The Rot at the Heart of the Brazilian Economy

Brazil is headed for catastrophe this year, unless it finally reckons with decades of failed economic policy.

BY CHRISTOPHER SABATINI    FEBRUARY 10, 2016

In late 2014, Brazil seemed on the verge of a meltdown. Its economy had grown a mere 0.1 percent that year, as its currency (the real) dropped like a stone and business confidence plummeted. In response, in November of that year Brazilian President Dilma Rousseff turned to a Chicago-trained technocrat — a common antidote among Latin American leaders. Domestic and international investors welcomed the appointment of Joaquim Levy, a former banker and fiscal hawk, to lead the finance ministry, but they acknowledged he would have his work cut out for him. If Levy hoped to enact the drastic fiscal cuts and structural reforms needed to fix the careening economy, he would have to first overcome the resistance of not only a fractious congress, but also many members of Rousseff’s leftist Partido dos Trabalhadores (PT) and her cabinet.

Success would ultimately elude Levy. In December 2015, he quit, handing the ministry over to Nelson Barbosa, another well-respected economist. But Barbosa lacks Levy’s credibility among investors. And the task before him has only become more unenviable. He will have to push through his predecessor’s stalled reforms, while turning around an economy that suffered a GDP contraction of 3.7 percent in 2015, staving off potential debt crisis, stabilizing the real, and avoiding what analysts predict could become Brazil’s worst crisis since 1901.

The first step to fixing Brazil’s crisis will have to involve recognizing that the rot goes much deeper than it might seem. Brazil’s troubles began with the downturn in the global commodity markets, which once bolstered the country. But the roots of the malaise trace much farther, to a historically autarkic economic model, a political system hobbled and corrupted by party factionalism and localism, and a constitutional carnaval of guarantees for social rights and payouts.
Brazil was only a partial participant in the neoliberal wave that swept much of Latin America throughout the 1980s and 1990s, in the wake of a regional debt crisis brought on by governmental borrowing sprees during the 1970s and the increase in interest rates in the 1980s. Compared to those of its neighbors, Brazil’s reforms were rather heterodox and limited. The state kept a majority stake in two of the country’s largest government entities: mining company Vale and massive energy company Petrobras. While both became independent and publicly traded, the Brazilian government indirectly or directly maintained a significant share of stock in each.

Policymakers under the Social Democracy Party, which governed in the late nineties, saw the semi-privatizations as a way to make the companies more efficient and attract private investment while maintaining them as symbols of national pride, and giving them preferential treatment as such. In those terms, the plan succeeded. During the go-go years of the commodity boom, Vale became one of the largest mining companies in the world, and an international brand for Brazil. And when lucrative pre-salt fields were discovered about 300 miles off the coast of Rio de Janeiro, the contracts to develop them were handed over to a Petrobras spin-off, Petrosal.

But the semi-privatization process also resulted in national monopolies that were suddenly awash in new private investments. All that new revenue swirling around protected industries was bound to go awry. For anyone paying attention, it should not have come as a surprise when federal prosecutors revealed in 2014 an unholy $2 billion corruption scandal involving collusion among infrastructure companies; bribes to high-level Petrobras executives; and payouts to politicians, including those in the governing party.

Its struggles with corruption aside, the Brazilian economy also suffers from its disproportionate dependence on one fragile market: its own. Brazil’s massive economy — today the world’s seventh largest — is fueled overwhelmingly by domestic consumption. Consider the numbers: From 2011 to 2015, only 11.5 percent of Brazil’s GDP came from foreign trade — a stark contrast to Chile, where 33.8 percent of the economy is driven by foreign trade, or much larger Mexico, where 32.4 percent of GDP comes from trade beyond its borders.
Part of this stems from Brazil’s association with Mercosur, the customs union it formed along with Argentina, Uruguay, and Paraguay in 1991. Members of Mercosur agreed to negotiate future free trade agreements as a bloc, and to maintain a common external tariff and a single internal tariff. Mercosur’s purpose was to consolidate individual economies into a larger, European Union-like bloc that would help Brazil expand its manufacturing base in a protected but larger market — in principle, at least. Instead, the common internal tariff has been more honored in the breach than in reality, with disputes over tariff and non-tariff manipulation a regular occurrence among the Southern Cone neighbors. While the economic crises and policy discrepancies have hobbled the economic potential of Mercosur, Brazil’s membership in the flailing customs union precluded it from negotiating individual agreements with more vibrant economies, stymieing Brazilian exporters.

While Brazil was shackled by its obligations to Mercosur (in 2013, the combined GDP of its four members totaled only $3.5 trillion, over half of which came from Brazil), its neighbors were looking beyond Latin America. Today, Chile has more than 23 free trade agreements; Peru has more than 15, Mexico, over 17. All three have formed a regional Pacific Alliance that seeks to unify their stock markets and trade and education standards, and have signed on to the 12-member Trans-Pacific Partnership. It’s no coincidence that while Chile, Peru, and Mexico will experience slower growth this year because of China’s cooling economy, none will experience an economic contraction. All are forecast to grow between 2 to 4 percent in 2016, thanks largely to their fiscal prudence and diversified markets.

Brazil, unlike some of its neighbors, also failed to put its fiscal house in order. While Chile, Peru, and Colombia benefited hugely from the global commodities boom from 2004 to 2011, their multiple trade obligations provided a strong incentive to keep their currencies from becoming overvalued, at the same time that many had already reduced their fiscal outlays. There were no such constraints on Brazil’s public spending between 2006 and 2013, when the price of its two main commodities — iron ore and agricultural products — rose dramatically, thanks in large part to demand from China and India. The economy’s good fortune coincided with the election of PT president Luiz Inácio Lula da Silva in 2003, and Rousseff, his handpicked successor, in 2011.
The candidates’ discipline on the campaign trail was not matched by an equal discipline in office. In 14 years, government spending as a percent of GDP increased from an already hefty 18.6 percent in 2000 to 20.2 percent by 2014. (In Mexico, by comparison, state spending accounted for only 12.2 percent of GDP in 2014.) That increase was spent on social programs, infrastructure, public pension obligations — which, in 2012, totaled 13 percent of GDP — and to the ballooning national Brazilian Development Bank, which provides cut-rate loans to Brazilian businesses to develop local industry and expand overseas. In an age of global markets and free trade, together with Brazil’s high tariffs, the heavily state-subsidized Brazilian Development Bank, which enjoyed a budget of $22.4 billion in 2014, represented a throwback to the days of state-led industrial development.

The combination of cheap credit, booming export growth, protected markets, and public spending created a bubble that postponed any serious reckoning of the country’s structural problems and fueled unrealistic growth expectations. Those expectations were also fed by international media, investors, and the Davos conference set that rushed to crown Brazil the new darling of emerging markets.

By 2014, when Rousseff was re-elected by a razor-thin margin, it was clear to many Brazilians, and many international observers, that the PT government’s program wasn’t sustainable. But it’s important to recognize that the combination of policies pursued by the PT government were more than just the realized dreams of Brazil’s left. They trace their roots deep into Brazil’s history, culture, and constitution.

The notion of the Brazilian government as an autarkic developer, building its own industrial base with state support, is a deeply embedded one, going all the way back to the populist Getúlio Vargas, who served as president on two separate occasions in the early twentieth century. That idea of state-driven, self-sufficient development persisted from 1964 to 1985, when Brazil’s military government attempted to seed a number of industries through credit and protectionist policies.
When Brazil transitioned to democracy in 1985, its new constitution committed the state to an agenda of national economic development. It included a laundry list of rights, including citizens’ rights to education, health care, work, a retirement pension, and free assistance for children six and under, among others. And if these guarantees weren’t met, citizens could petition the government. This deeply ingrained spirit — a state-centric economy bolstered by expansive social rights — played out in a highly fragmented political system. The result: Within Brazil’s array of largely left-of-center political parties, there are a number of regional, local, and patronage networks that make coalition-building on controversial issues a complex, often corrupt process.

With three years left in office, the Rousseff administration must force the congress to swallow a series of belt-tightening measures to reduce the government’s $13.5 billion primary deficit and reign in inflation, which is expected to hover around 6.9 percent this year. But with her popularity rating at an abysmal 7.7 percent, the greatest economic contraction the country has faced in more than a century, corruption scandals plaguing the country’s private sector, and the age-old shibboleths of Brazil’s economic development, the challenges may prove insurmountable.

As if all that wasn’t enough: This year, Rousseff must also push through a series of structural reforms, including raising the retirement age or reforming public pensions, reducing energy subsidies, cutting back on transfers to states, and reducing the Brazilian Development Bank’s role in the economy. Without these cuts, the government’s already hefty public deficit will expand exponentially. A furious public, mobilized over the Petrobras scandal, has placed Brazil’s political class under a magnifying glass, removing the tried-and-true means of lubricating a congressional coalition.

And to throw yet another factor into the mix, 40 million poor people have joined the ranks of Brazil’s middle class in the past decade. With job losses totaling more than 1 million in 2015, many of them have already begun sliding back into poverty, thanks to the economic contraction and subsequent reduced access to credit. More are sure to follow.
The problem goes beyond passing tough measures through a difficult congress. After nearly a century of hot-house autarkic capitalist development, are the country’s political and economic elite and its citizens ready to open up to the global economy? For all their talk of the importance of markets, Brazil’s industrialists remain quietly committed to cheap credit and protection. Rather than build a globally competitive manufacturing base — a noble and important goal — many of these protections have coddled industry, fueled corruption, and stifled competitiveness. Brazil’s best, most competitive producers are in commodities like agriculture. But the risk of betting on commodities and an overheated domestic market are already clear. Unfortunately, an active, powerful constituency for reducing social payouts and opening up the economy to the global market doesn’t exist. At the same time, budget cuts and austerity will dampen the main source of Brazil’s growth outside of commodity exports: its large domestic economy.

In the end, the seven years of Brazil’s miracle of commodity-driven growth may have been perfectly suited to the country’s flawed economic model, allowing it to ignore larger inefficiencies that fueled consumption and fiscal profligacy. Turning that around will require a national reckoning with issues that have been plaguing the country for decades and a dramatic political and economic realignment. There are some problems that even a savvy, Wall Street-friendly finance minister can’t fix.

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