



## A NEW BRAZILIAN ECONOMIC MIRACLE?

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The rise to prominence of Brazil is one of the salient features of the current global economy. To an increasing extent Brazil can be viewed as a paradigm case of how rapid economic expansion can be reconciled with democratisation and social justice. Still, it is easy to forget just how recently Brazil was a byword for economic mismanagement, poverty and yawning inequality. In the 1980s – the so-called ‘Lost Decade’ – growth stagnated while the gap between rich and poor widened. As recently as 1998, Brazil hit such difficulties that it required the assistance of the IMF.

Today, things are very different. While Europe and North America struggle to emerge from recession, Brazil is coping with the opposite problem: how to prevent a boom from overheating. Far from needing to reassure international investors, Brazil is now imposing capital controls to prevent an exchange rate overshoot. Matching growing economic self-confidence is an increasing ability to influence international events. The Brazilian government is, to an ever greater extent, a key player in international economic negotiations whether this be in the field of trade or in discussions affecting currency alignments (Brazil’s intervention over the valuation of Chinese *yuan* being a case in point).

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The current resurgence represents, in some sense, Brazil’s second economic miracle. The first occurred in the 1967–1973 period. It was associated with a state-driven industrialisation strategy known as ‘Post Import Substitution Industrialisation’ (Baer 2007). Eventually, that miracle expired in a haze of debt and inflation. Could the current miracle go the same way? I will suggest that this is very unlikely. Nevertheless, there are good reasons to be cautious in one’s optimism. In what follows I look at the causes of the current boom, examining the interplay of sensible macroeconomic, trade and industrial policy with fortuitous shifts in the pattern of international demand. Towards the end the discussion turns to the lingering challenges Brazil faces. Not the least of these comprises the need to tackle resurgent inflation and a long legacy of underinvestment in education and infrastructure.

### Brazil’s remarkable turnaround

As the data in Table 1 show, Brazil’s recent macroeconomic record has been impressive. The emphasis needs to be placed on the word ‘recent’ since, during the 1990s and early 2000s, the country suffered bouts of expansion interspersed with crisis and recession. Since, around 2002, though, there is evidence that a corner has been turned. Growth has tended to accelerate and, perhaps more impressively still, it has sharply rebounded following the international financial crisis of 2008–09. At the same time, unlike during the first miracle of the late 1960s and early 1970s, inflation, though still an issue, has remained under control and certainly in single digits. Other symptoms

Table 1

Brazil: key macroeconomic indicators, 2001–2010

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 (estimates)
GDP growth rate (%)	1.3	2.7	1.1	5.7	3.2	4.0	6.1	5.2	–0.6	7.7
Consumer price (% change, December to December)	7.7	12.5	9.3	7.6	5.7	3.1	4.5	5.9	4.3	5.6
Representative lending rates (% of annual average of monthly annualized rates)	41.1	44.4	49.8	41.1	43.7	40.0	34.5	38.8	40.4	38.6

Source: Economic Commission for Latin America and the Caribbean (ECLAC).

Table 2

## Brazil: export performance and external account indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 (estimates)
Exports (US\$bn fob)	58.4	60.4	73.1	96.5	118.3	137.8	160.6	197.9	153.0	201.9
Exports of primary products as % of the total	na	47.4	48.5	47.0	47.3	49.5	51.7	55.4	60.9	na
International reserves (US\$bn)	35.9	37.8	49.3	52.9	53.8	85.8	180.3	193.8	235.8	284.9
Net Foreign Direct Investment (US\$bn)	24.7	14.1	9.9	8.4	12.6	-9.4	27.5	24.6	36.0	na

Sources: Economic Commission for Latin America and the Caribbean (ECLAC); IPEA.

of an economic renaissance abound. The Brazilian *real*, from a position of chronic weakness in the early 2000s has become one of the world's best performing currencies. The trade balance has also performed well, though a deficit was registered in 2010.

Perhaps most notably, the fruits of economic success now appear to be being divided rather more equitably than ever was the case during Brazil's first economic miracle. Then, the military government prized growth and modernization above equity and poverty alleviation. Under civilian rule, however, the emphasis has changed markedly. The governments of Fernando Henrique Cardoso (1995–2002), Luiz Inácio Lula da Silva (Lula) (2003–2010) and Dilma Rouseff (2011–) are associated with conditional cash transfer programmes which have tackled extreme poverty and social deprivation. At the same time, accelerating economic growth and expanding employment opportunities have helped to create a new Brazilian middle class. This is a much broader and more populous demographic than its analogue in the earlier miracle.

What can possibly account for this rather dramatic reversal of economic fortunes? The answer here is a complex and fortuitous mix of internal and external factors. The obvious starting point of the story of Brazil's economic recovery lies with the Real anti-inflation plan launched in 1993. However, also of significance lies the decision of the governments of José Sarney (1985–1989), Fernando Collor de Melo (1990–1992) and Itamar Franco (1992–1994) to open up the economy to imports and greater inward investment. The decision to embrace economic openness meant that the supply side was obliged to behave more competitively while external price pressures could now act as a check on domestic price formation. In order to actuate this external check, it was necessary that the national currency became stronger and more stable (Amann and Baer 2003). The essence of the

Real Plan, then, was to tackle inflation through the use of a pegged currency – the *real* – through which the microeconomic reform agenda could be allowed to exercise a benign influence on the macroeconomic environment.

As is well known, the initial results of the Real Plan were highly favourable with inflation tumbling from quadruple to single digits in three years (ibid.). Growth also picked up, albeit not on a sustainable footing. The problem with the Plan was that, despite its anti-inflationary success, it did not prove compatible with external balance. The strong *real* sucked in imports during the late 1990s resulting in a rising current account deficit and high external borrowing. The high interest rates necessary to retain the currency peg generated painful public sector borrowing costs. These contributed to the emergence of a worryingly large fiscal deficit. International investors might have been prepared to overlook these shortcomings in a more benign global economic climate. However, the eruption of the Asian and Russian crises in 1997 and 1998 spelt disaster for Brazil. By 1999, the Brazilian Central Bank was obliged to abandon the *real's* Dollar peg. This was immediately supplanted by an inflation targeting regime. By late 1998 the authorities had become newly reliant on IMF funding to meet their short term international financial obligations. Matters arguably deteriorated further in 2001–02 as Brazil reeled from the negative effects of reduced capital inflows stemming from the end of the Dotcom bubble.

How is it, then, that Brazil has been able to pull itself out of these difficulties with such facility? The question is all the more puzzling at first sight given the absence of dramatic policy change in the past ten years. The answer, I would argue, lies in the combination of two factors. These are the consolidation of the long standing reform agenda on the one hand,

**Table 3****Brazil: fiscal indicators**

	2006	2007	2008	2009	2010 (estimates)
Primary balance (% of GDP)	2.1	2.2	2.4	1.3	1.2
Non-financial public sector debt (% of GDP)	47.0	45.1	38.4	42.8	39.1

Source: Economic Commission for Latin America and the Caribbean (ECLAC).

and the emergence of a more favourable international climate for trade and investment on the other. Turning to the first factor, it is clear that over the past decade the authorities have met with some success in cementing in place the key foundations needed to ensure continuing financial and economic stability (Sanchez-Ancochea and Morgan 2008). In particular, so far as fiscal policy is concerned, the main elements of 1998's IMF-agreed stabilisation plan have been retained in place with a continuing series of primary surplus targets set and met. A key consequence of this has been the containment of public debt expansion. This, in turn, has helped Brazil secure more favourable terms for external borrowing (see Table 3). It is also true that the Brazilian Central Bank has, by and large, met with success in implementing its inflation targeting regime. It has been willing, in the process, to countenance interest rates which are high by international standards.

On the microeconomic policy side, governments since 2000 have remained committed to economic openness whether in terms of trade policy reform, or, with one or two exceptions (notably in parts of the hydrocarbons sector) to the admission of foreign capital (Prideaux 2009). The continuity here stands in contrast to the behaviour of administrations in other parts of the region. In Argentina and Venezuela, for example, the past decade has seen a much more hostile attitude towards the role of foreign capital in the economy. There, nationalisations and forced divestments have become a common feature. In sum, it can be said that Brazil has provided a comparatively stable platform for investment. In this sense it was always going to be well placed to benefit from any improvements in the external environment.

Though it might be easy to forget in the context of the events of 2008-09, the past ten years have provided exceptionally benign international conditions for the growth and development of the Brazilian economy. There are two key elements to the story here: the first concerning exports and the second capital inflows.

In first place, as is well known, the expansion of emerging market economies in Asia, notably China, has contributed towards a surge in commodity prices (ECLAC 2010). For Brazil, this has proven to be a real bonanza since the country is a leading producer of many of the key commodities involved, especially iron

ore, soya, gold and, increasingly, oil (see Table 2). The acceleration in international demand and prices for such commodities has driven Brazil's exports sharply higher to the point where the country has been able to run a series of trade surpluses. The contrast with the first miracle is especially instructive here. Then, growth shuddered to a halt in 1973 following the ramping up of oil prices by OPEC. This generated large trade deficits which Brazil was obliged to finance via international borrowing throughout the remainder of the 1970s. Ultimately, the burden of debt servicing became unsustainable, triggering the eruption of the debt adjustment crisis of the early 1980s. The contrast with the current period could hardly be sharper. Brazil today, unlike the 1970s, is a major oil producer following huge onshore and offshore discoveries in the 1980s, 1990s and 2000s. Production has now reached the point where self sufficiency has been achieved. Against this background it becomes easy to see why the vertiginous rise in oil prices of the past few years has served to bolster both growth and the external accounts.

The second key element in the more favourable external environment concerns the state of international markets for capital flows, whether in terms of direct or portfolio investment. In response to the bursting of the Dotcom bubble in the early 2000s, advanced economy Central Banks, notably the US Federal Reserve, provided a massive injection of liquidity to the international financial system. The subsequent global recovery witnessed, perhaps unsurprisingly under the circumstances, acceleration in portfolio flows (Ocampo 2009). Brazil, having cemented in place a stable macroeconomic framework and, benefitting from reformed and increasingly open domestic capital markets, received from a surge of portfolio inflows. At the same time, foreign multinationals, drawing strength from stronger equity prices and more cost effective access to bond finance, embarked on a spree of foreign takeovers and greenfield expansion. Brazil's favourable investment climate, both in terms of regulation and growth prospects, meant that it was able to

attract substantial foreign direct investment (FDI) inflows (Chudnovsky and Lopez 2007). Such investments have brought two important benefits.

In first place, they have provided a more stable means of financing current account deficits when they occur. Second, the surge of inward FDI (see Table 2) has allowed productive capacity to rise and new technologies and organizational techniques to be introduced. Taking these effects together, the effect has been to increase the potential rate at which GDP can grow while avoiding the traditional pitfalls of debt led growth: in the previous miracle growth was fuelled by accumulation of external debt with the role of FDI in deficit finance being more restricted. Although capital inflows – both portfolio and direct – suffered during the 2008-09 international crisis, Brazil is now once again facing little difficulty in attracting foreign capital. Indeed, as already indicated, the recent surge in portfolio inflows has been such that the government has been obliged to impose a temporary capital controls tax.

### The challenges ahead

Brazil's current success, while impressive, should not obscure the fact that its economy continues to face serious challenges. Perhaps the most obvious sign that much remains to be done lies in the current resurgence of inflation. While nothing like on the scale of the early 1990s, inflation has been trending upwards. In part, this reflects increases in prices for basic commodities, especially foodstuffs and fuel. However, it is also evident that structural bottlenecks in the Brazilian economy are creating price pressures, while also constraining competitiveness and moves to diversify exports away from natural resource based products. The problem here is that, for years, thanks to the pressures of fiscal adjustment, lack of private sector funding and an uncertain regulatory climate, too little was invested in infrastructure. The issue of under investment in infrastructure is especially acute in the fields of transportation and electricity generation and distribution. Brazil's highway and port networks, in particular, are now quite inadequate to cope with the rise in traffic volumes resulting from the boom of the past few years.

The pressure to resolve difficulties here is especially urgent given the approach of the World Cup in 2014 and the Olympic Games in 2016, both events which, of course, Brazil will host. Fortunately, both the Lula

and Rouseff governments have recognized the scale of the problem and have acknowledged that something needs to be done. As a result, the government is now pressing ahead with the Growth Acceleration Programme (or PAC, as it is known in Portuguese), a portfolio of investment projects targeted at addressing infrastructural bottlenecks. The problem is that the programme, launched in 2007, has been making relatively slow progress. Many projects are facing delays or have failed to get off the ground at all. In the short to medium term, the government's ability to speed up progress on the PAC may be constrained by a series of spending cuts introduced in early 2011. These have been introduced in an effort to rein in inflation. Still, the PAC is not in crisis and should be able to benefit from National Economic and Social Development Bank (BNDES) funding as well as possible increases in private participation.

The issue of private sector, as opposed to public sector driven investment, is another area where urgent attention is needed. In order to contribute towards the PAC, but also in order to upgrade production processes and enter new markets, the private sector needs to ramp up its capital spending. Historically, private sector capital formation has been constrained in Brazil because of uncertainties in the investment climate, the existence of high real interest rates and thin domestic capital markets. Fortunately, domestic capital market reforms and innovations – notably the introduction of the Novo Mercado (which promotes shareholder confidence through better corporate governance rules) – mean that recourse to equity finance is a far more viable proposition today than was ever the case in the 70s, 80s or 90s. However, base interest rates remain high for reasons already explained and interest rate spreads over these are even more startling.

The upshot of this is that financing investment through private sector bank borrowing is rarely a viable option for domestic firms. The existence of high spreads means high effective interest rates (see Table 1) and reflects, in some part, the legal difficulties encountered by creditors in Brazil in securing their rights against debtors. However, high spreads may also reflect the somewhat oligopolistic structure of the domestic banking system. Here, competition is arguably more limited than in the more mature financial systems of the West. In order to bring interest rate spreads down, and unleash private sector investment, a process of further reform is needed in the financial system. The authorities will have to tread a fine line between stimulating productive investment and giving

rise to a damaging credit boom of the sort which has so badly traumatised the United States and Europe.

Another issue for the longer term comprises the pattern of exports. As already argued, Brazil has richly benefitted from its status as a major producer of key primary products. In the last decade these have driven exports strongly upwards with non-traditional exports such as manufactures losing ground in relative terms (see Table 2). The challenge for Brazil will be to ensure that the non-traditional export sector remains in good enough shape to be able to take up the slack should commodities prices enter a prolonged period of decline. Although the latter does not look probable in the short to medium term, even the most cursory examination of the historical record suggests that periodic commodity price slumps can and do occur. The problem at the moment is that the strong *Real* is starting to place manufacturers and other non-traditional export sectors under real pressure. This, of course, explains why the government has adopted portfolio inflow taxes and why it has gone on the offensive over the valuation of the Chinese currency. In the longer term, however, a more competitive valuation of the *Real* will require that domestic interest rates decline and converge towards international norms. This will not happen until inflation trails off.

One of the most significant achievements of Brazilian public policy over the last decade has been its targeting of poverty through the use of a conditional cash transfer programme known as the *Bolsa Familia* (Family Grant). This provides welfare payments to poor families on condition that children attend school on a regular basis (Amann and Baer 2009). The programme – which is justly famous – draws our attention to another lingering challenge: that of education. Educational provision, or the lack of it, is intimately tied up with such critical economic issues as productivity growth, technological upgrading and the ability to shift one's comparative advantage in the global economy. While rates of school attendance have benefitted from the introduction of the *Bolsa* the fact remains that average levels of educational attainment in Brazil lag well behind those common in the emerging market economies of East Asia. The quality of public sector primary education, in particular, has long been recognized as deficient while the best of the public sector education system – the federal and state universities – only serves a tiny elite. The challenge then is to both improve the quality of the educational experience while ensuring that as broad a section of the population as possible benefit from it.

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