How Busted Is Brazil?

Growth After the Commodities Boom

Stability Is Success

SHANNON O'NEIL

Ruchir Sharma ("Bearish on Brazil," May/June 2012) argues that Brazil's incredible rise over the past ten years has depended on the sale of commodities, and that as commodity markets begin to slow, so, too, will Brazil's growth. Sharma correctly notes that in the coming years, Brazil will likely need to confront a decline in commodity purchases from China. But he fails to recognize that economic stability has also driven Brazil's growth.

Throughout the late twentieth century, Brazil suffered from failed stabilization policies and devastating bouts of hyperinflation. In 1994, however, Brazil introduced a new currency, the real, which has kept inflation in check. Around this time, the government also began lowering tariffs, opening up markets, and privatizing industries, policies entrenched over the next decade by former Brazilian President Luiz Inácio Lula da Silva. These reforms convinced local and international skeptics that Brazil would not return to the days of closed markets and inflation—an evolution that, more so than the commodity craze, has spurred Brazil's economic boom over the last decade.

Sharma argues that the very measures Brazil has taken to reach this stability will hold the country back. In particular, he claims that Brazil's spending on welfare programs, such as Bolsa Família, an initiative that provides cash transfers to low-income parents who get their children vaccinated and keep them in school, has reduced inequality at the expense of development. Yet history suggests that to achieve sustainable growth, governments must care for the young, the old, and the less fortunate. European countries and the United States began building their own social safety nets at far lower levels of per capita income than those of emerging-market states today, thus expanding productivity and boosting demand. Indeed, numerous studies conducted by the World Bank and others suggest that the reduction of inequality in middle-income countries, such as Brazil, actually boosts economic progress.

What is more, several studies of Brazil itself, performed by Fundação Getulio Vargas, a Brazilian research institution,

demonstrate that Bolsa Família has increased self-employment and domestic consumption. Other studies, such as ones conducted by the International Food Policy Research Institute, show that the children of the families that receive aid from Bolsa Família are healthier and spend more time in school—offering the best hope for the increase in skilled workers that Sharma prescribes.

Meanwhile, Sharma compares Brazil to China, arguing that Brasilia has restrained development whereas Beijing has promoted it. Yet in making that contrast, Sharma overlooks the disparate levels of average income between Brazil and China, especially for the poor. According to the International Monetary Fund, per capita income in China, where GDP has risen rapidly over the past two decades, remains less than half of that in Brazil. And over the past ten years, the average income of Brazil's bottom 20 percent has grown by around ten percent, the same rate as China's total GDP growth.

Brazil has also outperformed China in enlarging the size of its middle class. According to a study performed by the Brookings Institution, roughly half of Brazil's population is now considered middle class, compared with less than ten percent in China. Brazil has brought so many people out of poverty not just by selling commodities but also by diversifying its economy, expanding its financial and service sectors, and reducing inequality. Such policies have created a strong base of domestic consumers that has helped power Brazil's economic rise and tempered the effects of external shocks, such as the 2008 global financial crisis. Despite all of this, Sharma mentions the Brazilian middle class only once.

Brazil faces many problems, from poor education and infrastructure to a complex bureaucracy and complicated tax regulations. The question is whether the country can solidify its gains and attain long-term growth—an outcome that will depend on far more than commodity markets.

SHANNON O'NEIL *is Douglas Dillon Fellow for Latin America Studies at the Council on Foreign Relations.*

Resilient Brazil

RICHARD LAPPER

Ruchir Sharma is correct that many challenges lie ahead for Brazil. Its savings rate is too low. Its infrastructure is inadequate. A dense bureaucracy and powerful vested interests often block necessary change. Reform efforts there move too slowly. But Sharma fails to see many positive signs that suggest that Brazil will continue to grow.

It is certainly true that over the past decade, Chinese demand for commodities triggered an economic boom in Brazil. Brazilian exports to China generated large trade and current account surpluses and allowed Brasilia to build up its foreign reserves. But Sharma wrongly asserts that Brazil spent this windfall on constructing a "sleepy" welfare state. Instead, trade surpluses helped stabilize Brazil's external accounts, reinforcing the confidence of local businesses and foreign investors in Brazil's economy Most of all, Brazil has benefited from a major expansion of its formal labor force, reducing the large

number of people who worked in the black market and did not pay taxes, such as street sellers and unregistered domestic maids. This growth in formal employment has occurred both in the public and in the private sector; companies, assured of their longer-term prospects, began hiring, encouraged by government policies that made it easier to borrow and raise capital. Since 2000,12.3 million formal jobs have been created, compared with only about 2.1 million during the previous decade.

Once formally employed, these Brazilians found it easy to borrow thanks to government programs that encourage banks to extend loans, such as an experimental system in which lenders collect debt repayments direcdy from the paychecks of borrowers instead of from the borrowers themselves. These borrowers now have access to such items as cars, television sets, and cell phones. Increases in the minimum wage have also raised the income of the poor. Social programs such as Bolsa Família, meanwhile, have boosted their living standards and provided them a safety net.

Together, these efforts have brought millions out of extreme poverty and increased the relative size of the middle class, known in Brazil as Class C (those with average monthly household incomes between $860 and $3,750, according to Fundação Getulio Vargas). Foreign companies, seeking new markets, have invested billions in Brazil, giving its citizens access to everything from cosmetics to cars. With unemployment still relatively high compared to in the 1990s, despite a recent decline, and loans to individuals accounting for only 12 percent of GDP, a low figure by international standards, there is still room for Brazil to create jobs and expand the credit market.

Brazil did not drive this growth by creating a bloated welfare state. Bolsa Família, for example, assists 13 million families but takes up only 0.6 percent of GDP. It is true that spending on other welfare programs remains high; for example, Brazil devotes five percent of its GDP to pensions for civil servants. Sharma, however, fails to mention that Brazil recently established ceilings on those pensions. Although the new regulations will not affect the entitlements of current employees, they will apply to fresh recruits and eventually save the government billions of dollars.

Sharma offers a misleading assessment of several other sectors of the Brazilian economy. He underestimates the extent of Brazil's comparative advantages in agriculture, mining, and other natural resource sectors. He rightly criticizes the country's high interest rates, but when he describes those rates as a "signature" policy, he ignores the recent drive to reduce them. In fact, since last August, Brazil's central bank has reduced interest rates by more than three percent. Ironically, it has done so in the face of opposition from the constituency for which Sharma presumably has the most sympathy: local financial firms. Sharma also notes that Brazil's investment in infrastructure remains too low, but in that assessment, too, he neglects recent progress. In 2004, only 62 percent of Brazil's roads were in good or excellent condition; last year, according to Brazilian government figures, that number had risen to 73 percent. Since Brazil launched an accelerated growth plan in 2007, public spending on infrastructure has more than tripled. Sharma

also ignores the fact that Brazil has made progress in attracting private investment to fund infrastructure projects; in February, for example, it privatized three of its airports.

In short, Sharma offers a simplistic and unduly pessimistic view of Brazil. The fact remains that throughout the financial crisis of the past several years, the country has outperformed the developed world. The social and economic changes of the last two decades and the dynamism of the internal market have not immunized Brazil against another global downturn, but they have made it resilient.

RICHARD LAPPER *is Principal of* Brazil Confidential, *a research and analysis service on Brazil published by the* Financial Times.

Democracy Matters

LARRY ROHTER

In comparing Brazil to China, Ruchir Sharma calls for Brasilia to follow Beijing's example of growth at any cost—a model that would cast the country backward into authoritarianism.

Since Brazil introduced the real in 1994, it has lifted roughly a quarter of its population out of extreme poverty and nurtured a growing class of middle-income consumers. Meanwhile, since the late 1970s, China has removed an equal proportion of its citizens from similar levels of poverty. But whereas China has grown under the direction of one-party rule, in which labor unions, an independent press, and autonomous civil society are repressed or forbidden, Brazil has done so amid the give-and-take of democracy. Whether by voting, joining unions, or speaking out through the free press, Brazilians have steered the direction of their country, whereas the Chinese people have had to accept the dictates of their government.

Brazilians have attempted to manage their country's rise by embracing governments that do not seek to fuel growth at the expense of human capital and in fact recognize that such capital is critical to continued prosperity. Since the mid-1990s, Brazilian leaders have spent billions improving the country's education, health care, and housing—not as handouts to the needy but as long-term investments in the manpower essential to the country's future. These efforts have also dramatically reduced inequality. Meanwhile, even as Sharma lauds China for "relentlessly" pursuing growth, he acknowledges that the country has built its success largely at the expense of its citizens. As inequality soars there, the Chinese people have little, if any, ability to resist it.

Indeed, in recognizing China's lack of concern for the welfare of its citizens, Sharma implicitly admits that GDP growth is not the only goal that a society should pursue. Brazilians value quality of life and individual freedom and are not prepared to sacrifice either so that local plutocrats or foreign companies that showed no interest in Brazil before the current boom and will leave at the first hint of a downturn or of cheaper labor and better markets elsewhere can eke out ever-greater profits.

Sharma is right to argue that Brazil faces many challenges. But it cannot confront these problems by following the Chinese model, which guarantees profit by imposing its policies and stifling

dissent. Such a system may seem more efficient to some, but pursuing growth without regard for transparency or the rule of law will only return Brazil to the era of authoritarian cronyism that its people escaped just a quarter of a century ago. To continue growing, Brazil must serve not hedge funds, banks, and big businesses but the well-being of its citizens.

LARRY ROHTER *is the author* of Brazil on the Rise: The Story of a Country Transformed.

Educate and Innovate

RONALDO LEMOS

Ruchir Sharma suggests that to sustain its success, Brazil should devote more resources to infrastructure projects, education, and research and development. But he fails to mention that over the past several years, Brazil has attempted to do just that, launching a series of programs meant to boost industry and technical education. However noble, these initiatives have failed to address the structural reforms necessary to promote the innovation that the country desperately needs.

To begin with, this past April, Brazil announced a stimulus package of $35 billion to aid its industrial base. The legislation also eliminated billions of dollars in payroll taxes, created subsidies for lending, and promised to weaken the currency. Although these measures will certainly spur some growth, they are centralized, capital-intensive, and offer little in the way of research and development or technology, ultimately reinforcing the outdated industrial model in place since the mid-twentieth century. In particular, the package will do little to eliminate the so-called Brazil cost—the additional expense for goods in the country due to the lack of infrastructure, high taxes and interest rates, and a complicated bureaucracy. According to the World Bank, it takes an average of 119 days to start a new business in Brazil, the fifth-longest time in the world. And the country remains one of the most expensive in which to conduct business. For example, even after Foxconn came to Brazil to make products for Apple, the first batch of iPhones made in Brazil cost the same amount as imported phones.

The Brazilian government has also attempted to support industry and innovation in the long term, particularly by improving education. But those efforts have proved similarly inept. For instance, the Ministry of Education devotes $750,000 every two years to fund the best proposals for schoolbooks. This year's process required bidders to attach DVDS to their books, in the hopes that they would make the educational experience more interactive. Yet the ministry is also sending schools tablet computers, which cannot play DVDS.

Another example of this ineptitude is the Science Without Borders program, a $1.65 billion scholarship fund for Brazilian students to study science, technology, engineering, or mathematics in the United States and other countries. Yet when those students return home, they will have trouble putting their degrees to use, since Brazil does not recognize degrees obtained abroad. Students hoping to have their degrees recognized must endure a years-long validation process before taking doctorate-level jobs,

defeating the very purpose of Science Without Borders.

This educational protectionism also extends to foreigners hoping to enter Brazilian academic institutions. At the University of São Paulo, the largest and most important university in the country, only 2.8 percent of the 56,000 students are foreign. And scholars who hope to enter the Brazilian university system have no formal mechanisms to aid their applications, forcing them to rely on local professors to help them obtain visas and work permits.

To truly advance innovation in industry and education, Brazil must experiment. Instead of retaining an outmoded manufacturing system, the country should embrace new models from around the world, such as the "maker movement," a do-it-yourself approach that encourages individuals to learn engineering-based crafts and empowers them to design new inventions through open-source collaboration and technologies such as 3-D printing.

The country should apply the same kind of courage to explore new ideas with regard to education. It should begin by accepting foreign degrees and opening its educational system to students and professors from abroad, which would alleviate the shortage of qualified professionals in the country and add to its talent base. Having done that, Brazil can support new industrial pursuits by creating a national innovation institution to serve as a laboratory of ideas and as a nexus among individuals, businesses, universities, and the government. And it can promote innovation in elementary and high schools, teaching students the programming languages and basic skills necessary to design everything from Web sites to widgets.

Cutting payroll taxes and subsidizing tablets will certainly help Brazil prevent itself from falling behind for now. But the country will continue to prosper only if it embraces innovation and takes the risks necessary to apply it.

RONALDO LEMOS *is Director of the Center for Technology and Society at Fundação Getulio Vargas and a Fellow at the Center for Information Technology Policy at Princeton University.*

Sharma Replies

Each of the four responses to my article addresses the same question: whether Brazil can keep growing after commodity sales slow. Shannon O'Neil and Richard Lapper admit that the country faces many problems, but they argue that it has achieved a level of stability over the past two decades that will at least cushion it from a commodities downturn, if not allow it to continue to prosper.

Yet Brazil's growth remains slow. It is true, as O'Neil notes, that economies should be measured against others with similar levels of per capita income. Brazil's long-term growth rate of 2.5 percent and its recent boom pace of four percent, however, are sluggish by any measure—lagging behind the rates of poorer countries, such as China and India, as well as those of fellow middle-income countries, such as Russia and Turkey. As Lapper notes, Brazil has outperformed the developed world throughout the financial shocks of the past several years. Yet that record is no sign of success. As a rising

country, Brazil should grow faster than wealthier nations, but its economy is now expanding at about the same speed as that of the United States, and it remains behind those of other emerging markets. That is all the case because Brazil continues to depend on commodities: since the 1980s, the country has exceeded its average growth rate of 2.5 percent only when prices for its commodity exports have spiked.

In my article, I illustrate the effects of that reliance on commodities by contrasting Brazil with China. O'Neil and Larry Rohter accuse me of overlooking the economic and political differences between the two countries and arguing that Brazil would have gained from following China's example. But China is a foil to Brazil, not a model. Through heavy investment and a cheap currency, China has created a high-growth and low-cost economy that rose quickly but now faces dangerous imbalances as a result. Brazil's record of weak investment and high interest rates has created the opposite: a slow-growth and high-cost economy that now faces imbalances not from speed but from sclerosis. China has grown at an extremely rapid pace, even for its income class, whereas Brazil has fallen behind its peers.

I do not, as Rohter suggests, make this comparison as a way of endorsing China's authoritarian model. In fact, when it comes to growth, systems matter less for economic growth than individual leaders who understand the basics of economic reform. Of the 124 economies of the last three decades that grew at five percent or better for at least ten years, 52 percent were democracies and 48 percent were dictatorships.

Brazil's leaders, unfortunately, have not demonstrated that they understand economic reform. O'Neil and Lapper note various examples of progress, such as job creation, educational improvements, a growing middle class, and investments in infrastructure. But as Ronaldo Lemos notes, Brazil's recent reforms have done little to lower the so-called Brazil cost of doing business, making it difficult for companies to prosper. And the 2011-12 *Global Competitiveness Report* ranked Brazil 104th worldwide in quality of infrastructure, placing it far behind middle-income peers such as Chile (32nd), Turkey (34th), and Mexico (73rd).

What is more, these developments, however beneficial, have bloated the Brazilian government. Since the 1980s, it has doubled its share of the economy, to 40 percent, one of the highest levels in the emerging world. The steady growth of Bolsa Família is just one example of this creeping statism. The problem is not that Bolsa Família is one of the largest initiatives of its kind in the world; it is that the program is just one piece of a growing welfare state. Brazil has seen costs soar across the board, from pensions to social security, which now accounts for nearly seven percent of GDP.

The rise of the welfare state is crowding out private investment, which remains stagnant at under 20 percent. And my critics fail to address my resulting argument: that weak private investment is the main reason costs are so high and capacity is so low, capping Brazil's growth potential.

O'Neil is right to say that Brazil's hard-fought stability is an achievement, particularly given its history of traumatic hyperinflation. But Brazil is hardly alone in having reined in its public debt; over

the past decade, Russia and Turkey have done much the same. Although stability came as a relief, it has not given Brazil any kind of competitive advantage. And there are increasing signs that it is beginning to falter. In a failing effort to maintain its four percent growth, Brazil has been extending vast amounts of credit. In the last five years, credit provided to the private sector, including both individuals and businesses, has doubled as a share of GDP, to 49 percent. A credit expansion this rapid almost always leads to a rise in bad loans and reduces the willingness of banks to lend—which is happening already for car loans.

The root of these problems is Brazil's dependence on the commodity boom. The country has experienced little increase in export volume, meaning that its increasing export revenues are coming largely from the rise in commodity prices. Although Brazil has been able to grow without developing a competitive industrial base, it remains one of the most closed nations among the emerging markets, and the fall of commodity prices, which is already under way, will leave it exposed. As O'Neil and Lapper point out, Brazil does have a rapidly expanding middle class. But the spending of that class is fueled by high commodity prices, and its contribution to Brazil's growth will likely shrink as commodity prices decline. And although inequality may have fallen, by international standards, it remains high, higher even than in China. This imbalance has bred class tensions: there is a reason why Brazil is one of the best places in the world to sell armored cars.

Long-term economic success depends on growth that is balanced across classes, regions, and industries, not biased toward the rich. Commodity bubbles produce exactly the opposite: high prices for staple goods harm the poorest members of society while building the fortunes of billionaires. The elite makes its money essentially by digging materials out of the ground, rather than by creating new services or companies that will continue to grow once the commodity boom passes. That is the bubble from which Brazil has benefited, and now it needs to get beyond it.

Fonte: Foreign affairs, New York, v. 91, n. 4, p. 159-166, July/ Aug. 2012.