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Brazil: a tale of two countries

BY RODRIGO ZEIDAN AND MICHELE BAGELLA

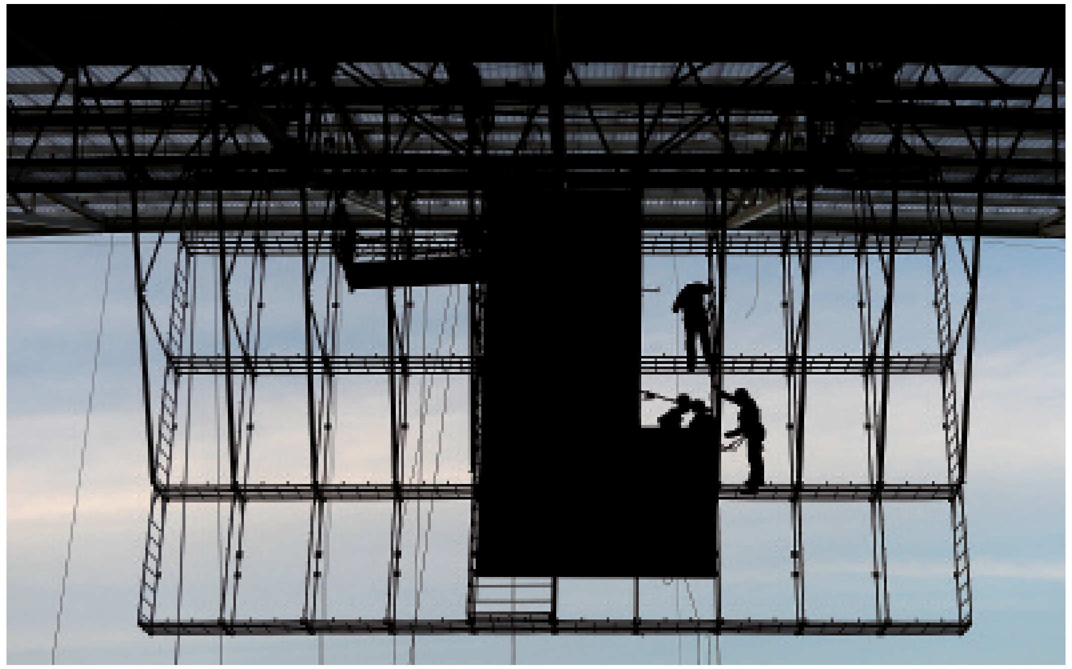
Once the quintessence of economic disparity and fiscal irresponsibility, Brazil is now showing other nations how to get their economies in order. But many of its problems remain and risk undermining the nation's hard-earned progress.

If this is indeed the best and the worst of times, to echo Charles Dickens in *A Tale of Two Cities*, there would be a strong argument that Brazil has been living in the best of times, given the world's perception of the recent evolution of the Brazilian economy. However, Brazil is a study in contrast, an emerging country full of aspirations and with hundreds of efficient companies that can compete internationally, it nevertheless maintains the characteristics of a poor country, in which millions have little chance of upward social mobility. In the past it was known as Belindia, a combination of a small part of the population, as big and as rich as Belgium, and the rest, as numerous and as poor as India. It is the rare country with a balanced budget (across the board, from the municipalities to the Federal government), but projected growth for 2012 is a paltry 1.5%. It has a surging middle class but one of the worst income disparities in the world. Young people have one of the most precious commodities, hope for a better future, but most of them will wind up in menial low-paying jobs because of a deficient educational system. Brazil was always known locally as the country of the future, an inside joke among Brazilians referring to the fact that the future would never come, the kind of self-defeating attitude common to Latin countries. Yet it seems the future has indeed arrived, and that this could be the century in which Brazil jumps from a third-world country to a global powerhouse, turning into a model for many countries with shared aspirations. However, many obstacles remain, and here we try to investigate the changes in the Brazilian economy during the last 12 years, with the goal of assessing the possibility that Brazil can overcome these obstacles to really become the country of the present.

The beginning of the 21st century marked a transition period for the Brazilian economy. The previous decade was one of the most turbulent in the country's history, first with hyperinflation looming and then with the beginning of reforms that took the economy from an inflationary cliff to a period of low inflation, low growth and many policies that reshaped the economy and prepared it for the future. The year 2000 was the first full year in which the Brazilian economy experienced a floating currency, because in January 1999, after months of billions of dollars fleeing the country, the government of Fernando Henrique Cardoso was forced to allow the Brazilian currency, the real, to float. The main problem that the Brazilian economy faced in the beginning of the 21st century was the surging public debt, both internal and external. The floating currency was supposed to take care of external imbalances, but high interest rates (over 40% a year in real terms during a period in the late 1990s) and budget deficits made the trajectory of the internal debt unsustainable. Adding misery to this situation was the expectation of economic agents who considered the stability of the economy a fragile one, with many structural problems that could see it descending into chaos.

This is a story of how the Brazilian economy shifted from a chaotic situation in the early years of the 21st century to a stalwart of the BRICS. We focus on two major reforms and a change in the international scenario: the introduction of the Fiscal Responsibility Law (*Lei de Responsabilidade Fiscal*, or LRF) by the government of Fernando Henrique Cardoso; The Bolsa Família program that lifted a multitude of families from absolute poverty and which was greatly expanded throughout

General view of the Paraisopolis favela, the second biggest, in São Paulo, Brazil, July 26, 2012.



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Workers put the finishing touches to the Arena Castelao venue for the FIFA 2014 World Cup in Fortaleza, Brazil.

the government of Lula da Silva; and the impact of external capital investment with regard to the stability of the Brazilian economy, especially from China. These three features are not the only reasons that the Brazilian economy has taken off in recent years, but without any of the three Brazil's path would be much more difficult.

Brazil is currently a paragon of fiscal austerity. Net public debt as a percentage of GDP is a meager 35%, and has been declining since 2002 (with the exception of a bump in 2009 due to a fiscal stimulus following the financial crisis). The country shifted from a confidence crisis in 2000-2002 to one of a few countries that can experiment with active industrial policies without calls for austerity. Recently, the government has spurred a plethora of policies to promote industrial activity, from tax breaks for auto manufacturers and the textile sector to public-private partnerships for infrastructure projects in the PAC (program for accelerated growth) program.

However, the situation was very different in the last years of Cardoso's government. Public deficit was over 7% of GDP in 1998 and 4% in 1999, and with high interest rates (over 20% per year during the 1997-2003 period) and an explosion in the public debt was expected. The resulting confidence crisis was compounded by external and internal factors, such as Argentina's default and energy rationing in 2001. Brazil's economy was on shaky ground during most of Cardoso's second term (from 1999-2002), and it was during this period that the LRF was enacted. It was, alongside inflation targeting, the cornerstone of Cardoso's austerity package to maintain market confidence that the "inflation demon" was dead once and for all.

Even though the law was enacted in a chaotic macroeconomic environment it survived successive governments and is now the main pillar of the public budget, with the country running a budget surplus of 3% of GDP (but a nominal deficit when interest payments of the debt are taken into account). In fact, it is so relevant that it works not only to curtail federal public spending but acts as a monitoring device for municipal governments. It works like this: because Brazil has something like 5,500 municipal governments and most survive by transfers from the federal government, such transfers are allowed only in the case that municipalities can prove that they comply with the LRF to the Court of Audit. In this sense the law transformed the relationship between municipalities, states and the federal government; all three are now responsible for fiscal discipline and all are subject to similar rules. To put into practice this very simple idea, in theory, it took a major political upheaval; previously states and some municipalities were able to issue bonds and borrow from state banks and capital markets in general. The LRF was the end result of a political shift that had governments scrambling to balance budgets. One of the main opponents of the law was a former president, Itamar Franco, who was then Governor of the state of Minas Gerais; Franco announced a default of the state's public debt months before the enactment of the law. In the end, governments abided by it and now must follow a balanced budget throughout the election cycle.

There is a paradox in the Brazilian fiscal responsibility law – it was based partly on the Maastricht Treaty, the same one that has been rendered almost useless by many European nations recently. By following a law similar to the European treaty, the Brazilian government was able to balance its budget, bring debt as a percentage of GDP down, and build enough credibility to curtail the growth of public debt. The paradox lies in the fact that Brazil, the country where politicians have a history of abuse of power and inefficiency, was able to take the necessary steps to make sure that the law gained traction, while the Maastricht Treaty was largely ignored by many European countries during the last two decades.

SERGIO MORAES / REUTERS

Workers check currency sheets in the Casa da Moeda do Brazil (Brazilian Mint) in Rio de Janeiro, August 23, 2012.

Most analysts had thought that Brazil would have been one of the last countries in the world, given its troubled history, to have a culture of budget surpluses. Yet this culture is now pervasive in the federal government, while municipal and state politicians usually follow a similar pattern in the four year political cycle: the first year is one of austerity for the purpose of cash accumulation, followed by a balanced second year, while in the third and fourth years spending is increased to build political capital.

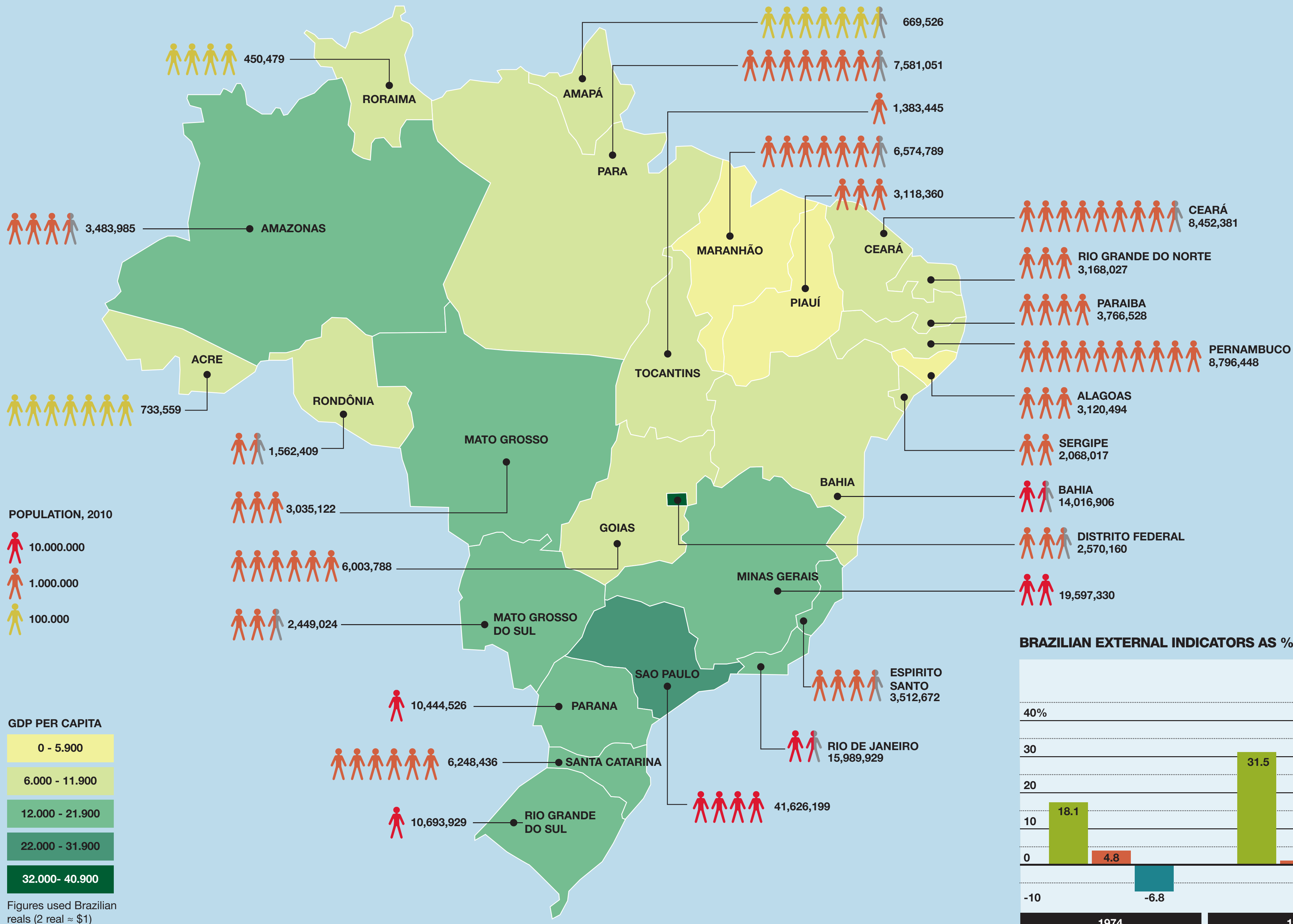
The flip side of the increased period of fiscal discipline is that recent Brazilian governments have had little incentives to promote a fiscal reform that would deal with a tax system that is archaic at its best and maddening at its worst. Moreover, there were squandered opportunities to increase public investment in infrastructure projects, with a focus on the hiring of new public employees instead (public employee wages increased 50% in real terms during the 2003-2009 period). Fiscal discipline is easy when the business cycle is favorable but quite difficult during a recession, as European countries have been experiencing. In a recession the LRF should prevent an increase in public spending and make it harder for the country to get out of it. However, in Brazil the public budget has been running on a 3%-4% surplus, and during the financial crisis the government was able to launch a stimulus program without running into the barriers imposed by the LRF.

Going back 20 years ago, the idea that the Brazilian governments would be able to run successive budget surpluses, even during an once-in-a-generation global crisis, would have probably discredited any analyst. But now the LRF is entrenched in the political scenario and is a cornerstone for how all spheres of government are run.

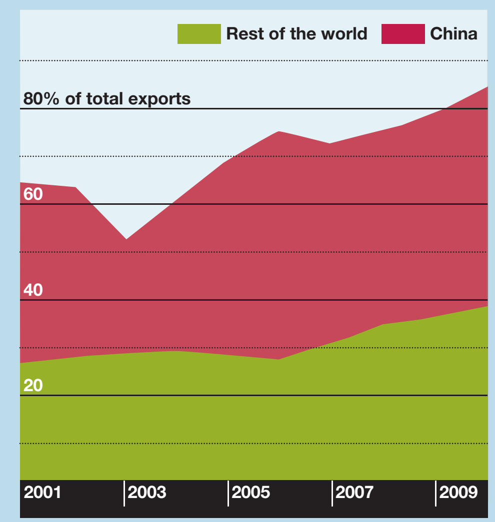
Negative income tax is a common concept in economics textbooks, but is rarely realized, given its politically controversial nature. The experience of income transfer in Brazil is of a transformative nature, given the impact of the program at improving income inequality in a country with one of the worst indicators in the world.

Conditional cash transfer was not a new idea, even in Brazil, by the time that Bolsa Família was launched in January 2004. Similar programs began in the mid-1990s; the best known was the Bolsa Escola, launched in 1995 by Cristovam Buarque. However, it was the expansion of the program, and the unification of different initiatives in a coherent framework that made the Bolsa Família so successful during the two governments of Lula. At the end of 2011 the program helped 13.7 million families, by supplementing their income an average of $50 a month. The main benefit of the pro-

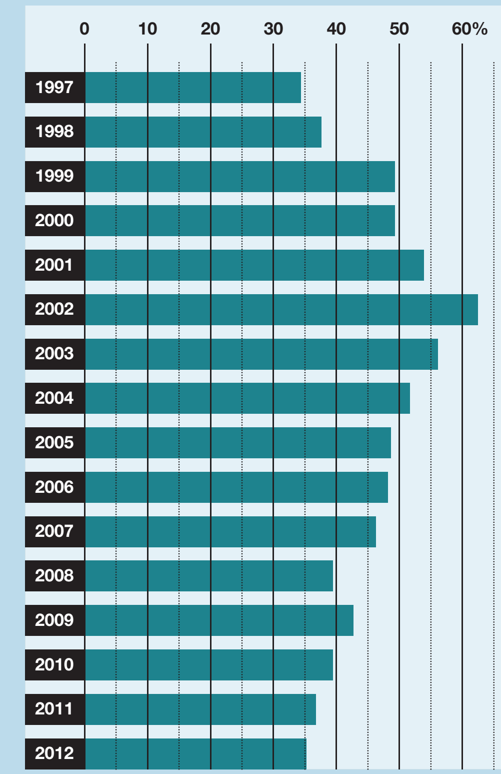
Charting Brazilian growth



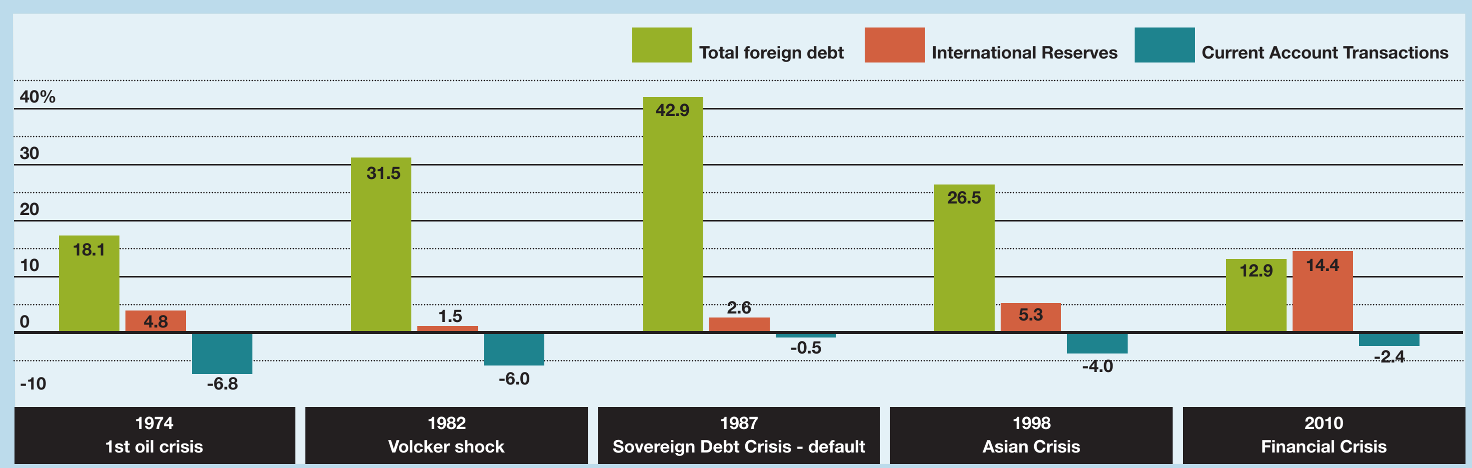
BRAZILIAN EXPORTS OF RAW MATERIALS TO CHINA AND THE REST OF THE WORLD



BRAZILIAN NET PUBLIC DEBT AS % OF GDP 1997-2012



BRAZILIAN EXTERNAL INDICATORS AS % OF GDP



TIMELINE OF BRAZILIAN GROWTH

2000
- Fiscal Responsibility Law
- First full year of inflation targeting
- US$1 is R$1.95 by the end of the year

2001
- Energy Crisis
- Argentina defaults
- US$1 reaches R$3.00
- External and internal debt increase sharply
- Recession and inflation

2002
- Lula is elected
- Confidence Crisis
- US$1 reaches R$3.99
- Inflation off target

2003
- 1st year of Lula as president
- Macroeconomic policies maintained
- Growth is 1% and average interest rate is 25%

2004
- Beginning of Boom years
- Ortodox marco-economic policies
- Trade surplus at US$34 billion

2005
- Mensalão corruption crisis
- Record US$45 billion trade surplus
- Expansion of Fome Zero and Bolsa Familia programs

2006
- Major oil reserves discovered
- Lula is reelected
- GDP growth is 4% with low inflation

2007
- Record 62 IPOs
- GDP growth reaches 6%
- Investment boom in many industries
- Record credit expansion

2008
- Brazil receives investment grade status
- Financial crisis hits the economy in the 2nd semester, but not the finanacial sector

2009
- Investment rate declines sharply
- Economy starts to rebound in the 2nd semester

2010
- Economy takes off
- GDP Growth reaches 7.5%
- PACII (stimulus package) is launched
- Some capital controls to stop appreciation of the real
- Dilma is elected

2011
- First year of Dilma's government
- Full employment
- Economy starts to decelerate, but FDI reaches US$66 billion

2012
- Low growth in developed countries coupled with low investment and deceleration in credit expansion results in low growth
- Interest rates reach a historical low of 7.25% a year

Sources: Brazilian Central Bank, 2012; Brazil Institute of Geography and Statistics

VANDERLEI ALMEIDA/AFP/GETTY IMAGES

Maria Nilza, 36, mother of four, shows her "Bolsa Familia" social plan card in Serra Azul, Minas Gerais.

gram is invisible: the transferred amount to each family is small, but it provides a stable stream of income that helps lift families from extreme poverty. The main criticisms of the program are that it is too expensive, creates a disincentive for individuals to look for formal employment and there is some level of corruption embedded in the system. Bolsa Família costs less than 1% of GDP – thus it is not an expensive program. Because amounts transferred are small the disincentive to work is marginal – it exists, but it does not exert a strong influence in the macroeconomic dynamics of the economy. Corruption is also not a big problem so far, as most cases are anecdotal and there is no evidence of widespread corruption.

There are many social programs in Brazil, but the advantages of the Bolsa Família rest on its capillarity and its ability to reach the poorest families in the country. It helped bring income inequality down sharply in Brazil (the Gini coefficient, an indicator of income inequality, came down from 0.596 in 2001 to 0.519 in 2012, according to Fundação Getúlio Vargas) – but it is still one of the worst income inequalities in the world. Of course, as the country progresses, the Bolsa Família should be phased out; but it will be difficult to terminate a program that generates copious amounts of political capital. There is little doubt that the Bolsa Família had a major impact in poverty reduction, especially in rural areas in Brazil. The challenge for the future will be to balance the economic efficiency of the program in the changing dynamics of the economy.

Many doubts existed with respect to the government's capacity to pay its external debts during the transition period from Cardoso to Lula. "Shares surged that year, 2003, as Lula curbed the budget deficit and kept up payments on government's overseas debt, instead of defaulting as some investors had predicted," according to Bloomberg new service. The need for foreign capital to finance the current account deficit was so pressing that in 2001 Fernando Henrique Cardoso made a famous prediction about the prospects of the Brazilian economy: "Export or Die." In retrospect this sentence summarized the main dilemma of the Brazilian economy: although it had a huge potential internal market, recurrent currency crises had made the economy vulnerable and always scrambling for access to external capital.

Things changed dramatically in the 2003-2007 period, when the country abruptly shifted from an external debt position to a credit one. Two main capital inflow movements explain this shift: carry trade and a sudden spike in trade surplus. A huge differential between the interest rate in Brazil and the rest of the world brought tens of billions of dollars in short-term capital; but, more importantly, Brazilian exports soared due to global demand and the depreciated exchange rate. In the year 2000 Brazil experienced a trade deficit of $700 million. In 2003, the first year of Lula's government, trade surplus was, by contrast, $25 billion, reaching $44 billion in 2005 and $46.5 billion in 2006. At the same time the capital account reached a 89 billion surplus in 2007, both by external inflows from carry trade and FDI.

One of the main impacts of this capital surge is that Brazil turned into a net external creditor in 2007. After many decades of living in the shadow of the IMF and other international lending institutions, the country was finally able to experience external account relief, and in turn was able to ride the financial crisis in a much better position than many other countries. Unlike earlier currency crises (in 1987 external debt was an astounding 43% of GDP), debt was 12% of GDP, but the country had accumulated over 14% of GDP as international reserves. Even though this reserve cushion (which is now even higher) can help Brazil hide future currency crises around the world, there are still many external imbalances in the Brazilian economy. One is the increasing reliance on raw material exports, while more importantly there is a structural current account deficit that is increasing over time. While capital outflows from services (including dividends, royalties etc.) were $25 billion in 2000, it reached $85 billion in 2011, resulting in a need to generate trade surpluses and capital account inflows to balance it.

Ultimately Brazil exported, and did not die; the huge inflows of capital helped the country curb inflation through the appreciation of the real (which fell from 3.99 real to the US dollar in 2002 to 1.54 real in 2008 and a little over 2 real in 2012), but challenges remain. The country is still dependent on capital inflows to curb a mounting current account deficit, thus needing to maintain inefficiently high international reserves.

CHRISTOPHE SIMON/AFP/GETTY IMAGES

A Brazilian policeman from the Action Battalion (BAC) searches for drugs in a favela in Rio de Janeiro, October 16, 2012.

Among many changes in the Brazilian economy during the last decade we chose to focus on the relevance of the fiscal responsibility law, the Bolsa Família and trade surpluses, three main components of the Brazilian surge from a poor country to a middle-income one. Brazil has emerged, not to developed status, but certainly away from its early developing roots. Transitioning from a middle-income country to a fully developed one brings many other challenges, however, from microeconomic reforms (a recent study by Fundação Dom Cabral concluded that inefficient infrastructure represents 5% of companies' revenue nationwide) to macroeconomic ones (a broad tax reform is one of the keys to the countries' future competitiveness). Even though it is not reasonable to predict substantial changes in the short term to the chronic Brazilian bottlenecks (education, poor infrastructure, low productivity, even lower levels of R&D, high crime rates, and crony capitalism), in the last few years some policies have been enacted to start tackling these issues with the purpose of ensuring long run growth and prosperity. Notwithstanding the income inequality that is still pervasive throughout the country, there are important signals that the country is improving the life of most Brazilians: wages are increasing across the board; and for the first time in decades there are major greenfield investments in many sectors, from manufacturing to agricultural firms. The next few years are going to be particularly important: if the positive trends continue and the improvement of social mobility solidifies weak institutions, they will strengthen the long term prospects of the economy. Further improvements may happen if pushed by industry and not only by the traditional commodities sector. In these troubled times around the world young Brazilians enjoy a rare commodity: *hope* – that they will do better than their parents and that they have a shot at the upward social mobility denied to countless generations of poor Brazilian families.

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