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Brazil in 2011: Growing Pains

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The economic wave that fanned Brazil with a decade of growth crested in 2010. Would 2011 feature Brazil riding gracefully toward the shore of advanced development, or awkwardly taking a splash? The economic law of convergence suggests the former, but history – Brazil's history, in particular – attests that the latter can't be written off.

On 1 January 2011 Dilma Rousseff was sworn into office as Brazil's president. Aware that her standing owed to the good graces of her predecessor, Lula da Silva, she pledged to continue his policies. She inherited a government of skilled technocrats warily eyeing inflation and ready to champion Palestinian independence, harvest offshore oil, and prepare for the upcoming Olympic games and World Cup.

Unexpectedly high growth gave her presidency an initial momentum boost. Finance Minister Guido Mantega formally announced that the economy grew 7.5% in 2010, the highest rate of annual growth since 1986. Based on that figure, Brazil passed Italy and Canada to become the world's seventh largest economy. At the time, Mantega forecast a palatable slowdown to 5.5% growth in 2011, which would allow policymakers the opportunity to get ahead of surging consumer credit and inflation, as well as address other signs of unbalanced growth.

By June a slowdown in the global economy was well underway. Brazil's economy, which has relied on commodity exports to China and surging consumer credit for years, appeared to be extremely vulnerable. The *Economist* magazine set out to compile an "emerging markets overheating index", cobbled together from a handful of steroidal growth symptoms. Argentina received the dubious title of the world's "most overheated economy"; Brazil finished second.[1]

Inflation is a big part of Brazil's problem. Tired and weary from battling the country's economic bugaboo, in early 2012 the central bank declared that inflation in 2011 was 6.5%, and therefore the inflation target was "hit for the eighth consecutive year". Few people should take solace: the longstanding inflation target is 4.5%, with a two-point band; hence, any upward revision would mean that inflation in 2011 exceeded the target, band and all. Furthermore, 6.5% is the highest rate of annual inflation since 2004. Most importantly, inflationary pressures in Brazil are mounting just as growth is slowing.

By November 2011, economic growth had slowed to a turtle stroll. The GDP numbers are 2.1% annualized growth in the third quarter.[2] Not only was that figure well below the growth forecast at the beginning of the year, it was significantly below revised forecasts made just a month before the numbers were released. In all likelihood Mexico's economy grew faster than Brazil's in 2011, the first time that's happened in a decade.

Abroad, Dilma gently pivoted away from the foreign policy of the Lula era. Lula devoted his second term to reaching out to other parts of the developing world by building embassies in Africa, massively expanding developmental aid to poorer countries, often through the Brazilian National Development Bank (BNDES), and by trying to forge close ties with other rising powers. For the most part this bequeathed Dilma a handy bit of international goodwill. And with regard to Africa and poverty alleviation she has wisely kept to Lula's path.

However, Lula showed poor judgment by glad handing President Mahmoud Ahmadinejad of Iran and Prime Minister Recep Tayyip Erdogan of Turkey. In recent years both governments have trampled human rights, especially Iran. Elevated by Lula to the status of "new geopolitical partner" in 2009, the *New York Times* retrospectively referred to Brazil's relations with Iran as a "blot" on Lula's "otherwise enviable legacy".[3] For her part, Dilma has occasionally criticized Iran for human rights abuses and played down ties to Turkey. The fact that Iranian President Mahmoud Ahmadinejad didn't visit Brazil during his

1 "Some Like It Hot" (*The Economist*, June 30, 2011).

2 Jeff Fick, "Brazil Growth Slows to a Crawl in 3rd Quarter" (*The Wall Street Journal*, 6 December 2011).

3 William Neuman and Simon Romero, "Increasingly Isolated, Iranian Leader Set to Visit Allies in Latin America" (*The New York Times*, 7 January 2012).

four-day trip to Latin America in January 2012 attests to Dilma's success in cutting ties with Iran.

In tandem, Rousseff and Itamaraty, Brazil's polished Foreign Ministry, sought to play a greater role in the advancement of Palestinian statehood. With 28 days left in office, Lula recognized Palestine as an independent state along Israel's pre-1967 borders. In short order, Argentina, Bolivia, and Ecuador followed suit. Uruguay, Chile and Guyana also recognized Palestine as an independent state in January 2011.

Dilma's Brazil may be the biggest national champion of Palestinian statehood. Brazil gave a block of land for the construction of a Palestinian embassy in Brasília. Speaking before the UN General Assembly, Rousseff said, "only a free Palestine can address Israel's security concerns".[4] Brazil has subsequently backed moves by the Palestinian delegation to gain UN recognition as a nation-state.

Though I've argued elsewhere that Brazil's advocacy of Palestinian statehood is partly an effort to save face in the Middle East after getting too cozy with Iran,[5] it could be that Brazil's plans to champion a Palestinian state were whole-heartedly a matter of seeking international justice for an aggrieved nation without a state. Regardless of the intentions, the outcome was more anti-climactic than had been expected. Global events overtook coordinated diplomacy. In terms of the Middle East, the Arab Spring became the cause of democracy and human rights in 2011.

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A spectacle of corruption

As Rousseff gained confidence in office, she tested waters diligently avoided by Lula. Her most publicized domestic undertaking in 2011 was an attempt to bleach corruption from government ranks in what has come to be known as the *faxina*, or house cleaning. From June to November six cabinet heads were sent packing because of corruption. One minister went down for paying a maid with public money; another was simultaneously drawing two government salaries; other cases stemmed from kickbacks in return for funneling government contracts to friends.

Meanwhile, over 100 senior bureaucrats from the ministries of tourism, defense, and agriculture were sacked or arrested on corruption-related charges.

Fact is, corruption dogs Brazil. In its 2011 Corruption Perceptions Index – which bestows Brazil the middling rank of 73 out of 182 – Transparency International chides Brazil for cronyism. The total amount stolen from taxpayers each year ranges between 2% and 5% of Brazil's GDP, depending on which authority is asked. Mathew Taylor, a political scientist at American University's School of International Service, points out that even by the conservative estimate the sum (US$50 billion) is six times the amount devoted to Brazil's feted *Bolsa Família* program.[6]

Who could quarrel with a crackdown on corruption? Rousseff's coalition partners, evidently. The Party of the Republic left Rousseff's coalition after its most executive member, the Transportation Minister, was sent packing. No big loss there, but in August the PMDB – the Brazilian Democratic Movement Party, the biggest partner to Rousseff's Worker's Party government – threatened to also march out if the dismissals continued.

With the PMDB in uproar and analyst's forecasting serious injury from the "wasp's nest" that the president kicked and kicked again, Rousseff backpedaled. On 24 August she said that no more ministers would be fired. In support of her efforts, on 7 September a "March Against Corruption" rally was held. Her popularity has remained high throughout the affair, though some commentators point to low turnout at the corruption rally.

In hindsight, what's more clear than the effect of the faxina on Rousseff's popularity is that her claim to stop firing ministers marked only the end of the beginning of the purge. In early December, Labor Minister Carlo Lupi resigned amid charges of corruption, becoming the seventh cabinet minister to leave office in 2011.[7]

A majority of the remaining ministers are now under investigation for corruption, and at least two could be booted from office in the early months of 2012.

4 "Brazil's President Dilma Rousseff urges reform at UN" (*BBC News*, 22 September 2011).

5 Sean Goforth, "Brazil's Middle East Roadmap" (*World Politics Review*, 20 January 2011).

6 Matthew Taylor, "For Brazil's Rousseff, Uprooting Corruption No Easy Task" (*World Politics Review*, 10 January 2012).

7 Helena de Moura, "Brazil's labor minister quits amid allegations of corruption" (*CNN*, 4 December 2011).

An economy in overdrive

With low benchmark interest rates in the United States and China's economy largely cordoned off to foreign capital investment, Brazil's fast growing economy made it a haven for outside investors seeking high returns. Hence, Brazil's currency, the real, spent most of 2011 horribly overvalued.

In this setting, Brazil's relations with China and the United States took on a different hue. Whereas Lula practiced a soft but consistent anti-Americanism, positioning Brazil, in the words of Julia Sweig at the Council on Foreign Relations, as "the Mac to the United States' PC",[8] Dilma tried to triangulate foreign relations between Beijing and Washington.

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As if Brazilian recriminations might succeed where American and European recriminations seemingly failed, President Rousseff, Mantega and Trade Minister Fernando Pimentel variously warned that a "global trade war" was at hand in 2011, each official strongly implying that China's manipulated currency would trigger the impending doom. They also chided the US Federal Reserve for its policy of quantitative easing known as QE2. And as post-tsunami Japan sought to prop up its battered export industries by intervening in the currency market to weaken the yen, Brazil quibbled about Tokyo, too.

In June, the real hovered at a 12-year high against the greenback, up 60% since 2009. To stay ahead of the problem, the central bank increased the benchmark-lending rate to 12.25% in mid-July; Goldman Sachs forecast an increase to 13.25% by year's end. Someone's prayers were answered, as the real soon lost value. But the change wasn't discreet. A resurgent Eurozone debt crisis spooked investors, who reallocated their investment to the global safe haven of US debt. Said Hideaki Iha, a currency trader at *Fair Corretora de Câmbio e Valores*, "with the danger out there, nobody wants to buy the real".[9] The currency sold-off, losing 15% of its value against the dollar in September.

Global factors began to weigh on Brazil. Based on the drop in the real and signs that Europe's debt crisis was nowhere near an end, Brazil's central bank cut benchmark interest rates. The monetary *volte-face* only stoked worries. "Cutting interest rates, screwing around with currency measures – the fact these measures are coming at a time when markets are really, really nervous about the world – I think it's magnified it", said Win Thin, global head of emerging markets currency strategy at Brown Brother Harriman & Co. in New York.[10]

Adding to the sense of vulnerability, when investors started eyeing the quick deterioration of Brazil's currency they soon seized on another, much more fundamental problem: Brazil's economy relies on Chinese demand. Trade with China accounts for 17% of Brazil's GDP. Consequently, if China's growth rate unexpectedly slows, then Brazil would be hurt; and if global commodity prices dropped, Brazil would suffer another blow.

Improved relations with the United States formed the silver lining of Brazil's lack of progress in cajoling China. US Treasury Secretary Timothy Geithner visited Rousseff in Brazil in the weeks before Rousseff embarked on an April visit to Beijing, setting the stage for greater cooperation between the hemisphere's largest economies. President Obama has also said the US will be happy to buy Brazilian oil when the pre-sal fields enter production. And on 31 December, the United States dropped its tariff on Brazilian ethanol.

Crude & sweet

On the energy front, 2011 appeared to be a blip in what is likely Brazil's rise to the top echelon of world energy producers. In 2007, Petrobras, Brazil's state-owned energy company, found enormous hydrocarbon deposits deep under the seafloor off Brazil's coast. If Petrobras meets its recovery forecasts at the so-called Tupi field, Brazil will be producing 5.4 million barrels of oil per day by 2020, perhaps making it the fifth-largest oil producer in the world. (Incidentally, if Brazil's economic growth continues at a steady pace it will also probably be the world's fifth-largest economy by that time.)

Since discovery, Lula has been only the most prominent of the many voices to proclaim Tupi as a sign that God is, indeed, a Brazilian. However, the message of providence is far from clear, the oil is yet to be recovered, and in the meantime the prospective bonanza is presenting economic and political challenges that Brazil has little experience in negotiating.

For one, as the significance of the Tupi pre-sal fields – the oil lies under as much as 2,000 meters of packed salt at the bottom of the seafloor – have become clearer to most

8 Julia Sweig, "A New Global Power: Brazil's Far-Flung Agenda" (*Foreign Affairs*, Vol. 89, No. 6, November/December 2010), pp. 173-184.

9 Josue Leonel and Gabrielle Coppola, "Brazil Real Drops to Seven-Week Low on Slowing China Manufacturing Growth" (*Bloomberg*, 23 November 2011).

10 Ye Xie and Josue Leonel, "Brazilian Real Hits 16-Month Low, Extends Month's Drop to 15% on Rate Cut" (*Bloomberg*, 21 September 2011).

Brazilians, squabbles are growing about how to spend the oil revenue. This is to be expected. Responding to demands to spread the future oil wealth widely, President Rousseff has pledged to use proceeds from oil sales to improve education, healthcare, and infrastructure. Petrobras, which projects to spend US$32 billion to recover the oil, is also counting on a good hunk of the proceeds.

Second, Brazil's interest in oil is spiking just as other countries are looking to alternatives forms of energy. Brazilian cane farmers naturally celebrated their newfound market access to the world's largest energy consumer when the US dropped its US$0.53 a gallon tariff on Brazilian ethanol. Along with subsidy cuts to its own corn-based ethanol producers, the move by the US government lays the way for the two countries – which combine for 80% of the world's ethanol production – to trade the fuel at market prices. Yet the tariff's demise only serves to a highlight a recent trend that bodes poorly for Brazil – growing ethanol imports.

In 2011, Brazil imported a record 1.1 billion liters of ethanol, almost all of it from the US. As is typically the case when a major producer country becomes a net importer of the good for which it has global renown, government policy is to blame. According to André Nassar of ICONE, a Brazilian research institute, the government has toyed with domestic fuel prices in recent years;[11] part of this tinkering included an effort to fight inflation by making Petrobras cap ethanol prices. To some degree, this discouraged investment in ethanol. Add to that, as the *Economist* points out, the Rousseff government cut taxes on gas, but not ethanol. The result? Last year 150 million tons of mill capacity reserved for ethanol production in Brazil went unused.[12]

Third, foreign investors are also eyeing Brazil's bonanza, and their money has flooded into the country in recent years, pushing up the value of the real. In other countries, energy windfalls have begot pell-mell development: foreign cash floods into the energy sector and bypasses other industries. Known as Dutch disease, this blessing becomes a bane, which can ravage a country's industrial base, create greater reliance on commodity exports, and stoke inflation. Brazilian technocrats are no doubt aware of this pitfall, but they've been helpless to check the rise of the real.

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Brazilian industry has been hurt as result. Siemens, a high-tech German firm, told the *Financial Times* in 2011 that the overvalued real was "crushing" the company's export business in Brazil.[13] Anecdotes like these speak to a major symptom of Dutch disease. A decade ago, raw materials accounted for 29% of Brazil's exports, now they account for 41% of exports. Commodities have taken place of manufactured exports. Given these factors, the politics surrounding Brazil's gas reserves will get tricky in 2012, and, in all likelihood, the challenges will linger throughout much of the decade.

All this presumes, of course, that there are no major leaks or explosions, in which case Petrobras's careful recovery projections are out the window. Petrobras is a serious student of the Deepwater Horizon disaster that occurred in the Gulf of Mexico in the summer of 2010. Even so, Brazil's pre-sal sites lie 250 km off the country's coast, and buried more than 7,000 meters below the sea surface, presenting an enormous technical challenge. Robert Bea, a contract engineer who does risk assessment for Petrobras and who has carefully studied the BP disaster, told the *Washington Post* that Tupi is "the tyranny of depth and darkness".[14]

Unfortunately, accidents happen. In November 2011, a leak at the Frade field operated by Chevron, spilled 3,000 barrels of oil into the ocean. While it is a small amount for a rig spill, and doesn't stand comparison with damage done from the Deepwater Horizon, the Frade spill flustered Brazil's regulators. Chevron has been fined US$28 million by Brazil's environment regulator and it may lose its license to operate, but the company also stopped the remote leak within four days.

11 Cited in "Brazilian Brew" (*The Economist*, 7 January 2012).

12 Ibid.

13 "The New Trade Routes: Latin America" (*Financial Times*, 26 April 2011).

14 Juan Forero, "Brazil faces 'tyranny of depth and darkness' in drilling for deep-sea oil" (*The Washington Post*, 8 December 2011).

Mexico's resurgence

In the first decade of the twenty-first century Brazil broke through Latin America's traditional spheres of influence, first by establishing dominance over Argentina, and later Venezuela. By 2009, when Honduras's Chávez-leaning president Manuel Zelaya was deposed, Brazil's role in arbitrating the crisis testified to Brasilia's dominance up to Central America, isolating Mexico in its own backyard. The last regional competitor had been chastened. But even before, Brazil had lost interest in merely regional affairs; from Lula down to mid-level businessmen, Brazil's wanderlust drew toward the 'BRIC'.

However, in 2011 Mexico resurfaced as a challenger to Brazilian influence over the region. Perhaps to a small degree this owes to South American worries about Brazilian hegemony – as one diplomat put it, "the new imperialists have arrived, and they speak Portuguese".[15] Colombian and Peruvian statesmen have directly called for a Mexican 'balancer' to Brazilian hegemony.

To a larger degree though, Mexican participation in South American affairs is harkened because Mexico is an ardent free trader. In April 2011 Peru's outgoing President Alan García said Mexico's "presence in the South American region is going to have revitalizing effects".[16] The hope of García and others is that Mexico's aegis will enable Latin America's Pacific states like Chile, Colombia and Peru to integrate into a trade bloc with economies of scale sufficient to export their manufactured goods to Asia and the United States. Brazil can't match Mexico's free trade record.

Moreover, given Brazil's economic reliance on commodity exports to China and the ho-hum results of Brazil's attempt to build international pressure against the undervalued yuan, Brazil has a weak record of standing up to China. Mexico offers more hope to Latin American countries fearful of China's trade agenda: not only is Mexico an industrial powerhouse, avoiding the trend toward de-industrialization that has gripped Brazil in the past decade, but Mexico has launched more cases against China before the World Trade Organization than the rest of Latin America combined. In short, Mexico's pattern of economic development is more appealing to market-oriented countries in South America than Brazil's.

President Rousseff's efforts to clean house are less impressive than her defenders might claim. Whatever credit one wants to give to Dilma's house cleaning, it must be balanced against the likelihood that corruption may actually worsen as Brazil looks to doll out billions of dollars in infrastructure contracts to ready for the upcoming Olympics and World Cup.

Rousseff the reformer?

Review articles like this one occasionally benefit from executive forecasts. In an article for the *Economist*'s "The World in 2012", President Rousseff argues for "the Brazilian model" to be emulated by other developing countries. The essay rightly emphasizes Brazil's record in poverty alleviation and environmental issues. At times though, she sounds off cue. For example, she writes: "we should all strive to raise wages in line with productivity, so that the recovery benefits the middle classes in rich economies and allows hundreds of millions of people to get out of poverty in developing ones. The market alone does not improve income distribution. Government action is needed".[17]

This bit of advice is inflated, and inflationary. Productivity in Brazil is woeful. According to a study by the McKinsey Global Institute, worker productivity increased 0.3% annually from 1995 to 2005.[18] Absent productivity growth, Brazil's economy has been powered in recent years only by massive commodity exports. To square the advice with the model, Rousseff is offering to stoke inflation in other parts of the world that rely on commodities.

In the domestic sphere, President Rousseff's efforts to clean house are less impressive than her defenders might claim. The scandals that brought down her ministers in 2011 were not linked. In each case, Brazilian media exposed the corrupt official, not Rousseff's office. Perhaps the Clean Slate Law (proposed in 2009) offers some hope for change in 2012: it would bar politicians from running for office if an appellate court upholds a corruption conviction against them. However, whatever credit one wants to give to Dilma's house cleaning and the CLS – still under review by Brazil's supreme court – it must

15 Russell Crandall, "The Post-American Hemisphere: Power and Politics in an Autonomous Latin America" (*Foreign Affairs*, Vol. 90, No. 3, May/June 2011), p. 89.

16 "Peru, Mexico sign trade deal" (*Fox News Latino*, 6 April 2011).

17 Dilma Rousseff, "The Brazilian model" (*The World in 2012*, November 2011).

18 Cited by Greg Michener, "Brazil's Productivity Gap" (*Observing Brazil*, 28 December 2011).

be balanced against the likelihood that corruption may actually worsen as Brazil looks to doll out billions of dollars in infrastructure contracts to ready for the upcoming Olympics and World Cup.[19]

To get to the nub of the problem, Dilma must dismantle Brazil's system of political patronage. Paulo Sotero, director of the Brazil Institute, at the Woodrow Wilson International Center, told the *Wall Street Journal*: "The machine is running the way it was designed to run. And that means corruption creeps in with the need to build and maintain coalitions".[20] Under Lula, the number of cabinet members swelled. The current Worker's Party coalition includes 10 parties; only a few them have a national presence. In return for joining the ruling coalition and towing the government line, cabinet heads have free reign to manage the revenues that come through their office, and they dabble in local politics as they see fit. The number of cabinet heads in Brazil is now 29, with a rumored increase to 32 in 2012. Corruption has grown alongside the growth of the cabinet size. To make a long-lasting cut in corruption, the number of parties in the governing coalition must be reduced at the federal level to get rid of relatively obscure parties with a lone minister.

In conclusion, Brazil's albatross is not the topsy-turvy global economy. Its not corruption. Rather, Brazil's politicians have time and again resorted to piecemeal solutions to structural problems. On this score, Rousseff has yet to signal that she's different from Lula. Brazil is becoming a world power, but 2011 didn't much advance the cause.

19 Sophie Mendes, "Will the World Cup and Olympics bring more corruption to Brazil?" (*Transparency International*, 5 July 2011).

20 Paulo Prada, "Brazil Corruption Ills Expose Underside of Lula Legacy" (*The Wall Street Journal*, 12 November 2011).

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