

The Lula Lieutenant Calming Business in Brazil

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An ex-physician-turned-politician named Antonio Palocci may hold the key to Brazil's continued success as a model of emerging-market growth and a favorite of stock- and bondpickers.

Palocci isn't running for office. His involvement in a major political scandal four years ago probably means the 49-year-old will never occupy the Presidential Palace. Instead, the ex-Finance Minister is economic adviser to the presidential campaign of Dilma Rousseff, the Workers' Party candidate who enjoys a 22-point lead over Social Democrat Jose Serra with just a few weeks to go before the Oct. 3 election. Rousseff, 62, served as Energy Minister and then chief of staff under President Luiz Inacio Lula da Silva, who backs her for the Presidency. Like Lula, Rousseff has a leftist past, and her days as part of a Marxist guerrilla group in the 1960s mark her as even more radical than her boss. Rousseff's rhetoric still has that radical flavor: In August she said it would be a "crime" to cut state spending. Her core following in the working class loves hearing that.

Such talk from the probable next President of one of the top emerging-market countries might ordinarily make investors nervous were it not for the presence of Palocci, who as Finance Minister from 2003 to 2006 guided Lula to tackle Brazil's mounting debt and curb inflation. Palocci paid off \$15.5 billion in loans to the International Monetary Fund ahead of schedule and sponsored a bankruptcy law favoring creditors over workers. He created rules allowing loan payments to be deducted from paychecks that fueled a record expansion of credit among low-income families. Under Palocci's watch, inflation slowed to 5.3 percent from 17.2 percent, and the benchmark Bovespa stock index more than doubled. Those achievements delighted the markets, which had expected Lula to usher in a disastrous era of overspending and attacks on the private sector.

Pimco, the giant bond fund manager, has made Brazilian debt its favorite among emerging markets mostly because of its long-standing confidence in Palocci, who is still a congressman from Sao Paulo state. Brazil's 11 percent bonds maturing in 2040, the benchmark, have tripled in price since Pimco increased its holdings eight years ago. "Palocci's steady hand is what kept us in the trade," says Mohamed A. El-Erian, Pimco's chief executive officer, who met with Palocci twice following Lula's election. Today El-Erian, who visited Brazil this summer, says he's still "comfortable" with Pimco's Brazilian holdings.

"The more the market sees of Palocci, the happier it feels about Dilma," says Urban Larson, who helps oversee about \$2.2 billion as a Latin American stock fund manager for F&C Asset Management in London. Palocci, who accompanies Rousseff to presidential debates and television interviews, declined to be interviewed for this story.

Political analysts say Palocci is more likely to serve as cabinet chief under Rousseff instead of picking up his finance portfolio again. Palocci's insistence on fiscal austerity during Lula's first term is needed again to rein in public spending and slow

the flow of "gusher" credit from state banks, says Thomas Trebat, head of the Institute of Latin American Studies at Columbia University. "What Palocci did as Finance Minister set Brazil on the right course," says Trebat, a former Citigroup analyst. "Brazil needs him again."

Palocci's role may include helping Rousseff battle those members of the Workers' Party who want to expand the government's role in the economy, says Paulo Vieira da Cunha, a director of Brazil's central bank until 2008 and now a partner at Tandem Global Partners in New York. "Palocci stands for fiscal prudence," says Vieira da Cunha. "It's not clear how much support there is for that within his own party."

Rousseff, under Palocci's influence, has toned down her rhetoric when speaking to investors. In May she surprised those attending a conference in New York by discussing a possible reduction of Brazil's inflation target--something Lula has refused to consider. Rousseff said it was "very important" to reduce lending by the state development bank, which has more than doubled since 2007. "It was a watershed event, and Palocci orchestrated it," says Carlos Thadeu de Freitas Gomes, a former central bank director who is chief economist at the National Federation of Commerce in Rio de Janeiro. "It was the signal the market wanted that she would follow an orthodox path."

Like Rousseff, Palocci joined the Marxist underground as a student, then later co-founded the Workers' Party with Lula. As mayor of Ribeirao Preto in Sao Paulo state, he learned the need for budget discipline. In his 2007 memoir, *About Ants and Cicadas*, Palocci said spending cuts are the first step to boosting investment and growth, while loose monetary policy is not the way to strengthen an economy. "A forced reduction of interest rates, without having savings and the investment capacity to increase the supply of goods, is an extremely risky path," he wrote.

Palocci had to resign as Finance Minister in 2006 after lawmakers accused him of illegally obtaining and leaking the private bank records of a witness in a bribery investigation that targeted senior Workers' Party officials. The witness, a caretaker, placed Palocci at a Brasilia mansion where politicians and lobbyists allegedly negotiated bribes and partied with prostitutes. Palocci denied any wrongdoing, and the Supreme Court cleared him of breaking bank secrecy laws last year. Lula continues to stand by him. "I owe him a part of my government's success," Lula said in an Aug. 5 interview with *IstoE* magazine. "Especially during the first two years, when we had to eat charcoal instead of filet mignon."

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