Konrad-Adenauer-Stiftung e.V.

BRAZIL
KATHRIN ZELLER
GREGORY RYAN

TRANSLATED FROM THE GERMAN ORIGINAL BY MAIK LUDEWIG

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Too Big To Fail?

First highly praised, then almost derided. The coverage of the Brazilian economy changed within a few months from one extreme to another. Brazil's President Dilma Rousseff even believed the country to be targeted by doomsayers who wanted to diminish the hopes of the nation to progress. Meanwhile, the Deutsche Bank causes additional confusion by predicting higher potential economic growth than Brazil's own central bank. What does the country actually stand for? And what role will it play in the future?

In the last years, Brazil was considered a fast climber. Together with other emerging markets such as Russia, India and China, which ran shortly thereafter under the seal of BRICS, the new players should not just enter the world stage, but change it drastically. With growth rates of over 5 percent, by 2008 Brazil had already begun to meet expectations as a BRICS country and with the media-savvy President Lula da Silva visibly won presence on the world stage. The world economy, however, took particular notice that the country was not only the last to enter in the international crisis, but also one of the first to come out again. In 2009, as a high-flyer on the cover of The Economist, Brazil's economy was the new darling of international analysts. According to the magazine, the country had finally begun to use its full potential. With 7.5 percent growth, 2010 was an equally strong year for Brazil. The international press had only the highest praise for the country, all signs pointed towards success. The short climb to the fifth largest economy in the world earlier this year was seen with great satisfaction. The glory was only short-lived and after a few weeks the country slid back to sixth place. Already in 2012, the first doubts about the sustainability of the Brazilian growth had appeared. The Financial Times wrote about the “chicken flight” of the Brazilian economy that crashes right after take-off. While China continues to fly with the wings of a condor, in Brazil the stimuli to overcome the crisis are exhausted. According to the FT, the rising inflation and the increasingly expensive Brazilian Real led to a nosedive. While Brazil’s president Dilma Rousseff gives speeches about the international currency war that toggles the growth of Brazil, the Brazilian press began to analyze the deeper structural problems of the country.

Brazil gets into debt

Former president Lula’s call for consumption and numerous programs to overcome the economic crisis in 2009 were able to drive the domestic economy to an all-time high. The appeal to spend money might sound strange to the ears of German savers. But Brazil traditionally has a less distinctive saving behavior than Germany, and installment buying with up to 24 installments - even for smaller products like shoes or books - is relatively common. At the same time however the market for credit cards had expanded enormously and today half of all Brazilians own such a card. Millions of people who until recently lived below the poverty line started to finance flat screen TVs and mobile phones using long-term credits. What might have worked for a short time is currently forming into a serious threat for the solvency of private households. After the end of the crisis the stimulus policy of private demands was barely revised and some other programs for tax-reduced products such as refrigerators or cars, are still running. According to a survey by the National Confederation for the trade of goods, services

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and tourism (CNC), the percentage of indebted households has risen from 57.6 percent in July 2012 to 65.2 percent in July 2013. That means that a Brazilian family spends 29.2 percent of its income on the reduction of debts. The assumption that the domestic consumption cannot be maintained at the same level is confirmed by another survey of the CNC, which finds a decline in consumer intention to 4 percent.

Inflation as sword of Damocles

Measures to reduce the costs of loans were also taken. The Brazilian prime interest rate decreased from 12.25 percent in 2011 to 7.25 percent in 2012 and therefore hit an all-time low. During the 90s Brazil had to fight yet another hyperinflation and a prime interest rate of over 30 percent - once bitten, twice shy. While with the reduction of the interest rate a collective „finally“ made the rounds and the low was celebrated as a first step for the relief from a historical burden, some skeptics were cautious.

With the low interest rate policy the prioritization of the fight against inflation had been abandoned. Instead, the Brazilian Finance Minister Guido Mantega, as well as the President Dilma Rousseff, had (also with regards to the overrated Real) advertised for a reduction of the prime interest rate. The fact alone that both government representatives present the reduction as an explicit act of the government is, passingly mentioned, characteristic for the state of independence of the Brazilian central bank

With an inflation rate of up to 5.84 percent, the central bank met its target for the past year, though came dangerously close to the limit of 6.5 percent. And also in the current year, the value is still within the set inflation limit. Ironically this is due in part to the mass protests of the past July, which prevented many of the upcoming price increases e.g. the bus fares. Also the prices for electricity have recently been reduced through a subvention program. The increasing consumer annoyance does the rest. Nevertheless, the government has little legroom and inflation hovers like the sword of Damocles over the heads of the political decision-makers, who had announced adjustments for other areas as well. Thus, an increase in gasoline prices in favor of the semi-public company Petrobras is delayed for months. In addition, it is feared that the policy of the U.S. central bank FED and the rising dollar will pass the rise in prices through the control over foreign imports through to Brazil, and thus also could push inflation as well. Thereby, ultimately came the diversion and the government reoriented itself away from the currency war and towards an active fight against the risk of inflation. The prime rate has now been raised again and is currently at 8.5 percent. Since the president constantly stresses that during her tenure she provided the lowest prime rate in recent history, it is expected by experts that before the election 2014 everything feasible will be done to prevent double digits.

The Development Bank BNDES

In the meantime, large amounts of money flow into the market via detours around the central bank. The Brazilian development bank, BNDES, whose mission is the promotion of projects for development of the country, meanwhile allocates billions to corporations. According to the business newspaper *Valor Economico,* about two-thirds of the total budget in the last year alone went to corporations. If the funds of a bank are in short supply, it can, thanks to a special clause, supply itself with fresh money from the central bank. Among the beneficiaries are not only semi-state companies such as Petrobras, but also companies like Fiat or the airline Azul, which could also provide for themselves using the regular credit market. Last year, the bank had allocated a record sum of 50 billion euros and the marker could be topped this year. The bank's president, Luciano Coutinho, now no longer excludes the possibility that BNDES has to be recapitalized again in September by

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the central bank. Mansueto Almeida, an economist at the National Institute of Applied Economic Policy, IPEA, criticized at a debate at the Chamber of Deputies in August, the lack of transparency in the allocation of loans from the bank. Liabilities of the Bank were also delayed by the ongoing policy from the current to future governments. It was not least due to bad investments in companies that stayed without commercial success, that the bank listed 9.55 percent less profit in 2012 than in 2011. *Moody's* downgraded the bank last March from A3 to Baa2, since the condition of the bank had deteriorated in terms of their core capital. Overall, the usage of the Bank is symbolic for a kind of state capitalism, which has increased since the crisis became noticeable in 2009. After a phase of economic policy in the 1990s, that was created relatively close to the idea of a social market economy and privatized large parts of the economy, a big part of the population now believes that the state must now take the place of the out-of-hand capitalism. So, ultimately the government determines through the assignment of credit lines to companies their economic success. Political considerations rather than economic criteria very often dictate the decisions, making a rational allocation of the Brazilian resources almost impossible.

Investments with the left foot

After the consumption-based model of the recent years began to reach its limits, Finance Minister Mantega announced in April a new government program to mobilize 150 billion Euros of private investments into infrastructure projects. The Brazilian investment volume of 18.1 percent of the GDP lies in regional comparison clearly behind other countries such as Mexico or Colombia, with 20.7 percent and23.9 percent respectively. Compared to the other BRICS countries like India and China, with 29.9 percent and 46.1 percent respectively, the gap is even more distinctive. Auctions for projects such as ports, highways, projects for the production of oil, gas and electricity, as well as airports and rail lines will still take place this year. Mantega tackles an issue which *The Economist* in 2009 had been rated as critical. While other BRICS countries like China already implemented large infrastructure projects, the Brazilian infrastructure is still in an almost precarious state. Each year thousands of tons of grain are rotting on the fields and in warehouses because there is not enough transport capacity available in the ports. While politicians - in an attempt to stimulate the infrastructure with investments - aim in the right direction, the implementation is already showing difficulties. An auction for the construction of a high speed train between Rio de Janeiro and São Paulo has just been postponed because the government was afraid to win over only a single candidate for the concession. The fact often quoted in Brazil that around 350 million Euros are spent, even though the project is not implemented, is not considered scandalous. Rather, the fact that in a market economy a train whose route, according to the annual study of *Amadeus Air Traffic Travel Intelligence,* covers the third highest air traffic route, seems not to be attractive for investors, is very revealing.

In the World Bank survey "Doing Business", which annually creates a ranking for 183 countries and their environment for private companies, Brazil slipped this year two places down to 131st place, just ahead of countries such as Nigeria, ranked 131st or the West Bank and Gaza, ranked 135th. According to the survey, a company's founder must run through 13 different procedures before he is able to open his business after an average of 119 days. In a medium-sized company, the amount of hours for the payment of taxes alone accumulates to 2600 hours per year. In Germany, which ended up 72nd in the ranking, they accumulate to 207.

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The average growth trap

„And for the New Year I wish for a gigantic GDP growth“, said the Brazilian president after the New Year celebration. An appropriate wish after an increase of 0.9 percent in the past year, but her hopes seems to lead to disappointed again. In the preceding year, a growth rate of over 4 percent had been forecast but had to be adjusted downwards almost monthly. Already in May, Mantega explained that the economy is on a path that would lead to a GDP of 2.2 percent. In June, the Deutsche Bank had anticipated increments from the infrastructure package auctions, and even with the pessimistic attitude of Mantega, anticipated at least 3 or even 3.75 percent. But week after week the grey clouds gathered in the Brazilian incremental sky and also the devaluation of the Real also gives reason for concern.

However, despite the unused potential and many missed opportunities, Brazil is probably not at the edge of an economic crash. The real danger is much more that of an eternally mediocre growth. Barry Eichengreen of the University of Berkley said in *Valor Economico* this August that Brazil can avoid this risk by better channeling investments in education and infrastructure. The new investment program is a first step but may not be enough. Therefore, Markus Jäger of Deutsche Bank is pleading for a change of strategy: Brazil should orient itself on the Chinese savings and investment behavior, while the Chinese model should use more consumption to “brazilianize” itself. Eichengreen also sees one more Joker in Brazil’s hand, namely the investment card, which supplied China with double digits in economic growth. Theoretically, the Brazilian economy has good preconditions. However, examples such as the high speed train between Rio and Sao Paulo teach us caution towards too much optimism. The earliest moment for a realistic picture of the state of the Brazilian economy is the second half of 2014, when economic policy is no longer dominated by the election campaign of the president and the coalition.

Bleak prospects in the field of foreign trade

A recent World Bank report also casts an unfavorable light on the developments in the field of foreign trade. According to that report, the Brazilian export rate has grown only by 262% in the past decade, while the other BRICS countries India, Russia, South Africa and China were able to increase their export rate by 439%. Therefore, Brazil is among those rising economic powers which profited the least from the potential that foreign trade offers. It is not surprising that the report also discovers that Brazil’s trade integration in global economy, as measured by per capita income, is among the lowest in the world without any prospect of improvement. The trade in 2005 had amounted to around 29 percent of the total economic activity, and then fell in 2010 to 23 percent. Even more disturbing, however, is the development in the field of high-tech exports. According to the report, they fell remarkable in relation to the overall exports, from 10.4 percent in 2000 to 5 percent in 2010. In absolute numbers, the export rate had grown but only by a modest 36 percent. In the same period, high-tech exports in India expanded by 389 percent and in China by 873 percent. Like it did in the past, Brazil is running the risk to degenerate into a mere exporter of raw material and agricultural products, depending on a barely predictable raw material demand from countries like China. In the meantime, Brazil’s balance of trade is heading for a new record-low. Despite a bumper crop in farming, the country bought between January and July 3.75 billion euros more than it exported, the worst level since recording began in 1959. So far the government has explained this negative record with the impact of the crisis in the economy and bureaucratic reforms which delayed the recording of some data. Even though it can be assumed that the weak Real will reduce the demand for imports, analyst

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don't believe that this tendency will change considerably during the year. Altogether, the trend of Brazil's declining share in world trade continues. José Augusto de Castro, president of Brazil's international trade agency, AEB, already foresees another reduction to only 1.25% of the world trade. A special commission is now supposed to examine how Brazil could use its potential better. Castro is pointing at China, which is generating additional value to its national economy through the processing of raw materials. So far about half of the Brazilian export consists of unprocessed raw material. Even Germany generates with coffee as much money as the „coffee country" generates from the export of the raw unprocessed beans. With 4.7 billion euro in 2012, Brazil was only slightly ahead of Germany, which generated 4.3 billion euro with the re-export of roasted coffee.

Brazil and the planned EU-US free trade agreement

The intended EU-US free trade zone, which was announced by Barack Obama in his State of the Union address in 2013 hit Brazil like a bomb. Foreign minister Antonio Patriota said that Brazil would follow the development with the utmost attention. Everything to avoid an unfavorable position for the country would be done. However, a gloomy atmosphere was described by some economic commentators. Some fear the creation of an economic NATO that, by its sheer size, would impose technological standards to other nations. Others criticized the government itself, as it had hidden too long behind measures of protectionism. Besides that, the own free trade zone, the *Mercosul*, was gridlocked and insufficiently innovative; even constricting Brazil's position in the world. The most pressing concerns, however, are held by the industry associations, such as the national industry association, CRF. They fear that Brazil could lose significant market share and are urging the government to act immediately. During the last years Brazil had found itself in the comforting position of the successful country with incredible growth in international interest. The newfound prestige of a country that until then had been merely one of many emerging countries leads until today to an ambivalence in the rhetoric of the Brazilians. On the one hand, one likes to be treated as an equal partner and sees the claim for a seat in the Security Council as absolutely legitimate. On the other hand, however, claims from the traditional economic powers for the accountability of Brazil to international security or environmental policies are often dismissed as an absurd imposition, as the West still has to settle a historic debt towards the former Portuguese colony until Brazil has reached the same level of development. First steps towards a rapprochement between the two positions have been taken. As, for example, Brazil assumed leadership in the currently largest UN mission in Congo (DRC). In this sense, even the horror created by the free trade zone could show a healing effect if it really manages to shake up the country and stir it towards more self-initiative and participation in global trade.

Brazil's future role

Despite less positive aspects, neither the potential nor the significance of Brazil should be underestimated. Brazil has made great progress in the fight against poverty and hunger. Poverty and unemployment have fallen to unprecedented low levels since the beginning of the 21th century. In addition, the per capita income increased by 27% from 2003 to 2011, while in the same period, the Gini coefficient, an index that measures inequality, has fallen from 0.55 to 0.50. These developments grant more credibility and, with that, the so called "Soft Power" towards other countries. Brazil's political weight as a popular figurehead of the BRICS group is now greater than ever, due to its function as an informal voice of both the Latin American continent and the Group of 77, a loose coalition of mainly developing countries, as well as by its success in the so-called South-South development cooperation.

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Because the fears that the BRICS countries would replace the old powers of the West are nowadays hardly sustainable, the opportunities for cooperation with this group, which includes 40 percent of mankind, should in fact be used. Brazil has enormous design potential within the international institutional structure, both as a direct partner, as well as a bridge to the countries of the South. Especially for Europe, the power of this country, which is the 6th largest democracy in the world, is essential!

However, the economic aspirations of Brazil continue to fall behind the political aspirations. Brazil's economic history is a succession of untapped opportunities and a picture of almost lethargic waiting and resting on a natural wealth, which has never made the need for serious and long-term development policy a necessity for survival. Nevertheless, despite all the hurdles, this country offers many opportunities as a growing market. Last year, Brazil climbed to fourth place within the countries with the most foreign direct investment. The volume of trade between Europe and the BRICS countries exceeds with 26.5 percent of the total EU trade already the trade with NAFTA, the merger of the U.S., Mexico and Canada, which stood at 17.4 percent for the year 2012. The EU also remains the main trading partner of the country. Brazil, the sixth largest economy in the world, is in the end still systemically important, *too big to fail* – simply too big to be allowed to fail.

This