Surfing a big wave of confidence
Jonathan Wheatley and Richard Lapper

Brazil's prospects, it seems, have never been better. Economically and politically stable, the country has become a poster child on international financial markets - the most fashionable, perhaps, of the so-called Bric group of large emerging markets that also includes Russia, India and China.

At a time of rising global demand for food and energy, Brazil is uniquely placed. Already the world's biggest producer of almost any farm product you like to mention, including ethanol made from sugar cane, Brazil is the fourth biggest manufacturer of cars and will soon become an important oil exporter.

Its home markets are booming and have become a huge magnet for foreign direct investment. Its capital markets are attracting massive inflows from overseas. Meanwhile, Brazilian society is being transformed as incomes rise and inequality falls.

Much of this has been made possible by reforms enacted over the past 15 years that have borne fruit during the past few years. It has all been helped along by international conditions that, for Brazil, have never been so benign.

It is no exaggeration to say that Brazil is on the verge of superpower status. But it is not there yet, nor is that status guaranteed. Things have been going so well - President Luiz Inácio Lula da Silva is the most popular president in Brazilian history -that there is a powerful temptation among the country's leaders to let things take their course. But the task of transforming Brazil is far from complete.

The country's infrastructure is a mess. Public health and education services are persistently inadequate. Businesses must still straggle through a mass of red tape and Brazilians seem addicted to a large and spendthrift public sector. The cost of failing to address these issues will be another generation of lost opportunities.

Even so, the momentum for change is strong. On the streets of Brazil's towns and cities, the feelgood factor is hard to ignore. Consumer and business confidence are riding high. In Sao Paulo, a spectacular new suspension bridge completed last month seems to typify the mood - brash, daring, brightly lit and monumentally confident.

Among the steel and glass towers of the business district around it, new buildings are sprouting like so much tropical undergrowth.

But it is among the lower-income groups and in some of Brazil's poorest states in the north-east that the most important changes are taking place. The Bolsa Família, an income-support programme developed under Fernando Henrique Cardoso, president from 1995 to 2002, and vastly expanded since then under Mr Lula da Silva, has brought a quarter of Brazil's nearly 190m people into the consumer market for the first time.

Across the country, though, there has been a rapid expansion of jobs and credit. Many new jobs - though far from all - are the result of migration from the informal to the formal sectors: workers who previously had no registration or rights are now tax-paying citizens with generous employment benefits.

"The creation of formal jobs is far outpacing that of informal ones," says Cristiano Souza of Dynamo, a Rio de Janeiro investment manager. "Companies are hiring better-educated and more productive people."

One reason for the rise of the formal sector is that government inspectors are cracking down on tax dodgers. But there are many other factors. Any owner of a company thinking of going public, of selling part or all of their business, of opening franchises, or of applying for credit,

must be able to show a genuine, clean set of books. Increasingly, companies demand the same of their business partners and suppliers.

By coming within the law, of course, many businesses have given up a huge competitive advantage of not paying taxes. This has forced them to work harder to achieve productivity gains. "If you talk to companies you see there has been a real change in expectations," Mr Souza says.

Partly because of Brazil's history of economic turbulence and recent memories of runaway inflation, companies have always been survivors, quick to adapt to changing circumstances. In the past, they spent much of that energy on maximising financial gains from inflation and other market distortions. Now, after decades of stagnant productivity, they are becoming more efficient and competitive.

With less likelihood of finding themselves unemployed, Brazilians have been able to plan for the future. They have also been able to take out longer-term loans for big-ticket items, especially cars. Changes in the law allowing lenders to foreclose on non-payers have helped a rapid expansion of credit, as have new forms of lending, especially arrangements under which instalments are deducted directly from borrowers' pay packets - or, commonly, their pensions. A new "positive register" of people with good credit histories will help lending expand further.

Such advances are even making a dent in Brazil's notorious income inequality. At the same time, stability has also brought more consistent rates of growth. Between 1990 and 2003, growth was extremely erratic and averaged out at less than 2 per cent a year. Over the past four years, the average has been more than 4 per cent. In the 12 months to the first quarter of this year, it was 5.8 per cent - and this at a time when the US economy has been growing at less than 1 per cent.

In the past it was said that when the US caught a cold, Brazil got pneumonia. "Now the US is in intensive care and we haven't even sneezed," says Aloizio Mercadante, a senator for Mr Lula da Silva's PT (Workers' party) and one of his economic advisers.

The foundations of Brazil's new prosperity were laid under the Cardoso administration and loudly denounced by the then opposition PT. But, in government, Mr Lula da Silva and his advisers have seen the value, especially to the poor, of low inflation and a stable economy.

A floating exchange rate, primary budget surpluses (before debt payments), inflation-targeting and central bank independence: these form the basis of stability which few question. "There is no longer any room in Brazil for populist adventurers," Mr Mercadante says.

His PT and Mr Cardoso's Social Democratic party may be on opposite sides of what remains of the political divide, but both agree that stability must be preserved.

Even so, Brazil faces some big challenges. When Mr Cardoso's government took office in 1995, it presented a list of priorities for change. Many of them were enacted. But others - especially reform of the pensions, tax and labour systems – remain to be done. Sergio Vale, an economist at MB Associados, a Sao Paulo consultancy, says that Brazil is now reaping the rewards of past reform. "To grow long term, we need to continue with the reforms," he says.

One of the main problems is that the shape of Brazil's expensive state sector is still an obstacle to development.

The cost of maintaining over-generous pension and other provisions for the middle class means that Brazil is still heavily indebted and has some of the highest interest rates in the world. Even though external debt has been virtually eliminated, net public debt in domestic currency is officially equal to 41 per cent of gross domestic product, a rate much higher than that of many of Brazil's peers.

Fiscally pressed, the government still invests too little in roads, energy and ports.

The country's soya exports - more than a third of those traded in the world - often travel thousands of miles from farm to port by lorry along potholed highways, at great cost to competitiveness. The threat of electricity rationing, last introduced in 2001-2002, looms on the horizon.

Yet many fear that the government - and even a future PSDB government, should one be elected - has little stomach for the political cost of carrying out the necessary changes. "To do reforms you have to burn up your own political capital," says Mr Cardoso. "But the gains come only over time."

Partly as a result, the reform agenda is subtly shifting, away from what Mr Cardoso calls "hard" issues such as pensions to "soft" ones such as education and security.

Yet the last thing Brazil can afford now is complacency. There are already signs that its macroeconomic stability is coming under threat. After years of surpluses, Brazil has recently developed a current account deficit, likely to reach $21bn by the end of this year. For the time being this is being more than covered by foreign direct investment, although the speed with which the deficit has emerged is causing concern. At the same time, inflation is creeping up and may end the year at as much as 6.5 per cent, two points above the centre of the government's target range.

In spite of such worries, Brazil's advances were rewarded this year with investment-grade ratings from Standard & Poor's and Fitch, two of the world's main ratings agencies. Such recognition, many both inside and outside the government feel, was long overdue. But such a view suggests that Brazil has laid the foundations of growth and that all it need do now is to avoid going backwards.

Yet some of the foundation stones of faster, sustainable growth, which is well within Brazil's potential, are still lacking. Leaving them out of place will risk stagnation -something Brazil well deserves to be rid off.

Brazilians, who could so easily enjoy European standards of living, will go on putting up with second best.

Fonte: Financial Times, London, Tuesday July. 8 2008 . Brazil Special Report . p.1-2.