economy. A capital market law strengthened and increased the use of the stock market, the government gave tax incentives to allocate resources in less developed areas of the country, the share of agriculture in the GDP decrease while the industry and services were almost evenly distributed, and policies opened the economy to foreign trade. The period from 1969 to 1973, where the economy had extremely rapid development with increasing employment rate, is called Milagre Econômico (Economic Miracle) (Brasil Escola, 2015). On the other hand, an equity issue was raised due to the income concentration, when 20 percent of the population was receiving 63 percent of the country’s income (Baer, 2014).

Another shock happened when in 1973 the Organization of Petroleum Exporting Countries (OPEC) quadrupled the price of the oil, leading to a contraction of the world economy. This was a major issue because Brazil imported 80 percent of its consumption, and that brought the country’s deficit to an almost sevenfold increase. Due to that, Brazil could have chosen to decrease its growth rate to avoid an even bigger debt or to continue with its high growth rates. As the country was facing the international criticism regarding its political repression and worsening income distribution, President Geisel opted for continued high growth rates. He then introduced another economic growth plan, called the Second National Development Plan (PNDII), which was a huge investment program that aimed the import substitution of basic industrial products and capital goods and the rapid expansion of the economic infrastructure. The purpose of this program was to try to fight against the consequences of the oil crisis by maintaining a reasonable rate of growth. The plan was successful, even though the GDP rate didn’t reach the level of the “miracle years” and it was all financed with foreign capital, which increased the international indebtedness.

By 1979, General João Figueiredo was the last military president and his goal was to restore Brazil to a democratic regime. However, he was facing a rising rate of inflation and a foreign debt whose service was taking up to two thirds of exports earning. Furthermore he had
to keep a growing GDP rate to avoid stagnation, as Brazil as facing a rise in world interest rate as the United States tightened its internal monetary policies and a second oil shock. Brazil decided to carry out its own austerity plan to control international trade, tighten credit, and reduce subsidies. The plan, though, did not solve those problems and left Brazil confronting a totally inelastic supply of international bank loans. Finally, Brazil had to turn to the International Monetary Fund (IMF) in 1982 to comply with an austerity program that would last from 1983 to 1984 and required the country to raise the real exchange rate, reduce the domestic demand, and increase tax rates.

By 1986, inflation reached a yearly rate of 300 percent. In order to address that issue, a decree established new policies, including a general freeze on final goods prices, a wage freeze followed by a planned readjustment, and, especially, the creation of a new currency, the cruzado, which would substitute the old cruzeiro (Cz$1 being equal to Cr$1,000). Those policies were supported by others that aimed to centralize control over all public expenditures and to increase tax rates on financial transactions. The Cruzado Plan had immediate success: the inflation rate declined, the economic activity accelerated, industrial production was higher, consumer durable production was also higher, and external accounts were producing strong surpluses. The Cruzado Plan was mostly based in consumer spending through substantial real wage increases, elimination of indexation from savings deposits, the price attractiveness of many goods that had their price level froze at low standards, and the “wealth effect” that resulted from the sudden change of inflationary expectations (Baer, 2014).

The plan, however, faced a real crisis through external accounts, since its capital account of the Balance of Payments was decreasing. The government didn’t want to consider any price alignment because the price freeze symbolized the success of the plan and the wages were allowed to rise automatically every time accumulated inflation reached 20 percent. Therefore a price increase would generate a “trigger” mechanism. Some attempts at stabilization were created in the following years. In 1987, the Bresser Plan froze prices and
wages for 90 days and allowed periodic readjustments and aimed to reduce the country’s deficit and to keep interest rates above the rate of inflation. Its basic problem was controlling budget deficits since government spending grew for several reasons. In 1989, the Plano Verão (Summer Plan) established a new price and wage freeze, the abolition of indexing, an attempt to restrain monetary and credit expansion, and the introduction of a new currency, the cruzado novo (NC$1 being equal to Cz$1,000). However, the low credibility of these policies and the negative expectation of economic agents led to the failure of this plan.

In 1988 a new Constitution was instituted and it had a serious negative fiscal impact: it established that the federal government should transfer 21.5 percent of income tax and manufactured goods tax to states and municipalities, which worsened the structural disequilibrium of federal budget. Fernando Collor de Mello took the presidency office in 1990 and introduced what was called Collor Plan. Among the measures in the plan, the most important were the elimination of various types of fiscal incentives, initial price and wage freeze, closure of various federal government agencies, preliminary measures to institute a process of privatization, 80 percent of all deposits larger than Cr$50,000 should be frozen for 18 months generating a return of the prevailing rate of inflation plus 6 percent a year, and the introduction of a new currency, the cruzeiro (Cr$1.00 being equal to NC$1.00). Initially, inflation seemed to be under control but soon after it started to rise again and Collor II, a second attempt of stabilization plan, was put in practice.

Collor II planned to control the cash flow and the money supply, unfreeze prices, prepare for the release of blocked assets, and to continue with the privatization process. The plan showed some positive results by having public servants wages to increase less the rate of inflation, by showing a decline in public investments, and also a decline in service expenditures on domestic public debt. These fiscal efforts were counterbalanced by a monetary expansion, caused mainly by excess of liquidity due to the release of blocked assets, growth of money supply, and the lack of anti-inflationary measures, which ultimately generated an explosion of
inflationary expectations. President Collor suffered an impeachment and was substituted by his Vice President Itamar Franco, who lacked political and economic leadership and a stable and reliable economic team. In 1993, when he finally introduced his fourth finance minister, Fernando Henrique Cardoso, Brazil could ultimately hope for a successful approach to control inflation.

As soon as President Cardoso took office he presented an austerity plan called “immediate action plan” where he planned to cut government spending, tighter tax collection, and fight against tax evasion. By the end of his first year, he proposed a new plan where he would implement a fiscal adjustment and a new indexing system that would lead to a new currency. This new index was called Unit of Real Value (Unidade Real de Valor or URV) and the government encouraged official prices, contracts, and taxes to be denominated in URV. Gradually, many prices were already stated in URV but the transaction occurred in cruzeiros reais. Months later, the new currency Real (R$) was introduced, which was equivalent to one URV, or one US dollar, equal to Cr$2,750.

The Real could finally control inflation and economic instability (Banco Central do Brasil (BCB), 2015), and this was done by maintaining a high exchange rate. The initial impacts of the new currency were positive: besides the controlled inflation and stability, the cumulative price increase reached lower levels, the growth rate of the economy rose, the rate of investment increased, consumption rose, implying that real income of low-income population had also risen. Even though the price stability was a good victory, the lack of a substantive fiscal adjustment was still an issue and the fiscal situation of the government had worsened. Only with the intervention of the IMF, did Congress finally approve constitutional amendments necessary to achieve a fiscal adjustment; but the government also relied on the privatization process to deal with the fiscal problems. Between 1995 and 1998, annual receipts from privatization of public utilities, steel, petrochemicals and minerals sector rose from US$2 billion to US$35 billion (Baer, 2014).
The economy was doing very well at the beginning of the *Real* Plan. It started with a good growth performance in the first year, which started decreasing in the following years due to consequences of high interest rates and got worse with the crisis in 1998. On the other hand, capital formation, investment in technology, and labor productivity increased. Additionally, the stable economy was specifically beneficial to the lowest income groups as they were severely hit by hyperinflation. Their increased real income led to a consumption spurt.

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<th>YEARLY BRAZILIAN GDP GROWTH RATE FROM 1950-2006</th>
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<td>President Cardoso</td>
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<td>President Lula</td>
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*Source: Baer, 2014.*

**Table 1. Yearly Brazilian GDP growth rate from 1950-2006**

The presidential election of 2002 brought a big surprise to Brazil’s economy, since the elected president, Luiz Inácio Lula da Silva, had a huge concern regarding the major socioeconomic failures in the country and was explicitly devoted to address those issues in his mandate. His social development program had two main goals: tackle hunger, through a program called *Fome Zero* (Zero Hunger), and the minimum income guarantee, by giving assistance to children in poverty, giving students grants, and a minimum income and professional training to unemployed. All that generosity, however, caused fear among international investors that the current government would default on part of the national debt, that foreign investor agreements wouldn’t be maintained, and that fiscal responsibility would not
be sustained. In regard to that, for the initial years, the government was concerned to end foreign investors’ fears by maintaining a tight fiscal policy and its international responsibilities.

Under President Lula’s command, the economy was supported by spurt in consumption, which was financed by the expansion of credit. However, that boom in credit led to an increase in delinquency and consumer credit defaults had risen to 6.3 percent in 2010. Besides that, one of the main goals of the president, the inequality issue, was properly addressed and the economy felt a positive growth in the minimum wage and an increase in real salary. Nonetheless, one problem remained: the base of growth is human capital, which Brazil still lacks, according to its literacy, school attendance, school performance, and investment measures (Baer, 2014).

Even though Lula’s government had some corruption scandals, he was able to use his popularity to elect his successor, President Dilma Rouseff. She not only continued some of the previous president’s social and development programs like Bolsa Familia (income redistribution program) and PAC (Acceleration Growth Program, an infrastructure program), but also she expanded them and even created some more. Most of these actions took place in her first mandate, while she was organizing the country to hold the World Cup in 2014, but at the end of her first mandate and beginning of the second, a huge money laundering and corruption investigation started involving President Rouseff and ex-President Lula.

Politics in Brazil

Brazil became a Portuguese colony in 1530, exactly thirty years after its discovery date. Portugal decided to establish a General Government in an attempt to centralize the control of the colony, along with Municipal Chambers, to make policies for the cities and villages. At that time, the capital was Salvador, at the northeast of Brazil (História do Brasil Colônia - O Período Colonial, 2015).
In 1808, the Portuguese monarchy was transferred to Brazil to escape from Napoleonic wars. They received help from England and, in return, the Prince Regent D. João agreed to open Brazilian ports for commercialization. The Portuguese Royal Family arrived in Rio de Janeiro, establishing the city as the new capital. After 1821, when now King João VI of Portugal returned to Portugal, Brazil was governed by the Prince Regent Pedro I. Pressured by land owners, Pedro I declared the independence of Brazil from Portugal in 1822, inaugurating the Brazil Empire and declaring himself the emperor.

The first Constitution was established in 1824 by the new emperor, Emperor Pedro I of Brazil, and it implemented a centralized government, with a Senate and a House of Representatives, and 4 powers: Executive, Judiciary, Legislative, and Moderator – the last one only exercised by the emperor. However, in 1831, conflicts within Portugal made the emperor resign in favor of his son, Pedro II, still a child. While he reached maturity, the country was governed by three regents until 1840, when Pedro II was considered able to govern (Portal Brasil, 2009). From 1870, the Brazilian monarchy faced some crisis and started to ruin. In 1888 it was declared the abolition of slavery and in 1889, the emperor was overthrown and the First Republic was established.

A provisional government was introduced in order to approve the first republican constitution, approved in 1891. After 2 military presidents, the presidency started following a rule called Política do Café com Leite (Coffee and Milk Politics), where only candidates from the richest and most populous states (São Paulo and Minas Gerais) could run for the office. This politics kept going almost uninterruptedly until the revolution of 1930 bring Getúlio Vargas to the presidency to start the period called New Republic.

A temporary government was instituted until 1934 when a new Constitution was created. In 1935 there was an attempt of a communist revolution and, in 1937, the then President Vargas took over the power, closed down the Congress, and established a fascist dictatorship called New State, which was regulated by an authoritarian Constitution and lasted until 1945 when
Vargas was deposed by the military. He returned to power in 1951 after being elected by popular vote but his government had many conflicts and he committed suicide in 1954.

In 1956, Juscelino Kubitschek was the president in office and, with him, the country witnessed major infrastructure development, along with the establishment of the new capital, Brasilia. The next president, Jânio Quadros, resigned seven months after its inauguration, leaving the rest of his 3 years of government to his vice president, João Goulart. The more conservative citizens and the military disliked the idea of Goulart being in the power and in 1964, he suffered a coup d’état, when the military took over power and started a military dictatorship. Their main concern was national security and they changed and created many laws in order to change the Congress and control economy, finance, and politics. The first years of this regime were conservative as the government controlled society freedom of speech and all kind of liberty. During the last years, the military started to prepare to return the country to a democratic regime, pardoning some political prisoners and allowing them to return to Brazil.

In 1982, popular movements asked for new direct elections to consolidate the return of democracy; and in 1985, Brazil had a new indirect democratic election for president. As the elected president passed away in his inauguration eve, his Vice President José Sarney assumed the office. During his mandate, a new Constitution was created in 1988. In 1992, President Collor, elected in 1989, suffered an impeachment because he was indicted for corruption and his Vice President Itamar Franco assumed presidency (Só História, 2015).

In 1994, Fernando Henrique Cardoso (also known as FHC), former Minister of Finance from the previous government who had created the Real Plan and was responsible for finally controlling inflation in Brazil, was elected president, governing for 2 full mandates until 2002. During his administration, he promoted human rights and started addressing the inequality issue in Brazil. He was an internationally famous sociologist and built good relations with diplomats in many countries. He faced some problems, as dissidents in the party didn’t give him much support to approve all the reforms he planned for the country.
In 2003, Luís Inácio Lula da Silva (also known as Lula) took office, a president whose biggest concern was to solve the country socioeconomic issues. Nonetheless, instead of implementing the radical social changes he proposed, he only passed reforms in retirement, labor, and tax areas. His administration, however, was full of corruption scandals with many officials being charged of involvement in cases. Lula had also been charged by the Brazilian Attorney-General with the crime of omission; even though one of his party members declared he had warned the president about the financial schemes, Lula claimed he did not know anything.

According to Brazilian laws, a president cannot run for a third consecutive mandate, so in 2011, Lula prepared his successor, his former Chief of Staff of the Presidency Dilma Rousseff, to become the first female president of Brazil. She established some popular measures in her government to increase her popularity. However, in early 2015, her popularity began to decrease and by June her approval was as low as 9 percent. By the end of the year, popular pressure made the Speaker of the Lower House of the Congress start the impeachment process against President Dilma Rousseff.

**Financial Crisis of 2008**

The financial crisis of 2008 had its origin by 2006, when the subprime mortgage default rates started to increase, leading to a decline in the price of houses in the U.S. By late 2007, the prime mortgages default rates were also increasing (University of Mary Washington, 2009). When banks became allowed to trade mortgage-backed securities, the problem spread from the mortgages market to financial markets as a whole (Amadeo, 2015), because as the value of mortgages went down, so did the value of securities. These mortgages were sold to Freddie Mac and Fannie Mae, government-chartered institutions that buy up mortgages to provide mortgage lenders more liquidity (Havemann, 2013). Then, these mortgages were resold to investment banks, where investors bought mortgage-backed securities thinking they were insured by credit default swaps provided by the American International Group (AIG), the largest
insurance company in America. As the securities’ value went down, AIG couldn’t honor all swaps, and financial institutions realized they would have to absorb all the losses, spreading the panic. When banks cut back their loans, the rate at which they lend money to one another (LIBOR) increased (Amadeo, 2015).

This economic slowdown in early 2008 spread to investments in business equipment and consumption of durable goods. During the summer of 2008, the low consumption pushed down the GDP, making the economy decline at an annual rate more than 6 percent (University of Mary Washington, 2009). The devastating consequences in the financial system started with Countrywide Financial Corp., the largest American mortgage lender, which was then purchased by Bank of America. The Wall Street investment house Bear Stearns, which had a thick portfolio of mortgage-based securities, was the second institution to go down and it was rescued by JPMorgan Chase (Havemann, 2013). The U.S. Treasury Department (Treasury) was authorized to take over Freddie Mac and Fannie Mae to avoid a worst aftermath (Amadeo, 2015). Merrill Lynch and Lehman Brothers were the next investments banks to suffer the consequences. Merrill Lynch was lucky to be bought by Bank of America, but Lehman Brothers had to declare bankruptcy. AIG was facing enormous losses. The Federal Reserve (Fed) and the Treasury helped the insurer, which had to give almost 80% of its equity to the U.S. government. Goldman Sacks and Morgan Stanley were the only investment banks left standing and, instead of declaring bankruptcy, they became ordinary bank holding companies to receive the Fed’s protection (Havemann, 2013).

The crisis spread internationally because, when the prices of the houses had gone up, international investors became interested in making business in the U.S., but when the mortgage values were falling, investors couldn’t liquidate their positions on their securities and were just dragged into the chaos. U.S. imports went down, pushing also down its major economic partners, such as the European Union, Mexico, and China (University of Mary Washington, 2009). The “output in the 15 euro zone countries shrank by 0.2 percent”
(Havemann, 2013). Greece, Iceland, Hungary, and Latvia are among the countries that were really damaged by the economic stagnation and even Germany, the largest economic output in Europe, contracted at an annual rate of 0.4 percent. In Asia, export-oriented countries like Japan and China also felt the consequences of the crisis. Japan faced a contraction rate of 3.7 percent; China didn’t contracted, though, but stopped growing in its double digits rate like the past years (Havemann, 2013). The Latin America only felt the impact on the crisis in the first half of 2009. Even though the region did relatively well when compared to Asia and Europe (Blanco, 2010a), these effects were quite heterogeneous among the Latin American countries, reporting Mexico as the one that suffered the most (Blanco, 2010b).

**Petrobras**

Petroleo Brasileiro S.A., mostly known as Petrobras, is a Brazilian integrated energy company. In Brazil and internationally it works in the exploration, production, and transportation of crude oil, natural gas, and other oil products. It was founded in 1953 and is headquartered in Rio de Janeiro. It is a semi-public company with the government as its biggest shareholder.

Recently, Petrobras became the center of a corruption and money laundering investigation called Operation Lava Jato, conducted by the Brazilian Federal Police and Department of Justice. A large number of suppliers and construction companies, along with political parties, politicians, former Petrobras executives, and other individuals, were involved in an unlawful payment scheme. Its main consequence was a company’s loss of R$6.2 billion, reported by the organization in April of 2015 (Petrobras, 2015). The investigation is far from its end but has already shown some results. Some of the involved people were already prosecuted and are in jail, the company was able to recover R$296 million due to a court order (Alvarenga, 2015), and the organization now has a new chairman and chief officers and created an office for Governance, Risk, and Compliance.
All these factors contributed to Petrobras to becoming the public company with the second biggest debt in all Latin America and the United States, with total debt of $127.5 billion, only one position behind General Electric (Alvarenga, 2015). Due to all these negative factors, the company still seems risky to investors and this is reflected in Figure 1 below, which presents the organization’s declining performance in the BM&F Bovespa Brazilian stock exchange under the tick symbol PETR4, during the period we are considering for this project (from 2007 until 2015). Another way the international market has been punishing Petrobras for its bad debt profile was the company’s credit rating downgrade by Moody’s; it started 2014 as Baa2 and it finished 2015 with Ba3 speculative grading (Almeida, 2015).

**Figure 1. Values for PETR4 from 2007-2015**

**Gross Domestic Product (GDP)**

The Gross Domestic Product, or simply GDP, is “the market value of all final goods and services produced within a country in a given period of time” (Mankiw, 2011). It can be calculated under the supply perspective or the demand perspective. Under the supply perspective (or output side), the GDP is calculated by combining the economic value added (EVA) of each firm from the agriculture, industrial, and services sectors to the tax collected from the final goods and services produced and sold by these companies. Another way of calculating the GDP is under the demand perspective (or expenditure side), which represents the sum of
four components: consumption, government spending, investment (fixed capital formation), and net exports. The consumption includes the household spending in goods and services. Government spending means the expenditure from the local, state, and federal governments in goods and services. Investment relates to the purchase of capital equipment, inventories, structures, and expenditure in new housing. Net exports include the export of domestic produced goods minus the import of foreign goods. Besides these two approaches, other factors can also influence a country's GDP such as the unemployment rate, inflation, exchange rate, and monetary and fiscal policy.
Methodology

This paper utilizes an original dataset created specifically for this purpose. The data collected come from a variety of sources, including some Brazilian governmental databases, published academic papers, and books from the economics field. Some considerations are important to be made. All the monetary data is in Reais (R$), except the commodities price and when mentioned otherwise. Also, the GDP value used in this work is from the nominal GDP in market prices.

I will perform an analysis on the components of the GDP, study their evolution in the period I am considering for this project, examine their impact in the current economic situation of Brazil, and present the results of my findings on tables and charts.

In this argumentative research paper, my goal is to prove that government practices culminated in a mismanagement of public money and the biggest consequence was an economic crisis. At the end, I will offer solutions on how to put Brazilian economy back in track.
Analysis

In 2007, Brazil was in a wave of prosperity. Since the election of President Lula in 2002, when all foreign investors were afraid, many things had happened. The skilled economic crew chosen by the president was able to control the rising inflation and they brought credibility to international investors, who starting investing in the country again from 2003 on. Businessmen and consumers also believed in the economy and the country started to grow. The rigid monetary and fiscal policy provoked a retraction of consumption and generated a surplus to be exported, and the economy boomed. Then, there was an expansion of credit because the consumers were spending more and businessmen were investing again. Investors had a good feeling about the future and the interest rates started to decrease gradually, helping to increase the GDP, employment, and wages. Besides that, since 2004, the Real was overvalued and exports were booming, so the GDP kept growing. This is the economic scenario we will find Brazil in the beginning of this analysis.

Figure 2 below contains the information for the Brazilian GDP for the years analyzed here. It presents both current values of the GDP and the yearly growth rate. The following table (Table 2) presents some additional information important to understand the analysis of the items that will follow. For the next subsections of this analysis, this information will be mentioned many times, but the table at the beginning of this section ends the need of presenting this data at every mention.
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Figure 2. GDP evolution from 2007-2015

Table 2. Additional information to the GDP analysis

The GDP

Figure 3 introduces a comparison of the economic growth for eight countries during the period from 2007 to 2014. Brazil, China, India, and Russia represent the BRIC, the group of then growing emerging economies; Argentina, as a comparison of a neighbor country to Brazil; Germany, representing one of the most powerful countries in the world; The U.S., where the crisis really originated; and Mexico, as a new growing emerging economy and also one of the biggest partners of the U.S.
According to the graph, Russia was the country that suffered the most with the economic crisis of 2008, with a declining growth rate of 7.82 percent, because the country largely relies on the production of oil and gas. Since Germany is one of the largest exporters of machinery, vehicles, and chemicals (Index Mundi, 2014), the country experienced a serious fall in its economy due to the crisis. As Mexico has close economic relations to the U.S., and is the U.S.’ second-largest export market and third-largest source of inputs, the country’s economy contracted 4.79 percent. In the United States, where the downturn had its origin, the economy entered in a recession from mid-2008 to the third quarter of 2009 and the country didn’t face even more harsh consequences only because the government acted fast with expansionary fiscal and monetary policies to motivate consumption and help recover the economy. Argentina and Brazil were also hit by the crisis, but not as hard as the abovementioned countries. They both faced recessions, with growth rates of 0.05 percent and -0.24 percent respectively. The remaining countries of the BRIC, China and India, were hardly hurt by the global downturn.
China saw an insignificant decrease in its growth rate, from 9.62 percent in 2008 to 9.23 percent in 2009. India, on the other hand, was not as dependent as other countries on flow of trade and capital, and even besides the global recession, the country kept producing to satisfy its internal market needs; and that attracted investors. Despite that the large majority of countries faced negative growth rates, India’s economy grew 8.48 percent in 2009 (Tharoor, 2010).

Brazil was one of the first emerging countries to recover from the crisis and by 2010, its growth rate was 7.53 percent. Nonetheless, the country has recently shown a declining growth rate and is currently in a deep recession. Just like Brazil, in 2010, the Argentinian economy fiercely recovered to a growth rate of 9.45 percent, but had faced both positive and negative growth as the country is now trying to strengthen ties with the international financial community. China and India had maintained a sustainable growth since the crisis, with an average yearly rate of 7 percent. On the other hand, Russia has been facing a declining growth rate due to the falling oil prices and the difficulties in attract more investments. The U.S. had slight swings in its growth rate but has maintained an average yearly growth of around 2.3 percent, and Mexico has been accompanying those moves. Despite Germany had experienced a decline in its growth rate lately, it is the largest national economy in Europe and it has a positive economic forecast for next years.
The GDP by the supply perspective

Agriculture

Figure 4. Agriculture evolution from 2007-2015

Agriculture is the sector with the lowest participation in the GDP under the supply side. The year of 2007 had a record soybean crop and that coincided with an increase in the price of the commodity. From 2008 to 2009 many factors contributed to the fall in agriculture: bad climate conditions, high stocks, and weak global demand due to the economic crisis, but in 2010, the sector started recovering. In 2012, adverse conditions partially destroyed the annual crop, but in 2013 the soybean crop helped recover those results. However, in 2014, the drop in the soybean productivity caused a bad outcome in agriculture. In 2015, however, it was the soybean crop that helped the sector achieve a positive growth.
Industry

The industrial sector presented a positive growth in 2007 and 2008, but the international crisis damaged investor confidence, lowered global demand, maintained the stocks high, and the sector presented a retraction. With the aid of many economic policies to incentive production, the industrial sector recovered and, in 2010, it achieved a pre-crisis level. Nonetheless, in 2011, industry grew slower and was stagnated at the end of the year. The situation deepened in 2012 due to the uncertainty of the United States regarding to its indebtedness. The year of 2013 showed a slight positive result. Adverse conditions in 2014 hit the country with a severe drought and that led the government to substitute its hydroelectric power plants for thermal power plants, which generates electricity at a much more expensive cost. The fall in this sector derives especially from the losses in the transformation, utilities and urban sanitation, and construction subsectors (Cury, A. & Cardoso, C., 2015). In 2015, the industrial sector presented its worst result so far, influenced by the drop in construction - indicating that investments also had a bad outcome - and transformation - driven by the lower demand.
Services

The service sector showed good results in the years of 2007 and 2008 due to the higher purchasing power of the population. Since this is the biggest sector in the supply side of the GDP, this was the major boost for investor confidence during the crisis at the end of 2008. Despite the hostile economic conjuncture, services still had a positive growth, but at a much slower rate than the previous year. As it was not deeply hurt during the crisis, already in 2010 the sector kept growing continuously until 2013, always supported by family and government consumption. The service sector didn’t have a satisfactory performance in 2014 because during the World Cup, the government declared many holidays in order to prevent traffic jams and lags during the events, but that compromised greatly the profit of the sector. Commerce is one of the subsectors mainly affected by that since is directly related to industry, which also had reported a drop in the period. The service sector also decreased in 2015, especially commerce and the services related to the transformation industry.
The GDP by the demand perspective

*Family consumption*

**Figure 7. Family consumption evolution from 2007-2015**

The Brazilian economy is based on internal consumption, which is the major component of the country’s GDP on the demand side. In order to help the economy recover from the international crisis, the government bet on strategies to keep boosting consumption, such as credit expansion, tax reduction, and low inflation. In doing so, the domestic demand was able to recover faster than the global demand. In 2011, although the government had withdrawn the stimuli, consumption was still showing a positive growth. Despite the uncertainty of the international economic scenario of 2012, Brazilian families had been favored by better employment conditions. The positive situation was maintained for 2013 when consumption also reported a positive growth. This scenario changed in 2014, though, due to the domestic crisis suffered by the country, especially caused by the energy crisis that pushed electricity prices up. Besides that, family consumption grew less in 2014 than the previous year because it had been held back by the increasing interest rate and inflation. The consumption in 2015 dropped, driven by the disappointing scenario of inflation, interest rate, credit, employment, and wages (Cury, A. & Caoli, C., 2016).
Government spending

The Chinese growth scenario pushed the commodities price up, and the exports results had helped the Brazilian government to balance its finances in 2007. Motivated by that positive scenario, the government adopted investment programs to stimulate the economy, such as the Growth Acceleration Program (PAC), a multiphase infrastructure program, in 2007. However, the international crisis hit Brazil at the end of 2008, and in 2009 the government implemented countercyclical measures to absorb the impacts: it expanded its spending and reduced taxation to impulse consumption. Nonetheless, when the market had already recovered in 2010, those incentives had not been withdrawn (Mendes, M., 2015).

Since 2011, there was an increase in specific expenses, such as subsidies (especially for Minha Casa, Minha Vida, – My House, My Life, a housing program for low-income families), administrative expenses, and health and education expenses. During the period analyzed in this project, government expenses, as a percentage of the GDP, had increased significantly, going from 18.94 percent in 2007 to 20.20 percent in 2015, generating a crowding out effect (Valor Econômico, 2016). A big portion of this increase is due to income redistribution programs (Almeida M., 2015). In 2015, due to the discovery of the big government debt, a fiscal...
adjustment was implemented to increase tax collection, in order to generate revenue to cover the fiscal deficit, and to cut governmental expenses, indicated by the big drop in the graph.

*Investments (Fixed Capital Formation - FCF)*

![FCF evolution from 2007-2015](chart)

The Fixed Capital Formation (FCF) in 2007 presented an increase of the productive capacity without creating inflation, and that contributed to the increase of the GDP. However, in the last quarter of 2008, the international crisis hit Brazil and lessened the confidence level of the investors, leading to a big fall in investments. Only in 2010 this sector had completely recovered from the crisis and the FCF had a huge revival, reaching investment rates at a pre-crisis level and growth rate above the GDP. The beginning of 2011 was also a positive period for industry, which contributed to the increase on FCF, but the uncertainty of the American economic condition brought some stagnation to some industry sectors. After showing signs of recovery in 2013, the FCF presented a solid positive evolution, with growth rate twice as big as the GDP. The investment sector in 2014 had a huge downfall because both the variation of stocks and investment in fixed capital had poor performances. The drop in investments in 2015 derived from the fall in the industry and the reduction of imported capital goods.
Since global demand during 2008 and 2009 was still very weak due to the economic crisis, Brazil had had a poor performance for exports. Allied with that, the industrial sector hadn’t presented a scenario good enough to wake global demand. In 2010, with developed economies recovering, the exports showed a little increase, but not higher than the imports. The same scenario was maintained for 2011, with imports growing at a higher rate than exports, and 2012 had a more balanced situation. In 2013, the decrease in international oil prices increased imports. In 2014, the poor economic scenario in Brazil and the devaluation of the Real started to
affect consumers, and that reflected in the fall in imports. However, that devaluation contributed to raising exports in 2015 and, in contrast, the imports dropped down, especially under the influence of the drop in machine and equipment and cars.

**Labor Market**

The prosperous economic scenario of Brazil in 2007 had led to an expanding labor market, with decreasing unemployment rates. However, this scenario started to change after the crisis in 2008. In 2009, the labor market felt the recession but had not suffered more because the government encouraged measures to maintain jobs, such as reduction of working hours, collective vacation, and voluntary resignations. From 2010 until the end of 2014, the country reported a decreasing unemployment rate, reaching the lowest levels ever registered.

Even though the unemployment had been reaching those low levels, that did not mean the goods produced had quality, the reason being that Brazil has a shortage of skilled labor. Another factor that explains this historically low unemployment level is that around 20 percent of young Brazilians are “nem-nem” (neither nor), meaning that they neither work nor study. As they do not look for jobs, they do not pressure labor statistics to go up, and that generates an unreal situation that the unemployment is really low. This happens for many reasons, including that these people may benefit from income redistribution programs or they may be even defrauding unemployment insurance. If the unemployment was really low, the industrial production should be booming, which it is not (Roque, 2014). As the poor economic scenario worsened in 2015 due to high inflation, devaluation of the Real, fiscal tightening, a drop in industrial production, and an increase in interest rates, the unemployment rate started to rise again and real wages started to decrease.

**External Sector**

In 2007 the level of Foreign Direct Investment (FDI) was increasing in the country, which helped accumulate foreign reserves and reduce the external debt. For these reasons, the rating
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agencies Standard & Poor’s (S&P) and Fitch granted Brazil with the investment grade in 2008, allowing the country to raise funds at lower interest rate, increase investor confidence, and increase even more the investment flow in the country. The rise of imports in the first half of 2008 supported economic growth, which ended up with deficit. However, the crisis in the end of the year strongly affected exports and imports. In 2009, the situation had deepened due to the higher flow of remittances from the Brazilian subsidiaries to the headquarters abroad. Despite that, there was a good internal flow of FDI that allowed the country to control its Balance of Payments (BoP) and continue to accumulate foreign reserves. The weak global demand reduced the prices of the commodities and the import quantum was lower than the export.

In 2010, the Brazilian economy was stronger, and the increase in imports reduced the results of the BoP. However, the price of commodities increased, helping exports, but not enough to make them reach the level of imports. Even though the country ended up with a deficit, that meant that the Brazilian economy recovered faster than the global demand. In 2011; despite the continuous deficit, there were many investment opportunities and the high capital flow allowed the country to finance its BoP and accumulate foreign reserves. Even though in 2012 the remittances sent abroad had fallen due to the devaluation of the Real, in 2013 there was an increase in imports, which worsened the deficit, but it was compensated with the high capital flow from abroad.

In 2014, the deficit continued, but there was an increase in the FDI flow that was applied towards the country’s BoP. In 2015, regarding the recession the country was facing, the political instability, and the lack of investor confidence, S&P decided to decrease Brazil’s status to “junk” rating (Braga, 2015). Moody’s and Fitch, the two other rating agencies that compose the group called big three, had also decreased Brazil’s rating status.
Monetary Policy

Starting at 2007, the government implemented a tight monetary policy due to the expanding economy, increase in commodity prices, and high inflation. With the crisis at the end of 2008, commodity prices drop, along with the global and domestic demand and the expected inflation. The private banks became more careful in lending money and that stagnated the credit market for the first months of 2009 (Figure 12). That forced the government to establish countercyclical policies to promote credit expansion and liquidity in the market, such as incentives to construction, reduction of interest rate, income redistribution programs, and higher empowerment to public banks to lend money. In doing so, it was responsibility of the public banks to offer credit and boost the economy (Roque, 2014). This measure was successful in the beginning of 2009; the Brazilian economy was already seeing signs of positive results.

As of 2010 private credit also became available to economy. As a consequence of the rising inflation and domestic demand in 2010, monetary policy had to become tighter and the Banco Central do Brasil (BACEN – Central Bank of Brazil) adopted an increasing interest rate strategy until 2011. At 2012, due to the international uncertainty, the interest rate was reduced to one of its lowest levels and that helped the country go through 2012 without feeling much impact from the international scenario. However, in 2013, the monetary policy had to align with the rising inflation scenario and increasing prices, and the BACEN adopted an increasing interest rate strategy, effective until today. In order to avoid that the economic downturn from 2014 spread to other sectors, the BACEN increased the interest rate even more. However, 2015 presented the consequences of the previous year, and the government felt the need to realign prices, control inflation, and recover the fiscal situation. The monetary policy adopted was to keep increasing the interest rate. Along with that, the realignment of prices also generated increasing inflation.
It is also of interest to note the impossible trinity that Brazil has been facing recently. Assuming that the country already has free capital flow, the fixed exchange rate has been incompatible with an independent monetary policy. The inflow of foreign capital, in spite of increasing the foreign reserve level in the country, devalues the Real. In order to keep it at the level adopted by the fixed exchange rate strategy, the BACEN increases the interest rate to value the currency. The consequence is that this hike of interest rate ends up by being an instrument used only to control the exchange rate, rather than being applied to other interests of the country, such as the inflation control (Machado, 2012). The higher the interest rate, the more attractive the Brazilian market is to foreign investors, who keep increasing the capital inflow here

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1 Operations are in R$ millions. Private banks are represented by the red graph and public banks are represented by the blue graph.
and feeding the depreciation cycle to the domestic currency, which nullifies the effects of a fixed exchange rate. According to Delfim Netto (2011), former Minister of Finance, Agriculture, and Planning of Brazil, this economic policy will not be successful while the domestic interest rate is much higher than the international rate.

Political Crisis

In 2013, the Brazilian National Treasury began resorting to a series of fiscal tricks, called “pedaladas fiscais”, to camouflage the public accounts. These tricks consisted of the following: the public money destined to pay social benefits was to be transferred to public (and sometimes private) banks and those banks would make the payments to the beneficiaries. However, to make government expenses look lower than they really were, the Treasury released that money late on purpose. These actions led to two serious consequences: (i) the government lied to specialists and financial market experts by showing them unrealistic public accounts, and (ii) according to Brazilian law, this practice is forbidden and considered a crime. The Lei de Responsabilidade Fiscal (Fiscal Responsibility Law) forbids public banks to finance any Federation member, and that was exactly what happened when these banks had to pay the beneficiaries from their own pockets while the government hasn’t made the transfers.

After an investigation performed by the Prosecutor’s Office, it was proven that the government did commit this crime and, in consequence, many political authorities were/are being prosecuted for that, including the President. The country, that was already facing a recession, got into an even worst scenario when the justice determined that the government should catch up all the late payments and that led the Brazilian gross public debt to grow from 53.77 percent of the GDP in 2012 to 66.23 percent in 2015.
In order to strengthen tax collection to fix the public accounts, the government implemented a strong fiscal tightening to generate extra revenues to cover the debt. Those measures are explained in the Table 3, which contains the actions taken by the government, the expected revenues from each one, and their impact on society. The “pedaladas fiscais”, despite have been condemned, continued happening during 2015, generating a debt of R$57 billion only in 2015, according to the then Ministry of Finance Joaquim Levy (Reuters, 2015).
Table 3. The government fiscal tightening

By the end of 2015, the government made the last payment of over R$55 billion related to the “pedaladas fiscais” of 2014, which totaled R$72.4 billion, and the agreement with the Tribunal de Contas da União (TCU – Federal Court of Accounts) was fulfilled. From these R$55 billion, R$21 billion went to Banco Nacional de Desenvolvimento Econômico e Social (BNDES - National Bank of Economic and Social Development), R$12 billion to Fundo de Garantia por Tempo de Serviço (FGTS – Guarantee Fund for Time of Service), R$12 billion to Banco do Brasil (BB – Bank of Brazil), and over R$9 billion to Caixa Econômica Federal (CEF – Federal Savings Bank). After these payments, the fiscal year of 2016 already started with a deficit of R$118.65 billion (Martello, 2015).

In parallel with that, Operation Lava Jato from the Federal Police investigates corruption and money laundering crimes with money diverted from Petrobras, the big Brazilian state-owned oil company, to benefit the country’s major construction companies and to finance the government political campaign. When construction companies won construction and services bids for Petrobras, the costs were overpriced and then the bribe money was “donated” to the
governing Workers Party (*Partido dos Trabalhadores* – PT) in order to finance the reelection campaign of the current President Dilma Rouseff. The operation, which started in 2014, is still going on and, so far, over 40 businessmen and politicians had been arrested and many more are still under investigation.

All these scandals, plus the worsening economic situation in Brazil is leading to high inflation, diminishing purchasing power, high taxes, and increasing unemployment; this scenario helped inflate the population’s anger towards the government and make them start protesting in favor of the impeachment of the President. President Dilma Rouseff was removed from office in mid-May 2016 and the first in line of succession is Vice President Michel Temer, who has impeachment processes requested against him, followed by the Speaker of the Lower House of the Congress Eduardo Cunha, who has been currently removed for being facing money laundering and bribe charges and is fighting against a request for revocation of his mandate.

![Figure 14. Government evaluation survey](chart.png)

*Figure 14. Government evaluation survey*

*Source: Matoso (2016).*
Conclusion

The Brazilian government is very effective in implementing countercyclical policies to absorb external shocks and prevent them from spreading further damage to economy. That implies care and responsibility with the government accounts, does it? The latest economic scenario reported by the Brazilian government accounts do not show that. On the contrary, it shows the irresponsibility, lack of transparency, and lack of compromise from politicians not only with economic and finance experts, but especially with Brazilian citizens. The economic team of the government and other political authorities proved that they are very talented in conducing good economic policies to drive the country out of international economic turmoil. However, the messy politics, the struggle for power, and the thirst for public money were enough to turn a solid economy into a chaos.

“It is not only a crisis of governance, but also a crisis of ethics,” said Braga (2015) when referring to the Brazilian crisis. What caused the recession that the country suffers today were not economic events that culminated in this disaster. One of the most important Brazilian businessmen, Abílio Diniz, assured that there is no economic crisis in Brazil but a political crisis that is affecting investors, businessmen, and consumers trust (Silva Junior, 2015).

The political choices led to the misuse of public money and have culminated in a political crisis and economic pandemonium. The solution is not even preparing a strong economic team to create strategies to bring the country back to a solid position. First, we need to solve our political institutions, stabilize the situation, and then implement an efficient plan to help the Brazilian economy recover. Below I will note the main deficiencies in Brazil and propose ways to solve them.

*Education.* One of Brazil’s big problems is the poor education system. There are low investments on the sector and low pressure to demand actions from the government. Education forms better citizens, who become aware of their rights and able to fight against a corrupt and
unsatisfactory government. Besides that, education is an investment in human capital, which is an input for a solid economic growth. This is the way to reduce inequalities and it allows the government to reduce expenses in social programs.

*Income redistribution programs.* It is increasing the spending in social programs, which is one of the major government expenses. Instead of providing never-ending benefits, the government should implement ordeal mechanisms to make beneficiaries not need this help anymore. Ways of doing that are offering more opportunities, stipulating an expiration date for the benefits, and reducing the benefit rate. These are ways to avoid moral hazard and fraud, so the government can focus on people who really need that kind of assistance.

*Politics.* Political reform is a widely discussed topic in Brazil. The plans that have already been discussed point many changes, including the end of mandatory vote for the population, the way the Congress votes, and the end of presidential reelection. These measures would help avoid having politicians who commit crimes such as corruption, money laundering, and election schemes from taking high executive and legislative offices.

*Corruption.* Another main problem in Brazil is corruption; however, this is not only inside politics, but also in the whole population. The latest results from Operation *Lava Jato* have made the population hope for a fairer political scenario. The Federal Police and the Prosecutor's Office need to be independent authorities not to be obstructed in their investigations.

*Economy.* This is surely the most needed situation to be solved and the one to be done fastest. High inflation, high unemployment, high interest rates, and low investments are damaging the country. The population is already suffering with the excess taxation, so the way is to significantly reduce government expenses (reducing Ministries and reviewing benefits policies for example), reduce bureaucracy, stimulate investments to increase the country’s productive capacity, and develop infrastructure.
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