

In Lula's footsteps

Brazil according to *The Economist*

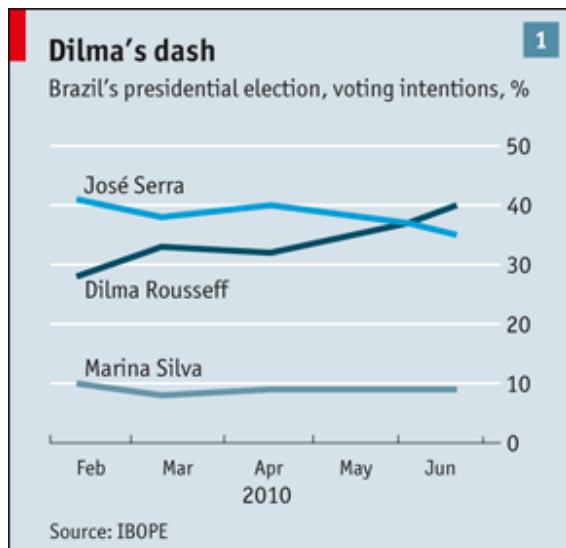
Dilma Rousseff is cruising towards victory on the coat-tails of a popular president. But there is more at stake in October's election than meets the eye

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AT THE moment only one thing matters to Brazilians: the performance of the national football team in the World Cup, where lifting the trophy for the sixth time is considered almost a right. Even a normally hard-working city like São Paulo, where supermarkets open at 7.00am and heavy traffic is a way of life, came to a standstill for Brazil's matches. Across the country factories, offices and even health posts shut down. But the country's politicians are limbering up for a different contest. On July 6th the campaign for October's general election formally kicks off. It will be the first presidential election since democracy was restored in the 1980s in which the name of Luiz Inácio Lula da Silva does not appear on the ballot. But Lula, Brazil's president since 2003, is nevertheless the dominant figure in the campaign.

For the past 18 months he has put all his efforts into trying to get Dilma Rousseff, his former chief of staff, elected as his successor. She is not an obvious presidential candidate: an efficient though notoriously bad-tempered administrator, she only joined Lula's Workers' Party (PT) in 2001. She has never before stood for elected office. But several more senior figures in the PT were forced out of politics by a corruption scandal during Lula's first term, and others have proved electoral flops.



Barely known to the public at the outset, Ms Rousseff spent half of the past year recovering from lymphatic cancer. Despite all these handicaps, she has risen inexorably in the opinion polls. This month she overhauled the opposition's standard-bearer, José Serra, formerly the governor of São Paulo state, for the first time (see chart 1). The only other plausible candidate is Marina Silva, a long-time member of the PT who is standing for the small Green Party. Like Lula, she was born in poverty, but she fell out with him over what she sees as his government's failure to defend the environment.

The election has now become Ms Rousseff's to lose. Her rise in the polls shows that Lula has been able to transfer his own extraordinary popularity to her. A former trade-union leader, Lula has a rapport with ordinary Brazilians that no other politician enjoys. But he can also point to solid accomplishments. He has presided over both a steady increase in economic growth which is now—conveniently—reaching new heights, and a sharp reduction in poverty. Even allowing for an expected slowdown, the economy will have grown by around 8% in the year before the vote. The polls show that roughly 75% of Brazilians approve of the job Lula has done. Alexandre Marinis, a political consultant in São Paulo, notes that recent elections show a close correlation between the president's popularity and his candidate's success.

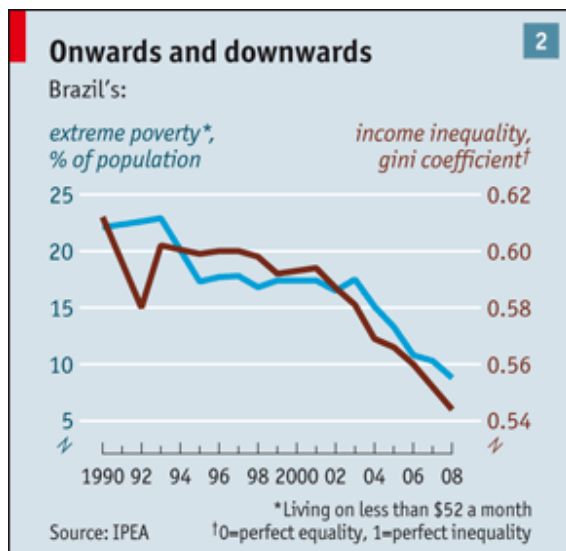
All this makes Mr Serra's job exceptionally hard. A minister in the government of Fernando Henrique Cardoso, Lula's predecessor, he trumps Ms Rousseff in political experience and has been an effective governor of São Paulo, the country's second-most-powerful job. His supporters are counting on his opponent to make gaffes. But Ms Rousseff is looking increasingly assured.

And he is struggling to make his experience count in an election where most Brazilians—especially in the country’s poorer areas—want continuity.

To see why, visit places like Jardim Iguatemi, a *favela* (a self-built settlement) straggling over steep hills on the eastern extremity of São Paulo. Bordered by forest, it is an hour and a half’s drive from the city centre. Mr Serra’s state government built a big new school and a health clinic there. But it is the president who commands the sympathy of many residents. They credit Lula with Bolsa Família, a programme under which 12m of the poorest Brazilian families get a monthly stipend of up to 200 reais (\$111), paid to mothers provided they keep their children in school and take them for health checks. His government also opened a free technical college nearby in Itaquera. “He’s made a big effort. He thought a lot about concrete problems,” says Milene Ribeiro, a single parent of three children, whose ambition to be a teacher was frustrated when she had to drop out of university for lack of funds. “Living here so far from the world, we have to vote for someone who will do something for us,” says Quitéria de Souza, a separated mother of three girls.

The statistics of social progress in Brazil are remarkable. The number of people living in poverty has fallen by 20m under Lula, from 49.5m (or 28.5% of the total) in 2003 to 29m (16% of the total) in 2008, according to calculations by Marcelo Neri, a social-policy expert at the Fundação Getulio Vargas, a university. Although the world recession and its brief impact in Brazil temporarily halted the progress, it did not reverse it. Using different criteria, Ricardo Paes de Barros of the Institute for Applied Economic Research, a government-linked body, paints a similar picture. He finds that the number of Brazilians too poor to feed themselves properly has fallen from 17% of the population in 2003 to 8.8% in 2008.

Levelling the playing field



At the same time Brazil’s notoriously unequal distribution of income is becoming a bit less so (see chart 2). The Gini coefficient, a standard statistical measure of inequality, has fallen steadily since 2001 (though it remains very high by international standards). Over that period the income

of the poorest 10% of the population has grown at 8% a year, while that of the richest tenth has grown at only 1.5% a year, according to Mr Paes de Barros.

In various ways Brazil is starting to become a more homogeneous society. Regional inequality has been diminishing, too: average income in the poor north-east has been growing faster than the national average. A majority of Brazilians (some 52%, up from 44% in 2002) now belong to what marketers call social class C, or the lower-middle class, meaning that they have a monthly household income of between 1,064 and 4,561 reals.

This progress stems from a mixture of faster economic growth and government policies. Though there is debate about the details, around half of the fall in poverty comes from higher income from employment. Better social policy accounts for a big share of the fall in inequality—or at least of the narrowing of the bottom of the pyramid. Bolsa Família has been particularly effective in helping the poorest.

How much of the credit does Lula deserve for all this? His government turned Bolsa Família from a small-scale experiment into the world's biggest conditional cash-transfer programme. He also raised the minimum wage by two-and-a-half times since 2003, taking its purchasing power to its highest level since 1979. This has not destroyed jobs: some 13m new jobs in the formal (ie, legally registered) economy have been created since 2003. Lula is also proud of a government programme under which 12m people in rural areas have gained access to electricity, and another programme that provides subsidised housing for the poor. Above all, the polls suggest, he has given poorer Brazilians a new sense both of self-esteem and that their government is not just for the rich.

But faster economic growth and the social transformation are also the result of longer-term trends. Mr Cardoso's two governments tamed inflation, creating the stability that has allowed credit, investment and jobs to grow. And part of the fall in inequality (which began in 2001, before Lula took office) stems from a big effort over the past quarter of a century to expand Brazil's previously woeful education. The average Brazilian worker now has 8.3 years of schooling, up from 6.1 in 1995.

Certainly Lula deserves praise for not imitating the economic populism of some of the other left-wing leaders who have come to power in Latin America over the past decade. Broadly speaking, his government has stuck to the responsible macroeconomic policies that have kept inflation low. After some procrastination, it has also continued the progress in education. His education minister, Fernando Haddad, has introduced standardised national tests of schoolchildren, for example. And as Ms Rousseff points out, the government has respected the contracts under which private companies, including foreign ones, have invested in Brazil.

The state and the nation

The question the candidates have to answer in the next three months is how to sustain Lula's legacy and build on it. There is broad political consensus about economic stability, the importance of education and, to a degree, on social policies (Mr Serra would maintain Bolsa Família, for example). Apart from foreign policy (which matters to some Brazilians but not to

the mass of voters), the differences between the two main candidates are sharpest over the role of the state in the economy.

In many ways Lula has been a lucky president. Brazil has benefited hugely from China's industrialisation. China's appetite for foodstuffs and iron ore has boosted Brazil's exports, helping growth and eliminating the balance-of-payments troubles that so often dogged the country in the past. But this has masked some important weaknesses that Lula did not fix, and may even have exacerbated.

Mr Serra likes to say that Brazil holds three negative world records: it has the highest interest rates in the world, the heaviest tax burden of any emerging country and one of the lowest rates of public investment. All of these, he has argued, stem from an "obese" federal government that is spending too much on public-sector jobs for its supporters. He says he would slash wasteful public spending, leaving room for interest rates to fall (the Central Bank's benchmark rate is 10.25%). That in turn would allow the real, which is overvalued, to weaken, helping manufacturers cope with competition from China. He would simplify and reform the labyrinthine tax system. The aim would be to boost investment, both public and private, so that Brazil could take greater advantage of the opportunity granted by its commodity boom, which will not last forever.

The shortfall in investment means that, by common consent, Brazil cannot sustain this year's growth spurt. If the economy is to continue to expand at 5% a year, Brazil needs to double its annual investment in infrastructure, to 4% of GDP, according to Marcelo Carvalho of Morgan Stanley, an investment bank.

The airports are clogged. Off Santos, Brazil's biggest port, a line of ships queuing to load stretches to the horizon. The lack of good roads and railways adds to the costs of business. This year soyabean-growers in Mato Grosso, an inland state, spent up to 38% of their revenues just on getting their crop from the farm to the docks, according to José Roberto Mendonça de Barros, an economic consultant in São Paulo. Under Lula, the price of electricity for industrial users has more than doubled.

The government has cautiously allowed private investment in roads, railways and ports. But airports are run by an inefficient state body. Such mismanagement is a luxury Brazil can ill afford—if only because it will need to handle visitors to the football World Cup, to be held in the country in 2014, and the Olympic games, in Rio de Janeiro two years later.

Meanwhile, the government is spending more and more on pensions. Fábio Giambiagi, an economist at the National Development Bank (BNDES), notes that although only 6% of Brazilians are of pensionable age, the country spends 11.3% of its GDP on them; in the United States, by contrast, the 12% of the population who are pensioners receive around 6% of GDP. Spending on pensions for private-sector workers in the formal economy has tripled as a share of Brazil's GDP since 1988. This is partly because the economy grew quite slowly (until recently), but mainly because of the generosity of the pension regime. Many affluent Brazilians retire in their 50s, and many pensions have risen steeply because they are tied to the minimum wage.

The result is that the federal government bails out the national pension system to the tune of 1.5% of GDP. Mr Giambiagi points out that the number of pensioners will grow by about 4% a year for the next ten years. Provided the economy grows at a similar rate and the next government slows the rise in the minimum wage, the pension burden will be just about manageable. But it reinforces Brazil's inequalities. Mr Paes de Barros notes that the government transfers ten times more money to pensioners than to children. He is advising the third candidate, Ms Silva, the only one who talks much about pension reform.

Banking on industrial policy

The government's critics also worry about the implications of a big expansion of the role of state banks (Brazil has three large ones). This came about partly as a result of the world financial crisis, when private banks temporarily cut back their lending. But the BNDES, in particular, has become an important agent of industrial policy under Lula. Over the past two years the federal government boosted the bank's capital base with two long-term loans worth 180 billion reais. Its annual lending has reached 4.5% of GDP, and should be double its 2008 level by year's end. Its loans are mainly long-term (for up to 30 years), with priority for infrastructure, investment in industry and services and seed money for innovation. They cost around half of the Central Bank's benchmark interest rate.

The BNDES has given big loans to state-owned electricity companies (revived by Lula) and to Petrobras, the government-controlled oil giant. But it has also financed takeovers by big private companies, both at home and abroad, creating national champions in businesses ranging from food to pulp and paper. Eduardo Giannetti, an economist in São Paulo, worries that all this involves big, but opaque, subsidies (of perhaps 8 billion to 12 billion reais a year, he thinks) while extending government influence over business.

Luciano Coutinho, the BNDES's president (who is tipped to be finance minister if Ms Rousseff wins), insists that the bank deploys professional techniques of credit analysis and dismisses as a "conservative fiction" the notion that its loans are governed by political criteria. The bank's role is transitional, he says, until private capital markets develop long-term savings and lending instruments.

Ms Rousseff champions industrial policy—indeed her critics see her as more *dirigiste* than Lula, whose instincts are pragmatic. But Mr Coutinho says that this does not involve a return to the big Brazilian state and the high tariff protection of the 1960s and 1970s, as the critics charge. Brazil's economy is more open today. Mr Coutinho says his inspiration comes from Asian countries such as South Korea and China (though average tariffs are still higher in Brazil than in those countries).

This debate is most intense over how to develop the vast new oil deposits found deep beneath the Atlantic in 2007. Their discovery followed Mr Cardoso's decision to open up the oil industry to competition and subject Petrobras to market discipline (though the company continues to be controlled by the government, a majority of its shares are publicly traded).

Since Lula's administration thinks it clear that there is much more oil to be found, it wants to change the rules governing the industry. Instead of concessions under which oil companies pay royalties and taxes but keep the oil they extract, in any future fields the oil will belong to a new state company and Petrobras will be the sole operator (though it can team up with partners under production-sharing agreements). These changes are embodied in four laws, though only one—allowing the government to vest oil deposits in Petrobras as a way of increasing its capital—has so far been approved by Congress.

The government also hopes to create a national oil-supply industry. It is drawing up requirements that equipment, from tankers to service platforms and drilling rigs, should be mainly locally produced. Already Petrobras is doing much of its procurement locally, and officials point to a revival in Brazil's shipbuilding industry as an early success. Provided such restrictions are temporary, they may pay off for the oil industry. But there are risks. One is a repeat of the mistakes of the 1970s, when a government attempt to develop a computer industry by banning imports cut Brazil off from new technology. Another is placing too much strain on Petrobras, which has also been required by the government to build four new refineries.



Serra ponders how he fell behind

This month Petrobras unveiled a huge increase in its five-year investment plan, to \$224 billion (up from \$187 billion). But the next day it abruptly postponed until September a planned share offering expected to be worth up to \$25 billion. The price of the company's bonds has fallen recently because of fears that the accident at a BP rig in the Gulf of Mexico will add to the cost of deep-sea oil operations.

Oil now accounts for 12% of Brazil's GDP, a fourfold increase since 1997. It will climb as high as 20%, reckons Adrian Pires, an industry regulator under Mr Cardoso. The opposition's nightmare is that Ms Rousseff might use oil revenues to entrench the PT in power and that Brazil might go the way of other oil-rich Latin American states, such as Hugo Chávez's Venezuela or Mexico under the Institutional Revolutionary Party. But officials have other models in mind, such as democratic Norway, which has saved much of its oil revenues. "We want to use the oil wealth in ways such that it doesn't contaminate the rest of the economy," says Márcio Zimmermann, the energy minister.

Brazilians thus face a choice in October. Mr Serra would provide them with a strong but lean state, that would make room for more private investment and initiative and would tax its citizens less. Ms Rousseff's advisers think that Brazil has time to bring down interest rates and taxes gradually, and that the state should promote industrial development and redistribute income. After 16 years of stability and policy continuity under Mr Cardoso and Lula, neither candidate offers a radical change of course. What is at stake is the speed of the country's progress.