The Lula bonanza - how reform is eluding a more prosperous Brazil

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João Ferreira leans against the fence surrounding his two-room house - one of a row of simple properties on a farm outside Coração de Maria in rural Bahia, north-eastern Brazil. "I've never voted for Lula but I will on Sunday," he says. Why? "Prices aren't going up. It used to be that every two weeks everything was more expensive - but not any more."

In nearly four years of President Luiz Inácio Lula da Silva's left-leaning government, low inflation is not the only improvement to Mr Ferreira's life. He and his wife have one 11-year-old son and receive R$65 ($30, £16, €23) a month from a federal income transfer programme in exchange for keeping him in school.

The Ferreiras are one of 12m families - about 44m people - receiving such benefits under a scheme known as Bolsa Família, started under the previous government of the centrist PSDB but quadrupled in size by Mr Lula da Silva since he came to office in January 2003.

Economic stability, the Bolsa Família, a rising national minimum wage, stable and even falling food prices and a dramatic expansion in consumer credit are among the reasons why Mr Lula da Silva appears to be heading for a decisive victory on Sunday in a presidential election that is being held alongside congressional and state polls.

It is not such policies alone that have boosted Mr Lula da Silva's support. Rocketing demand for Brazil's commodity exports from China and other fast-growing economies, low international interest rates and a glut of liquidity on global financial markets have contributed to what is for Brazil an extraordinarily benign international environment. Healthy current account surpluses have allowed Brazil to pay off external debts. The strengthening currency - the Real has gained 60 per cent in value against the US dollar under the Lula administration - has underpinned price stability and benefited the poor.

The feelgood factor has been enough to push the administration's many difficulties into the background. Less than a year ago, the president had been written off as no longer electable after a series of corruption scandals culminating in the so-called *mensalão* affair, under which senior members of his government and the PT, his party, were accused of bribing legislators.

It has also distracted attention from a potentially much greater problem: Brazil's failure to achieve fast and sustained growth. The economy is expected to expand by just 3 per cent this year - short of the government's target of 4-4.5 per cent and much less than the country needs to overcome its social problems.

So far, however, this has had little impact on voters. His main rival, Geraldo Alckmin of the PSDB, is still hoping to force asecond-round run-off but polls show Mr Lula da Silva is likely to win the majority needed for outright victory. "Lula has been lucky with the international situation," says Ricardo Noblat, a much-read political blogger. "But his social programmes aren't a matter of luck. Put those together with admittedly timid growth and his personal charisma, and they explain why he will win on Sunday."

Ever since his inauguration speech four years ago, Mr Lula da Silva has emphasised his concern for Brazil's poor. Income transfer programmes begun under the PSDB have been vastly expanded: spending has risen from R$2.3bn in 2002 - the last year of the previous administration - to R$8.3bn this year. The number of families receiving benefits from the Bolsa Família has risen from 3.6m in 2003 to 11.1m.

The electoral dividends are particularly evident in the north and north-east, the least developed parts of Brazil and home to one-third of its 180m people and more than half of its poor. In Bahia, the most populous state in the region, the president's support in opinion polls is running at about 70 per cent.

"Of course I'm going to vote for Lula," says Márcia dos Santos, an unemployed mother of one who lives in Lobato, a slum on the outskirts of Salvador, the state capital of Bahia. "He's the one who gives us benefits."

It is a much-heard view across a region that until recently voted for traditional rightwing and populist parties. "Lula has turned the Bolsa Família into the biggest vote-winner in Brazilian history," says Bolivar Lamounier, a political scientist. "The poor electorate of the north-east has been turned captive."

Mr Lula da Silva has won over the poor in other ways, too. With a stronger currency and inflation under control, food prices have actually fallen in the past 12 months. The national minimum wage has increased by 26 per cent in real terms under the Lula government. In 2002 it was enough to buy 1.3 *cestas básicas* - the basic monthly basket of food for a family of four. It buys 2.3 today.

The government has also stimulated consumption through new forms of credit. Payroll-linked lending introduced in 2004, in which instalments are taken straight from borrowers' wage packets, reached a total of R$44.3bn last month.

More generally, stable economic conditions have paved the way for an increase in consumer borrowing, especially in the form of instalment schemes offered by retailers. "Before, it was much more difficult to get credit," says Helinita Santana, who earns R$350 a month as a domestic servant for a middle-class family in Salvador. In the past two years, Ms Santana has bought a 20in television, a DVD player and a refrigerator from Insinuante, a local chain of household goods stores. Ms Santana also says she will vote Lula.

The Lula government has, however, done more than tend to the poor. Four years ago Mr Lula da Silva was anathema to financial markets. Yet by sticking to the orthodox monetary policies and moderately tight fiscal policies of the previous administration, he has produced a sharp reduction in overseas borrowing costs, improved the profile of domestic debt and built up comfortable foreign reserves. Brazil seems certain to achieveinvestment-grade status - which would allow mainstream US and European institutional investors to buy its assets - by 2008 at the latest, a prospect that should lead to further rises in the prices of outstanding bonds.

While Brazilian financial market investors and entrepreneurs may not have been converted into ardent *Lulistas*, they are happy enough with the status quo not to be agitating for change. High overnight interest rates have helped contain inflation but have also provided unprecedented profits for Brazil's banks and growing band of hedge funds. They have also brought a bonanza for anyone with capital to invest on financial markets.

"Lula is good for the poorest and the richest," says Luiz Carlos Mendonça de Barros, a member of the former government who now runs a hedge fund in São Paulo. "For the financial markets, Lula is wonderful."

But critics warn that the boom times for both rich and poor will come to an end if Brazil's growth rate remains stuck at less than 3 per cent a year. The biggest problem, they say, is Mr Lula da Silva's failure to follow up initial efforts to reform the public sector by trimming spending on public-sector payroll and pensions. His government won praise for being quick to enact much needed reform of the public-sector workers' pensions system in 2003 but has not tackled the INSS, the much more problematic public system for private-sector workers. Spending on the INSS rose from 6.5 per cent of gross domestic product in 2002 to an estimated 7.8 per cent this year - dwarfing the 0.4 per cent of GDP spent on income transfer programmes such as Bolsa Família. Likewise, spending on the public-sector payroll will be 5.1 per cent of GDP this year. Far from trimming payroll spending, the government recently announced plans to increase it by 11.4 per cent next year, well above the rate of inflation.

The government counters such criticism by pointing out that it regularly achieves budget surpluses before interest payments of 4.25 per cent of GDP. But the surpluses have been possible only because the tax take has risen in line with public spending. It was about 35 per cent of GDP when Mr Lula da Silva took office and reached 39 per cent this year. That is roughly double the level of competing developing countries and, as Mr Mendonça de Barros says, similar to that of developed countries such as the UK and Germany - which finance comprehensive social welfare provision that Brazilians can only dream of.

"Brazil spends a lot but it spends badly," says Marcelo Neri, director of the social policy unit at the Getúlio Vargas Foundation, a university in Rio de Janeiro. "Policies like Bolsa Família clearly target the poor but they live alongside others that go to the non-poor."

Spending ineffectively also means that the government has less money available for roads, ports, power generation and other physical infrastructure that help promote growth. For the same reason, the government has been unable to improve the quality of public services. Education is almost universal but teaching standards are poor. Regulation, too, leaves much to be desired, with investors frequently complaining of a lack of transparency or arbitrary decisions by officials. Little has been done to ease the complexity of doing business.

Favourable global conditions have contributed to a lack of urgency over addressing such issues. Yet these conditions are creating new problems of their own. Brazil's enormous trade surpluses of more than $40bn a year, combined with high interest rates and resultant inflows of short-term capital, have contributed to the rapid appreciation of the currency. This in turn has reduced the competitiveness of Brazilian manufacturers. While exports continue to rise, they are increasingly led by iron ore and other commodities with little or no added value. Meanwhile, thousands of companies in sectors such as footwear and textiles have gone out of business.

All these factors help explain why Brazil is sliding down the league table of international competitiveness. According to the World Economic Forum's survey published this month, Brazil ranks as the 83rd most competitive country in the world, nine positions lower than in 2005, and behind all three bigger emerging economies - China, India and Russia - with which it is sometimes compared.

Mr Mendonça de Barros goes as far as describing the current mix of policies as "financial populism". Unlike leaders such as Hugo Chávez in Venezuela, Evo Morales of Bolivia or Argentina's Néstor Kirchner, Mr Lula da Silva is adhering to orthodox macro-economic policies and has ruled out the kind of pricecontrols or nationalisation favoured by his more radical - some would say traditionally populist - neighbours.

But by failing to take action to encourage greater investment he may be storing up problems for the future, putting short-term concerns over long-term ones.

It is a critique that Mr Alckmin has attempted to articulate, although without achieving much resonance among voters. Mr Mendonça de Barros says that because things have just been going so smoothly, few Brazilians are interested in discussing economic alternatives. "God has helped Brazil," he says, "but maybe it was really the devil."