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**PROMOTING INSTITUTIONAL REFORMS IN  
LATIN AMERICA**

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DAY ONE**

[TRANSCRIPT PREPARED FROM TAPE RECORDINGS.]

**MR. DA NOBREGA** [Interpreted]: Thank you very much, Ricardo.

I have to say it is a pleasure to be here again at the University of Sao Paulo. I have many friends here, and as a visiting researcher, I am working on a book on the institutions in Brazil.

I will start by saying something that might surprise you. In the Brazilian development of the last 100 years, at least, the formal institutions in the sense given by Professor Douglass North played a secondary role. Up to the seventies, Brazil was one of the economies that developed worldwide without the participation of the institution as the constitution of the two pillars, which are property rights and respect of contracts or agreements.

This period was characterized by authoritarianism. In 171 years of independence, Brazil only knew two periods of democracy--from 1946 to 1964, and this current period of 19 years. This is the period where democracy is consolidated. This developing period was characterized by strong state intervention not only as a service and infrastructure provider, regulation provider, but as a promoter of the development of protectionist policies in terms of imports, subsidies, fiscal incentives.

I have a friend who is an economist, and he usually says that Brazil was in Latin America the country that was most similar to the Soviet Union in terms of state intervention.

And there is another feature. The judiciary in Brazil did not play an important role in the consolidation of a strong economy. The Brazilian judiciary acted mainly in the criminal area, association and family. Labor/justice, when the judiciary acted there, it was in a very paternalistic fashion.

Along this period, Brazilian tradition has been totally the opposite of what one could expect of a developing economy. It is the tradition of the disrespect of the agreements and contracts on the side of the government. The Labor Party that is ruling now over 25 years recognized the default, and we had a sequestration of assets during the Government of President Collor, and we have seen very often the violation or contract breaches in Brazil. We had several stabilization plans and I have participated in a couple of them, and the judiciary is able to reach agreements and not enforce them.

In the center of this process of state intervention, we had public finances that were organized in a very naive or primitive way from the institutional point of view. Firstly, there was more than one public project. It was the budget of the state-owned companies, the real public budget, and the monetary budget. The budget that was passed by the Congress was something more formal and less important.

The monetary budget was the place where we had the public debt and a set of public policy, especially those geared toward agriculture and export. The government could incur costs disguised as credit without authorization.

I would say that in the end of the military government, the government, the President, and the Minister [inaudible] had powers which were very similar to the powers of the Englishmen before the glorious Revolution. They could do whatever they wanted to do without the previous authorization of the Congress.

The main feature of the Congress was the central bank that would lend to agriculture and exports. It would manage the public debt and not the national treasury. We had the Banco do Brazil [phonetic]. I worked there, and this was a commercial bank that belonged to the government but with functions of monetary authority. It was the depository of the reserves of the banking system, and would execute the budget of the state.

So the public debt and the execution of the budget would take place not in the framework of the Ministry of Finance, and Banco do Brazil and central bank were linked through an automatic link supplying resources, and this was named "movement account."

This system was in force without the public opinion being aware of the fact, because we didn't have room for criticism or reflection up to when the model became empty in the mid-seventies. When the society was getting tired of authoritarianism, the military regime lost very quickly its legitimacy, after the fiscal crisis of the end of the eighties and the crisis of the external debt of the eighties.

With the hyper-inflation process that we had in Brazil as of the mid-eighties, after that, the system did not work anymore. From this period, from the end of the model until the consolidation of democracy--and I would say that this democracy consolidates with the first elections of the President--in this period, we started a series of reforms. First, we had the perception of this primitivism. We had the debate with the International Monetary Fund of the difficulties we had in Brazil to calculate public debt and so on and so forth, so we had a change in the institutions taking place.

In 1986, this "movement account" disappeared, and we had the formal separation of the central bank and Banco do Brazil. In 1987, the monetary budget disappeared, and we had just one budget to be passed by the Congress, and the fostering functions of the central bank disappeared, too. It evolved to a classic central bank. In 1988, this program was consolidated through legislative measures through which the public debt had to be authorized by the National Congress or by the House, authorized by the Secretariat of the National

Treasury, and the budget of the state had to be carried by the Ministry of Finance.

The concentration of all public finance in the National Treasury as happens everywhere gave birth to a set of perceptions that converged over the years to the law of tax responsibility passed in the year 2000. This is a landmark in this process.

The features of the law are typically Brazilian in terms of its validity, because it is a law of constitutional character. It is a bylaw and obliges all the entities of the federation--the states, the municipalities and the federal government--and it is seen as a benchmark by the International Monetary Fund and others.

At the same time, the monetary regime started to change after the central bank did not carry out the fostering or incentive activity, that we had an improvement of the activity of banking surveillance. In 1985, we had a committee on monetary policies, so the interest rate started to be decided by a board of directors of the central bank. Until then, it was decided by the president of the central bank, after he talked to someone, sometimes with the Minister of Finance.

So we had the institutionalization of the decision process in the interest rate. These two movements together, one in the taxation area or fiscal, and the other in the monetary area, created a new institutional environment characterized by transparency, and this is something really unseen in Brazil, this transparency, which is not usual even in Latin America.

The predictability of the monetary policy and tax policy is also new in Brazil, something unknown before. This meant the beginning of an institutional control process of the government--what we call the "taming" processing in Brazil between the eighties and the nineties.

The President in Brazil is not allowed anymore to make an individual decision and say, "I will bill Brasilia," because the decision to bill Brasilia was made, how could I say, solely by the President. He did not have to go to the House to have the expenditures approved. This is the origin of our hyper-inflation process, I would say--Brasilia.

With the increase of transparency, we started to have the watchers, the watchers of the central bank and of the tax process. Today we have a network of watchers, and they said their input to the central bank computers with the main macroeconomic indicators, the inputs, the forecasts, and the central bank divulges the document every week, and every three months, we have the report on inflation. We have the full disclosure of all the techniques and models used by the central bank, not only to forecast the main macroeconomic indicators, but also

the relevant indicators used by the board of the central bank to make decisions on the interest rate.

In this sense, the decisions of the committee were really very highly predictable. We are used to this now, because the COPOM [phonetic]--this is the name of the committee--became something very popular in Brazil, known by everyone, and the central bank created a mechanism of competition among the watchers. It developed a model according to which every month it divulges the top five watchers, which were the top five watchers, and which watcher was most accurate in the prediction. Usually, these are university banks, consulting firms. Our consulting company decided to become part of the list, because if we are out of this list for a year, we are out of the business. We are a consulting company with low capability of forecast. Well, we have more meetings, economic [inaudible], and we have been trying to be among the top five in the last 12 months, not necessarily the first one, but in most cases as to the macroeconomic indicators, we have been among the top five watchers.

Concurrently, we saw in Brazil an evolution in terms of beliefs of the society. Daring, I could say that we are seeing a cultural change in the Brazilian society. I will summarize this change. There is a development of the intolerance of the Brazilian society against corruption and inflation. For those of you who are seniors, you know that the politicians said that inflation was sort of a fuel for the development, and this was accepted by the Brazilian population. The Brazilian population interpreted inflation as a part of the political system. Sao Paulo, which is a more evolved state, had a very corrupt Governor, and people said that they would vote for him because he would do something. This was Governor Ademart Vajos [phonetic]. But the situation has changed.

Finally, we have a third element in the process which is the press freedom. Today the media in Brazil is not only independent, but they are sophisticated in terms of policies, economy. Radio, TV, newspapers, and the Web work in a totally independent manner, with criticism, which is sometimes very exaggerated, but this is something new in the Brazilian scenario.

We had times in Brazil in which the journalists would survive with a job in a newspaper and job working for the government. This is not the case anymore.

In this evolution process, we had the help of the victory against inflation, stability brought about by the real [inaudible] of 1994, amplified not only transparency but the process of perception of the institutional distortions we had built over the period.

During the government of Fernando Henrique Cardoso, also the first sociologist who becomes a President I think worldwide, he

saw that his political legitimacy would derive from monetary stability, and he should have an organism that would be safe from political pressures, and informally, he allocated autonomy to the central bank to decide, and the central bank became an autonomous institution in the process I have described.

President Lula, who during the debate said that the central bank should be the tool for development and not a tool for the bankers, nominated as a president for the central bank a banker, and a banker from abroad, a foreign bank. This was the first sign of change. He maintained the same autonomy environment of the central bank to make decisions. And last week, the Minister of Finance announced the draft of the formal independence of the central bank that shall take place in the next semester.

I am almost concluded, but I would like to mention a couple more things.

The institutional change in the tax and monetary arenas is very important, and the new institutional environment limits severely populism. The degree of information of the market agents, of the press, of the academy on the indicators, on the tax policy and so on, and you have the limitations of the tax responsibility law that established limits for expenses in terms of debt and created the crime of tax responsibility--theoretically, you can go to jail—

[TAPE CABINE F-3, SIDE A]

MR. DA NOBREGA [continuing]: --eighties, the rules of the game, according to the rules. And we know that we are experiencing a gigantic change. We have the overlapping of the old Brazil in terms of mentality, institutions, and the new Brazil which is in the agribusiness, in the aircraft industry, in software, at the University of Sao Paulo, and so on and so forth. And in this past, we see a part of the politicians, and unfortunately, the Brazilian judiciary that did not have the due importance.

The Brazilian judiciary has two kinds of problems. First is the whole process, which is slow, unforeseeable, and the vision of the judges regarding the contracts or the agreements.

A recent survey conducted by a Brazilian scholar, a Brazilian researcher who belongs to a Brazilian think tank, researched the Brazilian judges, and one of the questions was the following: A situation, the judge decides by respecting the law and the contract. B, the judge decides concerned with the social issue.

Seventy-three percent chose alternative B, so the Brazilian judge thinks that he changes the social picture, and this is a source of instability and uncertainty.

We have in our legislation qualification of property and contract. As we heard Afif saying, the Brazilian Constitution admits the right of property, however, it introduces the concept of the social function of the property. And of course, this is then, afterward, subjectively judged by the judge. And very recently, we saw something new--the social function of the contract. The judge can breach the contract if he understands that the contract does not play a social role.

We saw the concession of telecommunications in Brazil. We see that the tariffs will be readjusted according to a certain price index, and last year, it reached 20 percent. The Consumer Price Index reached 8 percent. So we have different indices.

A judge decided that to readjust the tariff is not what is in the contract but what is best for the society, for the Brazilian people. I think this proves this process. This is going to mature. It is just a matter of time. We will see the change of the syllabus of the law schools in Brazil, the introduction of the discipline of law and economy, not only in economics schools, but we will see the integration between the law school and economics schools. This is starting in Sao Paulo.

In the past, they were so segregated that the law school in Sao Paulo is physically segregated; it is not in the campus. We also have the tax or fiscal rigidity. Approximately 95 percent of the public revenue has to be spent on mandatory items--human resources, education, health--and this limits the government in terms of adopting the correct or appropriate public policies.

Is this it? Well, this process is really unpredictable in the judiciary. The judges don't like to hear that. We still have great uncertainties on the enforcement of the contracts on the right of property. This has not reached the degree we see in different countries. I would say that in spite of the several or the various problems we have to face,

I think we have started a path of no return, so of course, we have curves, we have ups and downs, but there is no going back to an institutional environment of the past. We will have the predictability, the rules, and the importance of contracts and right of property will allow for the total advantage of the potential of this large country which has risen.