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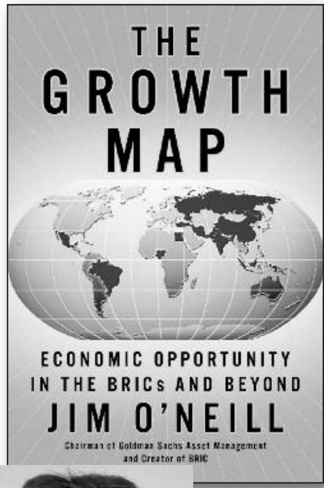
The Brazilian Miracle

In his new book, Jim O'Neill, inventor of the term "BRICs," describes the extraordinary rise of many of today's emerging markets, including Brazil.




Jim O'Neill

The first time I went to Brazil was in 2003 to give a speech about the BRIC dream. Just as I was about to speak, the man who had invited me whispered in my ear, "The only reason you included Brazil was so you had a nice-sounding acronym." Even Brazilians could not believe that the long-impossible economic dream had a chance of becoming reality.

Because expectations were so low, the moment I got home from that trip, I decided to buy some Brazilian reals. After about three months, I sold them, but that was a mistake, because over the past six years it has been a spectacularly strong currency. If I had told any of those foreign currency traders I hung out with in the 1980s that one of the strongest currencies this decade would be the Brazilian real, they would have laughed at me. But of course that is what has happened.

Brazil today is the most popular of the BRICs so far as foreign direct investment is concerned, and I am constantly invited to speak at forums in São Paulo and Rio. Investors, ranging from global private equity firms to hedge funds, are battling it out to acquire Brazilian assets. I would frequently visit Tokyo and used to meet representatives of various Japanese retail banks, who told me that conservative Japanese housewives, the mythical Mrs. Watanabes, were very excited to invest in the real. This has now been the case for years. Some time ago, I met the head of a South African bank who told me he was considering investing in a Brazilian bank. The whole world now sees that Brazil's economic transformation, from hyperinflationary basket case to a potential twenty-first-century Latin American superpower, finally had legs.

Just as China proved its maturity during the 1997 Asian financial crisis, Brazil showed its mettle in the 2008 global one. In the past, Brazil would have been guaranteed to be at the heart of the storm, its currency, interest, and inflation rates careening all over the place. But Brazil did not succumb to the crisis. Instead, the country cut rates on the back of it, managed its way through it and recovered

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quickly and easily. Stable policies over the previous decade allowed the country's leaders to implement expansionary policies at a time when other countries were being backed into a corner. This was virtually unheard of for a major developing economy, and certainly for Brazil. The boom we saw in Brazil in 2008–2009, while so much of the world suffered, surprised many, adding to the intensity of the markets' rising love affair with the country.

Popularity, though, has its price. These days I do worry that Brazil might be partially suffering from the so-called Dutch disease. As a result of the country's richness in commodity wealth, and with its high interest rates, the currency might have risen too far too fast, and this may damage the manufacturing part of the economy. So many Brazilian investors who visit my office in London tell me they find London cheap. Such a rarely heard observation is a reflection of the real's strength. As of mid-2011, Brazil had possibly the most overvalued currency of the BRICs. In the long term, I remain extremely optimistic about Brazil, and its recent successes, after decades of economic failure, are grounds for great hope. In the shorter term, I suspect that the strength of the real will be problematic.

As I've said, the decision to include Brazil among the BRICs was far from automatic. I wasn't necessarily looking for a Latin American companion for the other three, but Brazil, with its population exceeding 180 million and its policymakers finally prepared to target inflation, stood out. Many were skeptical and some, including some Brazilians, even begged me not to include it. Our 2003 paper laying out the path to 2050 for the BRICs included a large, separate section on Brazil, setting out conditions and reasons to consider Brazil separately from Russia, India, and China.

Goldman's own Brazilian economist, Paulo Leme, shared the concerns of many. Paulo had very good historical reasons to be worried for his country. Brazil, after all, had always been "the country of the future" that somehow never got there. Its vast territory and abundant natural resources reeked of economic potential. For much of the twentieth century it was one of the fastest-growing countries in the world, and attracted millions of immigrants. In the 1950s foreign investment began to pour in and multinationals set up offices in the country. In the 1960s people predicted that Brazil and Argentina would soon be the biggest economies in the world. Inflation and inept, highly centralized political leadership killed that dream. Brazil was undone by perpetual economic and political crises, alternating between democracy and military dictatorship; periods of vibrant economic growth were followed by extreme slumps. Governments would point to the high levels of foreign investment and the success of Brazil's soccer team and talk of their country in superlatives: Brazil had the world's longest bridge and the world's largest hydroelectric plant. But these boasts could not conceal the fact that the country rarely achieved the stability essential for making serious economic progress. Its growth was uneven and unequally shared. Living conditions for the country's rural and urban poor were a stain on its reputation. Its cities became notorious for their violence. A dismal low was reached in São Paulo when 8,092 people were murdered in 1997, an average of nearly one murder per hour. In my professional lifetime, Brazil has had four different currencies, a reflection of the economic chaos that has plagued the country. The problems of corruption and inefficiency were endemic. And for ordinary people, that manifested itself in runaway inflation that made shopping a nightmare and saving impossible.

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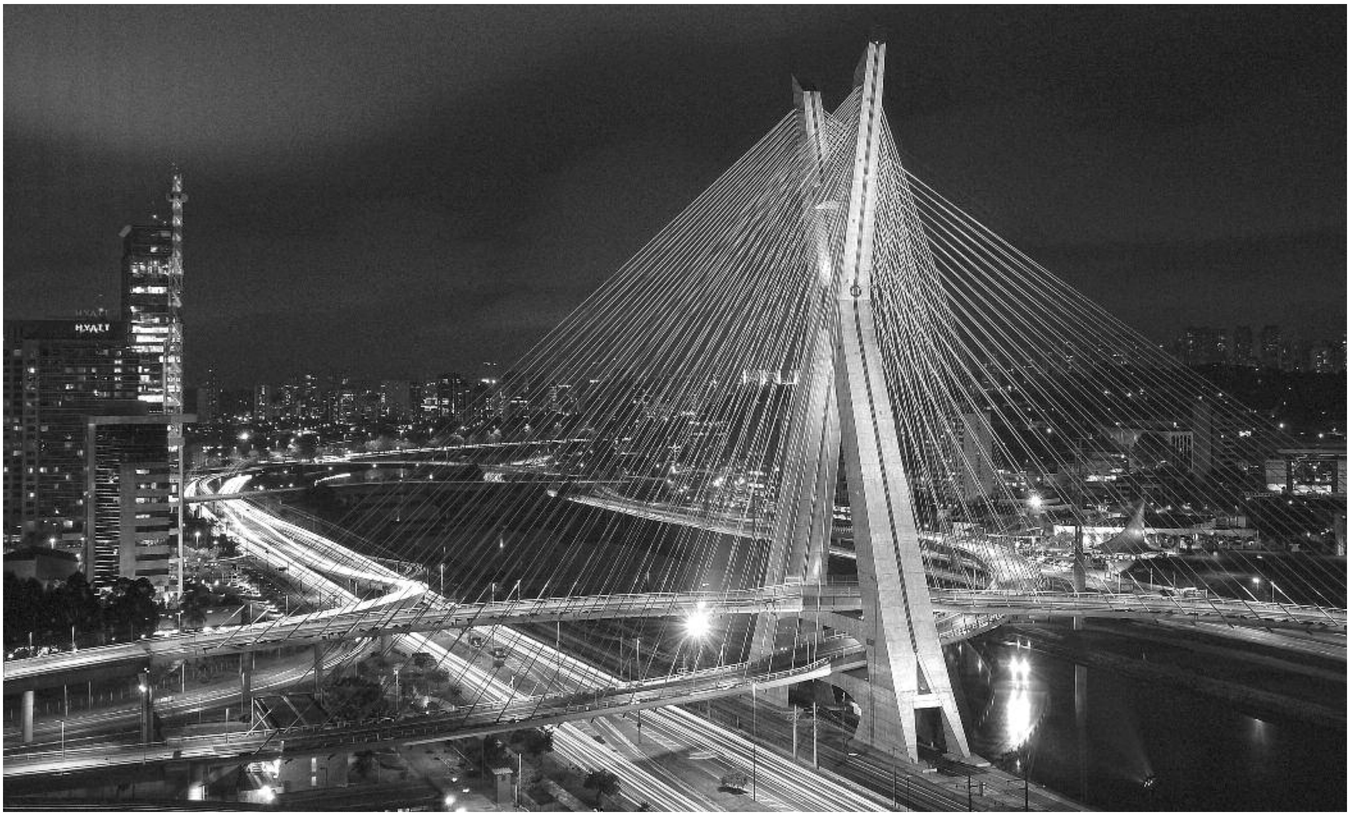
Since 1950 the country had grown at an annual rate averaging 5.3 percent, but between 1995 and 2005 that slowed to 2.9 percent. This was a consequence of a painful economic readjustment that transformed Brazil's economic destiny. In the 1990s alone, Brazil went through three financial crises. But a group of key politicians and economists, notably Fernando Henrique Cardoso, the president who first took office in the mid-1990s, identified hyperinflation as Brazil's curse and decided to fight it. After decades of relying on external financing, Brazil finally engaged in the hard work of stabilizing its currency. Its government's harsh cost cutting lowered investment in infrastructure and reduced the country's capital stock. Inflation was finally brought under control. But the benefits of this macro stabilization plan took time to feed through into higher growth. We argued in 2003 that Brazil still had important reforms to make, such as opening itself up to trade, cutting its debt-to-GDP ratio and allowing the private sector into the debt markets, and raising its investment and savings rate. Without these, we feared, Brazil might continue to underperform the other BRICs. As we wrote in 2003, our hopes



São Paulo, Brazil

for Brazil "may still prove too optimistic without deeper structural reforms."

Everything else about Brazil was immensely appealing: its culture, its sport, and its resources. It has always been an easy country to love. Once its economy turned, the world was ready to embrace it. Brazil's rise as an economic power has happened far more quickly, at least in U.S.-dollar terms, than we envisaged back in 2001 and 2003. While this is largely due to the remarkable rise of the real against the dollar and many other currencies, it is also recognition of the more stable and improved growth rate. By the end of 2010, Brazil's economy had reached $2.1 trillion. This has happened much sooner than we expected. In our 2050 projections, we assumed some real appreciation of the BRIC currencies, but not to this degree. There is the danger that the real in 2011 is overvalued, which brings its own risks, notably increasing the cost of all-important exports—and the risk at any moment of a large and messy reversal in the real. Its upward trend may need to be reversed in the coming years for Brazil's growth to be more sustainable.

But turning back again to the macro framework, the basic economic facts about Brazil are stunning. It is probably the fifth largest population in the world, and it's one that's young and growing. As the growth of the United States has demonstrated, having a rising young population can lead to very strong and prosperous economic growth. And as the 2050 projections show, Brazil has the potential to be much bigger. It has the capacity to become an economy close to $10 trillion, about five times bigger than it is today. On a relative basis, Brazil has the potential to overtake Germany and Japan—although it is unlikely that it could ever reach the size of the United States or, of course, China. While Brazil's economy is the second largest of the BRICs today, India will likely overtake it at some stage in the next decade or so, just because of the sheer number of Indians. But if Brazil can continue down the path of the past ten to fifteen years, then its population has a good chance of delivering genuine GDP growth and allowing the country to match its economic potential.

An important change in Brazil has been the transformation in its political culture. Many people worried that when Luiz Inácio Lula da Silva, the head of the Workers' Party, became president in 2003, he might reverse the economic policies of his predecessors. He was feared by many to be a left-wing fanatic who would undo President Cardoso's economic policies in favor of populist measures that would excite his supporters. I might have shared their worries, but Lula did two things that reassured me. He promised his support for a policy of inflation targeting, and then he delivered it in the form of a new Growth Acceleration Program (although no longer through Arminio Fraga, the early driver of the policy, who had been replaced by Henrique Meirelles as head of the Brazilian central bank). That was enough for me. In retrospect, he looks like the greatest G20 policymaker of the first decade of the twenty-first century. He succeeded in persuading the lower classes in Brazil that Western policies are good for them. Whatever pain inflation targeting might bring in terms of monetary discipline, it was certainly better than never knowing the value of the money in your pocket. Lula had grown up poor and knew how devastating hyperinflation and constant financial insecurity could be. He made a convincing advocate of the policies necessary for a developing economy to grow.

In September 2010, the *Financial Times*'s weekly "Lunch with the *FT*" featured an interview with Fernando Henrique Cardoso at a restaurant in São Paulo. I was asked to write a short piece to accompany the interview, which gave me a chance to compare his legacy with that of Lula's. I started by saying that few things would give me more pleasure than to have my own *FT* lunch, sipping caipirinhas on the beach at Ipanema and listening to a debate between Cardoso and Lula. Though very different men, Lula is in many ways Cardoso's heir. Cardoso gave him the platform to succeed and Lula was smart enough to keep most of what he inherited while translating the benefits of stability to the many, enabling people to rise up the income scale. This in turn gave policymakers the credibility needed to persist with stability-oriented policy. As Cardoso put it in his interview, "I did the reforms, Lula surfed the wave."

In 2010 the political mantle passed to Lula's successor, Dilma Rousseff. The challenge for her lies in improving Brazil's growth environment scores to ensure the country can continue to grow. In 2011, Brazil's scores were the highest among the BRICs, but there is a danger that the country's economic success may have, to use Cardoso's word, "anesthetized" Brazil to the need to keep the reforming momentum. Brazil is now home to giant companies such as Petrobras, which in September 2010 launched the world's largest share offering of $67 billion to fund exploitation of some of the world's largest oil reserves. Yet in 2010 Brazil ranked just 127 out of 183 countries in the World Bank's yearly Doing Business survey. The country still needs reforms in areas ranging from taxation to infrastructure. Brazilian democracy will require large-scale new programs to improve the quality of health care and education, and increase the use of technology. For all its successes, Brazil's growth environment score is still two points lower than that of South Korea, perhaps a sign of how far it has to go before it can be considered a fully developed economy.

At some point, the country will have to reverse the spending unleashed to counter the effects of the financial crisis, increase its role in international trade, and expand private sector investment. Despite an encouraging rise in foreign direct investment, Brazil remains more closed to world trade than it should. The government ought to be encouraging its companies to explore more international opportunities. Boosting private sector investment will be difficult, given that interest rates are still extremely high, despite the long and successful battle to stabilize inflation. Whether this is because Brazilian citizens doubt the longevity of low inflation or it is a symptom of "crowding out" by government spending is debatable, but both are possibly true. Reversing the postcrisis increase in government spending might help lower interest rates and ease some of the upward pressure on the real.

As I've already said, the strength of the Brazilian currency is another challenge. I suspect that the relatively high level of interest rates is helping sustain it, especially given the lack of yield available in most other major markets. If Mrs. Watanabe is buying the real for its yields, then you can assume a lot of other people are. But there may be other reasons for the real's strength. It may reflect the desire of businesspeople all over the world to invest in the country when they'd ignored it in the past. The only way of knowing for sure would be if Brazilian interest rates fell. It could be that Brazil's interest rates are where they ought to be, and that it's the rates in other countries that are too low. According to this argument, rates around the globe will eventually rise, narrowing the differential between Brazil's levels and the rest of the world's. In any case, high interest rates have not stopped Brazil from growing strongly in recent years and so cannot be seen as an insuperable obstacle.

On a relative basis, Brazil has the potential to overtake Germany and Japan.

But the most important thing Ms. Rousseff can do, in my judgment, is to make sure that the central bank stays independent and is allowed to pursue its own path for keeping inflation low and stable. Brazil's life as a BRIC has created the potential for its economic rebirth. Low and stable inflation gives every Brazilian the chance to plan more sensibly for the future, an underestimated plank of sustainable growth. As I write this in mid-2011, Brazil's average wealth is around $10,000 per head, a dramatic rise in the past decade. Tens of millions of Brazilians have risen out of poverty. By 2050 Brazil's wealth may approach levels currently enjoyed by the best of the developed countries, at least four times those of today. This would not only make Brazil one of the wealthiest of the increasingly inappropriately so-called developing economies, but at last a country of today and not just of the future. ◆