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Getting it together at last

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Brazil used to be all promise. Now it is beginning to deliver, says John Prideaux (interviewed here)

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BRAZIL has long been known as a place of vast potential. It has the world's largest freshwater supplies, the largest tropical forests, land so fertile that in some places farmers manage three harvests a year, and huge mineral and hydrocarbon wealth. Foreign investors have staked fortunes on the idea that Brazil is indeed the country of the future. And foreign investors have lost fortunes; most spectacularly, Henry Ford, who made a huge investment in a rubber plantation in the Amazon which he intended to tap for car tyres. Fordlândia, a long-forgotten municipality in the state of Pará, with its faded clapboard houses now slowly being swallowed up by jungle, is perhaps Brazil's most poignant monument to that repeated triumph of experience over hope.

Foreigners have short memories, but Brazilians have learned to temper their optimism with caution—even now, when the country is enjoying probably its best moment since a group of Portuguese sailors (looking for India) washed up on its shores in 1500. Brazil has been democratic before, it has had economic growth before and it has had low inflation before. But it has never before sustained all three at the same time. If current trends hold (which is a big if), Brazil, with a population of 192m and growing fast, could be one of the world's five biggest economies by the middle of this century, along with China, America, India and Japan.

Despite the financial crisis that has shaken the world, a lot of good things seem to be happening in Brazil right now. It is already self-sufficient in oil, and large new offshore discoveries in 2007 are likely to make it a big oil exporter by the end of the next decade. All three main rating agencies classify Brazil's government paper as investment grade. The government has announced that it will lend money to the IMF, an institution that only a decade ago attached stringent conditions to the money it was lending to Brazil. As the whole world seemed to be heading into a long winter last year, foreign direct investment (FDI) in Brazil was 30% up on the year before—even as FDI inflows into the rest of the world fell by 14%.

Much of the country's current success was due to the good sense of its recent governments, in particular those of Fernando Henrique Cardoso from 1995 to 2003, which created a stable, predictable macroeconomic environment in which businesses could flourish (though even now the government continues to get in the way of companies trying to earn profits and create jobs). How did this remarkable transformation come about? And how can Brazilian and foreign firms, from lipstick-makers to investment banks, take advantage of the country's new stability?

To see why Brazil currently seems so exciting to both Brazilians and foreigners, it helps to understand just how deep it had sunk by the early 1990s. Past disappointments also explain three things about Brazil which outsiders sometimes find hard to fathom: its suspicion of free markets; its faith in the wisdom of government intervention in business and finance; and persistently high interest rates.

When Brazil became independent from Portugal in 1825, British merchants, delighted to discover a big new market, flooded Brazil with manufactures, including, according to one possibly apocryphal story, ice-skates—an early example of emerging-market fever. Even so, real income per person remained stagnant throughout the 19th century, perhaps because an inadequate education system and an economy dependent on slaves producing commodities for export combined to get in the way of development. Ever since the Brazilians have tended to view free trade with suspicion, despite their country's recent success as an exporter.

In the mid-20th century Brazil seemed to have found a formula for stimulating growth and enjoyed what appeared to be an economic miracle. At one point its economy grew faster than that of any other big country bar Japan and South Korea. That growth relied on a state-led development model, financed with foreign debt within a semi-closed economy. But growth also brought inflation, which crippled Brazil until the mid-1990s and still accounts for some odd characteristics, such as the country's painfully high interest rates and its disinclination to save. All the same, the "miracle" wrought by the military government persuaded Brazilians that the state knew best, at least in the economic sphere, and even the subsequent mess did not quite persuade them otherwise.

Unhappy memories

When this development model broke down amid the oil shocks of the 1970s, Brazil was left without the growth but with horrendous inflation and lots of foreign debt. There followed two volatile decades, when Brazil started being likened to Nigeria instead of South Korea. Productivity growth went into reverse. Many of the country's current problems, including crime and poor education and health care, either date from that period or were exacerbated by it. Between 1990 and 1995 inflation averaged 764% a year.

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Then a real miracle happened. In 1994 a team of economists under Mr Cardoso, then the finance minister, introduced a new currency, the real, which succeeded where previous attempts had failed. Within a year the Real Plan had managed to curb price rises. In 1999 the exchange-rate peg was abandoned and the currency allowed to float, and the central bank was told to target inflation. The ten-year anniversary of this event has just passed, and although there is continuing debate about how to make the real less volatile, none of the big political parties advocates going back to a managed rate.

More than that, the reforms brought discipline to the government's finances. Both federal and state governments now have to live within their means. A requirement to run a primary surplus (before interest payments on the public debt) was introduced in 1999, and the federal government has hit the target for it every year since, though there is a good chance that it will miss it this year. This has allowed Brazil to get rid of most of the dollar-denominated foreign debt that caused such instability every time the economy wobbled. Now international creditors trust the government to honour its commitments. Moody's, a rating agency, elevated Brazil's government paper in September to investment grade just as the governments of many richer countries fretted about being able to meet their obligations.

Yet growth still proved elusive. It took a buoyant world economy and a surge in commodity prices to procure it. Although Brazil's economy is still relatively closed (trade accounted for a modest 24% of GDP in 2008, less than 60 years earlier), its growth is closely correlated with commodity prices, the Chinese economy, the Baltic Dry index and other measures of global trade. But at last in 2006 GDP outpaced inflation for the first time in over 50 years.

Cardoso (left) did Lula a big favour

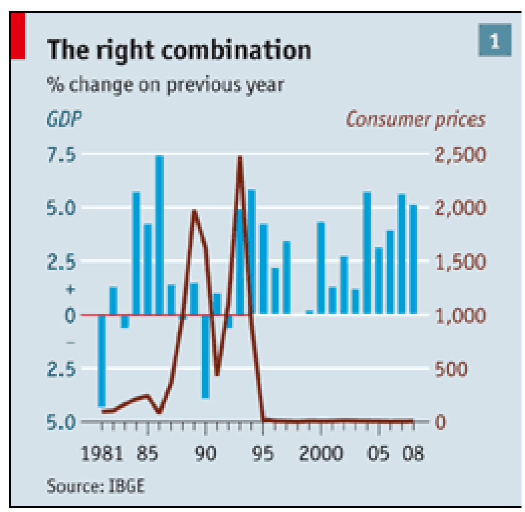
Lucky Lula's legacy

Brazil's current president, Luiz Inácio Lula da Silva, has been able to take much of the credit for the country's recent growth that perhaps properly belongs to his predecessor. Yet Lula's achievement has been to keep the reforms he was bequeathed and add a few of his own—not a meagre accomplishment given that for the past seven years his own party has been trying to drag him to the left.

Lula is often mocked for beginning his sentences with the phrase, "never before in the history of this country". What his political opponents find even more infuriating is that he is often right. Brazil was able to cut interest rates and inject money into the economy as the world economy faltered at the end of last year, the first time it has been able to do this in a crisis. Whereas others predicted that world events would tip Brazil into recession, Lula reckoned that the crisis would amount to nothing more than a small tide breaking on his country's beaches. The economy shrank for only two quarters and is now growing again. The contrast with Brazil's performance in previous crises could not be more stark (see article).

Plenty of problems remain. The central bank's headline interest rate is 8.75%, one of the highest real rates anywhere in the world. If the government wants a long-term loan in its own currency it still has to link its bonds to inflation, making debt expensive to service.

Productivity growth is sluggish. That may not seem the end of the world, but it reflects realities such as the two-hour bus journey into work endured by people living on the periphery of São Paulo, the country's largest city, during which they often risk assault before arriving too tired to be very useful. The government invests too little and has longstanding gaps in policing and education to fill. The legal system is dysfunctional. And so on.



Yet other countries face similar problems, and Brazil has made real progress. In a country where businesses became used to headline interest rates of 30% or more, a rate below 9% comes as a relief. "It's like the difference between running a marathon with 50 kilos on your shoulders and 20 kilos," says Luis Stuhlberger of Credit Suisse Hedging-Griffo, one of Brazil's most successful fund managers. Mr Stuhlberger thinks that Brazil's recent past was so awful, and its expansion of education and credit is so young, that the country can reasonably be expected to continue on its current trajectory, even without further big reforms. Even so, he argues, "we are not going to have a Harvard or a Google here." The blame for that, he says, lies largely with government policies.

Brazil's economic story could certainly be made more exciting with some reforms to its business environment. The country's potential growth without a risk of overheating can only be guessed at, but it is probably below the 6.8% it reached in the third quarter of 2008. Most economists put it at 4-5%. This suggests that interest rates will not be coming down to levels considered normal in other countries soon.

Still, stability has its own rewards. Edmar Bacha, one of the economists who worked on the introduction of the real in 1994, is pleased that the debates about Brazil's economy have become so narrow. Back in 1993, when he joined the ministry of finance, inflation at one point hit 2,489%. Nowadays, he notes with a wry smile, "the big debates are about whether interest rates could come down from 8.75% to 8.25%; or whether the central bank should have started cutting a month earlier than it did." That change has been good for Brazil, and particularly good for its banks and its financial system.

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