Brazil in the Current Environment: Will the Tropical Social Democracy Sustain the Momentum?

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In the last decade or so, an unusual commodity boom took place with interest rates decoupling from commodity prices and more recently commodity prices from the economic cycle of advanced economies. If historically interest rates, prices and global output moved together, the rise of China, India and other Asian commodity-dependant economies seem to be responsible for a new type of commodity super cycle taking place despite the difficulties of advanced economies to regain traction and move toward economic recovery. Although commodity prices are not indifferent to the current crisis, and short-term price movements do respond to spikes of risk aversion as observed during September, a combination of supply constraints and rising incomes in emerging and developing economies is putting sustained pressure on prices and it would take a major recession for a "shift down" in this long-term trend. Clearly a lot will depend on the growth prospects of China and other emerging economies. If trend deceleration becomes a fact and China's long-term growth peters down to 5 percent, the decoupling proposition loses strength. However, the view espoused here is that high commodity prices are here to stay in the foreseeable future.

One major implication of this phenomenon has been the boost to economic growth for low and middle-income countries with significant natural resource endowments—mainly countries in Latin America and sub-Saharan Africa. Those countries with fairly solid economic policies have benefitted the most by ensuring that the shift in the terms of trade and major income gains did not translate into price inflation; and the needed import space was occupied by a combination of consumption and investment goods necessary to sustain the growth momentum. Government finances also gained from the "boom", not only by growth-induced increases in tax receipts but from a change in the power balance between commodity producing firms and governments, with the latter bent on capturing a larger proportion of economic rents and improving their fiscal position. It seems that over the longer term, the consequences of the current commodity super cycle will have greater significance than the economic and political shifts propitiated by the 1973 oil shock and the rise of OPEC, for income gains are now more widespread and do not depend on a cartel arrangement but on structural factors linked to the fundamentals of supply and demand.

Among the large emerging economies, arguably Brazil has benefitted the most from the rise of China and other commodity-importing nations. After decades of facing growth arresting balance-of-payments constraints, Brazil´s external position is now a far cry from the past. Buttressed by $352 billion in international reserves, the external sector as a barrier to growth became an effective non-issue: a total trade flow of $456.5 billion generated a positive trade balance of $28.7 billion (over a 12-month period); a current account deficit of 2.1 percent of GDP is being over-financed by foreign direct investment flows equivalent to 2.4 percent of GDP; and total external debt at $297.1 billion implies a debt service ratio of 2.3 percent of GDP (versus 10.9 percent in 2002, when the reserves-debt ratio was a mere 18 percent). Although credit default swap spreads nearly doubled from December 2010 to end September 2011 (111 to 202 bps), they are still significantly under the average for emerging economies (370 bps), while the last time the country issued a sovereign debt instrument it paid 105 bps over Treasury bonds of same maturity.

The commodity cycle was relevant to the relatively solid fiscal position, by lifting profits and the wages in agribusiness, mining and energy, with positive spillovers across construction, manufacturing and services. The rise in taxation (which now amounts to 35.3 percent of GDP) mostly from an increase in taxable income in the formal economy and a reasonable degree of fiscal discipline (budget surplus before interest payments stands at 3.2 percent of GDP) brought the public sector deficit to 1.9 percent of GDP in July 2011 and net debt to an estimated 38.5 percent at the end 2011 (with gross debt at 60 percent of GDP).

With a little bit of luck, a modicum of prudence and competent macroeconomic management, Brazil avoided the squandering of resources and put them to good use overall.

On the domestic front, a new set of social policies providing cash transfer to the poor, the elderly and the disabled came to maturity. In the last decade, increasingly well targeted programs not only reduced poverty and income inequality but injected a measure of economic dynamism in poor and depressed areas in Brazil. Other growth inducing forces were at work and included an excess demand for labor at the bottom of the pyramid, centered on services, commerce and the housing industry, which sanctioned policy that brought minimum wage in line with perceived minimum consumption requirements. A proactive stance on labor rights also pushed employers to formalize relations, pay taxes and bring the working poor under the social security umbrella that was previously denied.

For Brazil, the numbers speak for themselves: in every single year since 2001 the Gini coefficient has decreased (at 0.53, it is still very high when compared to 0.36 for India and 0.42 for the U.S.); poverty rates have gone down during the period from 35.2 to 21.4 percent of the population by 2009, with extreme poverty being more than halved (15.3 to 7.3 percent)—12 million people have been lifted out of extreme poverty and 19.3 million have been lifted above the poverty line. From 2003 to 2011, 37.5 million people made the transition away from poverty into the middle class, which now makes up 55 percent of the population and 47 percent of purchasing power.

Rising domestic consumption was fueled as well by credit from a conservative, capitalized banking industry. In recent years, leveraged by low nominal and real interest rates (by historical standards), limited family debts and rising real wages, consumer and mortgage credit expanded to match a pent up demand for durables, vehicles and housing. In 2011, the ratio of total credit to GDP will reach 49 percent with a still low mortgage debt/GDP ratio of about 4 percent. This suggests that credit markets will continue to fuel domestic demand and therefore output growth and imports. With the current account deficit checked by the commodity driven export dynamism, Brazil might for the first time in decades be on a path for sustained growth at trend rates of 4 to 5 percent. While modest by Asian standards, this level of growth is high considering the record of the last three decades, that it is supported by a low investment rate (currently at 18.4 percent of GDP), and it is driven by consumption on the demand side and on the supply side by the service industries, which now account for two-thirds of the economy.

Brazil's positive economic record can actually be traced to two decades of reforms, which strengthened the basic institutions of economic management and improved the quality of policies. Helped by a more open economy, and having for reference a number of frustrated stabilization attempts, the 1994 Real Stabilization Plan was implemented in the context of effective institutions, including a highly regarded central bank and a ministry of finance well versed on debt management and the complexity of inflation dynamics. Monetary reform led to a quantum jump away from hyperinflations. And fiscal reform culminated in 2001 with a strict law of fiscal responsibility, which threatened with civil sanctions and criminal penalties public officers unwilling to follow the guidelines of prudent fiscal management. It is worth stressing that denied a generous inflation tax on demand deposits, over-branched and undercapitalized banks had to adjust, restructure and dispose of assets at a fiscal cost of less than 2.5 percent of GDP and thus with limited impact on public debt.

The other side of the silent revolution that Brazil underwent for the last two decades resulted from microeconomic reforms. Privatization, despite some misgivings, was a far cry from anything resembling a giveaway or the transfer of assets to a new economic clique. A competitive process raised resources and a significant chunk of public debt was transferred to the new owners. Initially, the fiscal imperative was dominant. However, following the examples of the United Kingdom, New Zealand and Chile, the promotion of entry and competition, and tracking of contractual obligations required regulatory oversight by newly constituted agencies. Some were more successful than others, but generally privatization and the opening to competitive rivalry injected dynamism, efficiency and promoted the modernization in sectors such as mining and metals, oil and gas, as well as in infrastructure.

Brazil's Workers Party government which took office in 2003 had some misgivings about privatization and doubts about the mandate of the agencies, but a reversal never took place. Moreover, a new agenda of reforms was initiated centered on the enhancement of credit markets which dovetailed with gains in real incomes starting in 2004 and pushed out the consumption envelope. Improvements in family incomes were propitiated by a combination of a rise in labor demand and increases in minimum wages often in excess of inflation and productivity. Yet overall these were consistent with labor market conditions and did not introduce major distortions.

Brazil does not stand out on the basis of its growth record, which since 2003 has been moderate at an annual average rate of 4 percent; nor even in terms of poverty reduction. Other countries have achieved faster economic growth and a number have been able to reduce poverty rates in significant ways—but more often than not at a cost of rising inequality, social tensions and political exclusion. It is the combination of growth, poverty reduction *and* lowering inequality in Brazil that raised eyebrows. It is also the fact that this was achieved in a broadly non-acrimonious atmosphere, with a de facto (implicit) compact expressing a convergence of views on the fundamentals of what constitutes economic and social progress. Political radicalism, religious sectarianism, and social Darwinism find little solace in Brazil. The ethos of moderation prevails in politics and religion, and a sense that the weakest segments of society have to be protected in a Rawlsian perspective on distributive justice —being the government's obligation to extend the umbrella—suggests that Brazil embraced a tropical version of social democracy.

The Brazilian *model* of growth-cum-redistribution and political accommodation is a product of the country's 1988 Constitution, which enshrined the notion of economic rights enforced for the disenfranchised, the elderly, the unemployed (and not only) by the state. It comes with some distortions —mostly in the pensions and unemployment insurance regime—and at a cost. Domestically, its financing requires steep and creeping taxation of economic activities; externally, the country needs a benign environment and a voracious China and other commodity hungry countries. Thus, Brazil is not impervious to the current crisis and authorities are quite concerned to say the least. They join the chorus of voices asking for determined action above all from European leaders, political institutions and the *troika* to act in the coming days and weeks. And they should move before the Greek drama spills over to a banking crisis and pushes the world to revisit the Great Recession, which it may *not* emerge from in the next two to three years.

In fact, Brazil has been a critic of the measures taken by the U.S. and Europe to deal with the recession. In an inversion of roles—denoting how the world has changed in less than two decades —it chastised politicians and policymakers from advanced economies for the fact that not enough has been done on financial reform; that banks "too large to fail" paid a light price for irresponsible behavior and therefore are bound to repeat it; that "quantitative easing" and similar initiatives brought about an exchange rate war, imposing the need for policy reversal in countries which had not actively managed exchange rates and had relatively open capital accounts; and that the larger and more solid European economies should be leading the way in shoring up the finances of the European periphery, even at the expense of political dogmas and conservative economic credo.

The perception of how deep the crisis is has changed in recent days and weeks. The symptoms abound: the divisions within Europe and an apparent absence of political urgency combined with a lack of a clear path out of the financial and fiscal mess; the last actions by the Federal Reserve and a sense that Ben Bernanke's "bag of tricks" is now empty, and political opposition to activism by the Fed is on the rise; and the appearance that President Obama is unable to communicate a strategy, galvanize his people and lead the U.S. out of the crisis, yet continuously surprised by the complexity and magnitude of economic problems the U.S. and the world face.

Brazilian policymakers and many of their counterparts are now pondering what the optimal defensive strategy is in view of the uncertainty clouding the world economy.

There are a number of channels through which low growth in advanced economies, or worse a new recession and a banking crisis, would affect the Brazilian economy. First and foremost, through credit and capital markets, as the last quarter of 2008 clearly demonstrated; second, from diminishing demand and lower prices for Brazilian exports from its major trading partners, with the looming danger posed by beggar-thy-neighbor policies.

The core objective of Brazilian policymakers is to ensure growth in the 3-4 percent range this year and possibly the next, while maintaining inflation in check (that is, below 6.5 percent, the upper band of the central bank´s target). Currently inflation is running at 7.3 percent on an annual basis. The most dramatic action undertaken by the Brazilian government was to change the policy mix: tightening fiscal policy while lowering interest rates from 12.5 to 12 percent on August 31. Nonetheless, with real rates close to 5 percent, it still contrasts with quasi zero real rates in India, China, Russia and Japan, and negative rates in the U.S., the U.K. and the euro area.

For Brazil's central bank, this was a bold move. Historically, real interest rates have been maintained at very high levels to ensure macroeconomic stability in view of the persistence of inflation, with economists unable to agree why that is so and such high rates are indeed needed.

Be as it may, the Brazilian central bank reassessed the balance of the risks, and loosened monetary policy despite inflationary pressures. It is taking a "calculated risk". In this regard it is not alone; on September 26, the Bank of Israel lowered rates to 3 percent despite 12-month inflation running at 3.4 percent (outside the 1-3 percent band). Stanley Fischer and his colleagues seem to be saying that at this juncture the inflation risk has been dominated by that of recession.

If the crisis looms, it has yet to hit the shores of Brazil. So far, credit markets in Brazil are functioning normally and well irrigated with resources; domestic banks are capitalized, not afraid of lending and borrowers are repaying on time; and lower interest rates will be a prop to both consumers and firms in the coming months. At the same time, the government seems to be increasingly bent on protecting industry from the combination of exchange rate appreciation and an import surge which has firms pondering if the most trade exposed manufacturing segments will survive in the coming years. Low-rate financing, tax incentives and more recently a de facto tariff barrier targeted on (basically Asian) automotive imports outside Mercosur, seems to be the wrong response to low savings, investment and productivity.

Indeed the Brazilian redistributive *model* of a consumption-driven economy has so far thrived on the back of a diversified, large and efficient natural resources sector, despite the shortcomings associated with low rates of investment in *collective* goods or those commanding large growth-inducing externalities, such as infrastructure or quality basic education. Therefore, one would not expect the country to significantly alter its economic trajectory in the coming years but to sustain moderate growth rates with reduced inequality levels and extreme poverty becoming a residual phenomenon, through a combination of market forces and government entitlements, and converging toward a middle class society characterized by a reasonable degree of social and economic mobility.

How long will this last? There is an undercurrent of demographic and economic forces that will no doubt challenge the fundamentals of the *model* in the coming years. Brazil is enjoying a demographic bonus that should peak at the beginning of the next decade and rapidly change the age structure of the population thereafter, as fecundity rates collapsed from 2.8 to 1.9 children per woman in 1990-2010. The population will get older, taxing the resources, straining the government´s fiscal position in the face of society's diminishing willingness to continue to pay for an expensive and relatively inefficient public sector. This will also happen at a time that the commodity bounty may be over as China and other emerging economies mature. At the same time, Brazil is not taking advantage of its current generous demographics. At the current exchange rate, and after a 16 percent devaluation in September, unit labor costs are still three times as high in Brazil than in China, while labor productivity in the last decade increased respectively by 0.4 percent and 5.2 percent annually. Large tracts of the Brazilian heterogeneous economy can be characterized by high cost and low productivity.

Both phenomena are intertwined: demographic and economic trends point to the necessity of social security and related reforms in the Brazilian government´s transfer programs, which simultaneously reallocate resources toward investments in infrastructure, human capital and other productivity enhancing factors while establishing the basis for a long-term increase in government and private savings. In this context, major improvements are due in the efficiency and quality of government services, the delivery of which is marred by bureaucracy, waste and corruption. Yet, despite the wish of many in government, the functioning of the political system conspires against significant reform initiatives so long as the sense of accomplishment and self satisfaction prevails.

What is being suggested here is that the imperative of reforms and structural change to enhance productivity—the only guarantee for sustained growth over the longer term—could in the Brazilian case possibly be postponed beyond this decade. For the next few years, Brazil should benefit from a combination of resource abundance on the supply side and a growing middle class with unsatisfied consumption aspirations providing dynamism to the domestic market as long as demand and prices for agricultural, mineral and energy commodities hold firm. Other emerging and developing economies may not have the same choice. But it is unlikely that Brazil will confront its fundamental weaknesses other than through incremental changes, as long as a generous resource endowment can continue to finance private and government consumption and investors continue to bet on the country's future.