

The Economist

NOVEMBER 14TH–20TH 2009

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Bland bosses

Brazil takes off



**A 14-PAGE SPECIAL REPORT
ON LATIN AMERICA'S BIG SUCCESS STORY**



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The Economist

Volume 393 Number 8657

First published in September 1843 to take part in "a severe contest between intelligence, which presses forward, and an unworthy, timid ignorance obstructing our progress."

Editorial offices in London and also: Bangkok, Beijing, Berlin, Brussels, Cairo, Chicago, Delhi, Frankfurt, Hong Kong, Jerusalem, Johannesburg, Los Angeles, Mexico City, Moscow, New York, Paris, San Francisco, São Paulo, Tokyo, Washington

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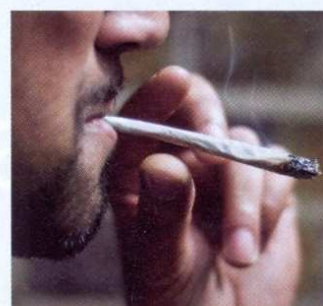
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Brazil takes off

Now the risk for Latin America's big success story is hubris



WHEN, back in 2003, economists at Goldman Sachs bracketed Brazil with Russia, India and China as the economies that would come to dominate the world, there was much sniping about the B in the BRIC acronym. Brazil? A country with a

growth rate as skimpy as its swimsuits, prey to any financial crisis that was around, a place of chronic political instability, whose infinite capacity to squander its obvious potential was as legendary as its talent for football and carnivals, did not seem to belong with those emerging titans.

Now that scepticism looks misplaced. China may be leading the world economy out of recession but Brazil is also on a roll. It did not avoid the downturn, but was among the last in and the first out. Its economy is growing again at an annualised rate of 5%. It should pick up more speed over the next few years as big new deep-sea oilfields come on stream, and as Asian countries still hunger for food and minerals from Brazil's vast and bountiful land. Forecasts vary, but sometime in the decade after 2014—rather sooner than Goldman Sachs envisaged—Brazil is likely to become the world's fifth-largest economy, overtaking Britain and France. By 2025 São Paulo will be its fifth-wealthiest city, according to PwC, a consultancy.

And, in some ways, Brazil outclasses the other BRICs. Unlike China, it is a democracy. Unlike India, it has no insurgents, no ethnic and religious conflicts nor hostile neighbours. Unlike Russia, it exports more than oil and arms, and treats foreign investors with respect. Under the presidency of Luiz Inácio Lula da Silva, a former trade-union leader born in poverty, its government has moved to reduce the searing inequalities that have long disfigured it. Indeed, when it comes to smart social policy and boosting consumption at home, the developing world has much more to learn from Brazil than from China. In short, Brazil suddenly seems to have made an entrance onto the world stage. Its arrival was symbolically marked last month by the award of the 2016 Olympics to Rio de Janeiro; two years earlier, Brazil will host football's World Cup.

At last, economic sense

In fact, Brazil's emergence has been steady, not sudden. The first steps were taken in the 1990s when, having exhausted all other options, it settled on a sensible set of economic policies. Inflation was tamed, and spendthrift local and federal governments were required by law to rein in their debts. The Central Bank was granted autonomy, charged with keeping inflation low and ensuring that banks eschew the adventurism that has damaged Britain and America. The economy was thrown open to foreign trade and investment, and many state industries were privatised.

All this helped spawn a troupe of new and ambitious Brazilian multinationals (see our special report). Some are formerly state-owned companies that are flourishing as a result of being allowed to operate at arm's length from the government. That goes for the national oil company, Petrobras, for Vale, a

mining giant, and Embraer, an aircraft-maker. Others are private firms, like Gerdau, a steelmaker, or JBS, soon to be the world's biggest meat producer. Below them stands a new cohort of nimble entrepreneurs, battle-hardened by that bad old past. Foreign investment is pouring in, attracted by a market boosted by falling poverty and a swelling lower-middle class. The country has established some strong political institutions. A free and vigorous press uncovers corruption—though there is plenty of it, and it mostly goes unpunished.

Just as it would be a mistake to underestimate the new Brazil, so it would be to gloss over its weaknesses. Some of these are depressingly familiar. Government spending is growing faster than the economy as a whole, but both private and public sectors still invest too little, planting a question-mark over those rosy growth forecasts. Too much public money is going on the wrong things. The federal government's payroll has increased by 13% since September 2008. Social-security and pension spending rose by 7% over the same period although the population is relatively young. Despite recent improvements, education and infrastructure still lag behind China's or South Korea's (as a big power cut this week reminded Brazilians). In some parts of Brazil, violent crime is still rampant.

National champions and national handicaps

There are new problems on the horizon, just beyond those oil platforms offshore. The real has gained almost 50% against the dollar since early December. That boosts Brazilians' living standards by making imports cheaper. But it makes life hard for exporters. The government last month imposed a tax on short-term capital inflows. But that is unlikely to stop the currency's appreciation, especially once the oil starts pumping.

Lula's instinctive response to this dilemma is industrial policy. The government will require oil-industry supplies—from pipes to ships—to be produced locally. It is bossing Vale into building a big new steelworks. It is true that public policy helped to create Brazil's industrial base. But privatisation and openness whipped this into shape. Meanwhile, the government is doing nothing to dismantle many of the obstacles to doing business—notably the baroque rules on everything from paying taxes to employing people. Dilma Rousseff, Lula's candidate in next October's presidential election, insists that no reform of the archaic labour law is needed (see page 46).

And perhaps that is the biggest danger facing Brazil: hubris. Lula is right to say that his country deserves respect, just as he deserves much of the adulation he enjoys. But he has also been a lucky president, reaping the rewards of the commodity boom and operating from the solid platform for growth erected by his predecessor, Fernando Henrique Cardoso. Maintaining Brazil's improved performance in a world suffering harder times means that Lula's successor will have to tackle some of the problems that he has felt able to ignore. So the outcome of the election may determine the speed with which Brazil advances in the post-Lula era. Nevertheless, the country's course seems to be set. Its take-off is all the more admirable because it has been achieved through reform and democratic consensus-building. If only China could say the same. ■

Getting it together at last

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Acknowledgments

The author would like to express particular thanks for their help in preparing this special report to: Eduardo Mufarej of Tarpon; Eduardo Giannetti and Claudio Haddad of INSPER; Marcelo Carvalho of Morgan Stanley; Fernando Reinach of Votorantim; Candido Bracher and Jean-Marc Etlin of Itaú BBA; Marcelo Neri of FGV; Alexandre Marinis of Mosaico; Mauro Azeredo of the World Bank; Heinz-Peter Elstrodt, Stefan Matzinger, Guilherme Lima, Tracy Francis, Fábio Stul and Roberto Fantoni, all of McKinsey; Walter Cruz of Marcopolo; Nilson Teixeira of Credit Suisse; Aldemir Bendini of Banco do Brasil; Francisco Valim of Experian; Damian Fraser of UBS; João Augusto de Castro Neves of CAC; Rodolfo Spielmann of Bain; Norman Gall of the Braudel Institute; and David Fleischer of Brasília University.

A list of sources is at

Economist.com/specialreports

An audio interview with the author is at

Economist.com/audiovideo

A country briefing on Brazil is at

Economist.com/brazil



Brazil used to be all promise. Now it is beginning to deliver, says John Prideaux

BRAZIL has long been known as a place of vast potential. It has the world's largest freshwater supplies, the largest tropical forests, land so fertile that in some places farmers manage three harvests a year, and huge mineral and hydrocarbon wealth. Foreign investors have staked fortunes on the idea that Brazil is indeed the country of the future. And foreign investors have lost fortunes; most spectacularly, Henry Ford, who made a huge investment in a rubber plantation in the Amazon which he intended to tap for car tyres. Fordlândia, a long-forgotten municipality in the state of Pará, with its faded clapboard houses now slowly being swallowed up by jungle, is perhaps Brazil's most poignant monument to that repeated triumph of experience over hope.

Foreigners have short memories, but Brazilians have learned to temper their optimism with caution—even now, when the country is enjoying probably its best moment since a group of Portuguese sailors (looking for India) washed up on its shores in 1500. Brazil has been democratic before, it has had economic growth before and it has had low inflation before. But it has never before sustained all three at the same time. If current trends hold (which is a big if), Brazil, with a population of 192m and growing fast, could be one of the world's

five biggest economies by the middle of this century, along with China, America, India and Japan.

Despite the financial crisis that has shaken the world, a lot of good things seem to be happening in Brazil right now. It is already self-sufficient in oil, and large new offshore discoveries in 2007 are likely to make it a big oil exporter by the end of the next decade. All three main rating agencies classify Brazil's government paper as investment grade. The government has announced that it will lend money to the IMF, an institution that only a decade ago attached stringent conditions to the money it was lending to Brazil. As the whole world seemed to be heading into a long winter last year, foreign direct investment (FDI) in Brazil was 30% up on the year before—even as FDI inflows into the rest of the world fell by 14%.

Much of the country's current success was due to the good sense of its recent governments, in particular those of Fernando Henrique Cardoso from 1995 to 2003, which created a stable, predictable macro-economic environment in which businesses could flourish (though even now the government continues to get in the way of companies trying to earn profits and create jobs). How did this remarkable transformation come about? And how can

► Brazilian and foreign firms, from lipstick-makers to investment banks, take advantage of the country's new stability?

To see why Brazil currently seems so exciting to both Brazilians and foreigners, it helps to understand just how deep it had sunk by the early 1990s. Past disappointments also explain three things about Brazil which outsiders sometimes find hard to fathom: its suspicion of free markets; its faith in the wisdom of government intervention in business and finance; and persistently high interest rates.

When Brazil became independent from Portugal in 1825, British merchants, delighted to discover a big new market, flooded Brazil with manufactures, including, according to one possibly apocryphal story, ice-skates—an early example of emerging-market fever. Even so, real income per person remained stagnant throughout the 19th century, perhaps because an inadequate education system and an economy dependent on slaves producing commodities for export combined to get in the way of development. Ever since the Brazilians have tended to view free trade with suspicion, despite their country's recent success as an exporter.

In the mid-20th century Brazil seemed to have found a formula for stimulating growth and enjoyed what appeared to be an economic miracle. At one point its economy grew faster than that of any other big country bar Japan and South Korea. That growth relied on a state-led development model, financed with foreign debt within a semi-closed economy. But growth also brought inflation, which crippled Brazil until the mid-1990s and still accounts for some odd characteristics, such as the country's painfully high interest rates and its disinclination to save. All the same, the "miracle" wrought by the military government persuaded Brazilians that the state knew best, at least in the economic sphere, and even the subsequent mess did not quite persuade them otherwise.

Unhappy memories

When this development model broke down amid the oil shocks of the 1970s, Brazil was left without the growth but with horrendous inflation and lots of foreign debt. There followed two volatile decades, when Brazil started being likened to Nigeria instead of South Korea. Productivity growth went into reverse. Many of the country's current problems, including crime and poor education and health care, either date from that period or were exacerbated by it. Between 1990 and 1995 infla-



Cardoso (left) did Lula a big favour

tion averaged 764% a year.

Then a real miracle happened. In 1994 a team of economists under Mr Cardoso, then the finance minister, introduced a new currency, the real, which succeeded where previous attempts had failed. Within a year the Real Plan had managed to curb price rises. In 1999 the exchange-rate peg was abandoned and the currency allowed to float, and the central bank was told to target inflation. The ten-year anniversary of this event has just passed, and although there is continuing debate about how to make the real less volatile, none of the big political parties advocates going back to a managed rate.

More than that, the reforms brought discipline to the government's finances. Both federal and state governments now have to live within their means. A requirement to run a primary surplus (before interest payments on the public debt) was in-

troduced in 1999, and the federal government has hit the target for it every year since, though there is a good chance that it will miss it this year. This has allowed Brazil to get rid of most of the dollar-denominated foreign debt that caused such instability every time the economy wobbled. Now international creditors trust the government to honour its commitments. Moody's, a rating agency, elevated Brazil's government paper in September to investment grade just as the governments of many richer countries fretted about being able to meet their obligations.

Yet growth still proved elusive. It took a buoyant world economy and a surge in commodity prices to procure it. Although Brazil's economy is still relatively closed (trade accounted for a modest 24% of GDP in 2008, less than 60 years earlier), its growth is closely correlated with commodity prices, the Chinese economy, the Baltic Dry index and other measures of global trade. But at last in 2006 GDP outpaced inflation for the first time in over 50 years.

Lucky Lula's legacy

Brazil's current president, Luiz Inácio Lula da Silva, has been able to take much of the credit for the country's recent growth that perhaps properly belongs to his predecessor. Yet Lula's achievement has been to keep the reforms he was bequeathed and add a few of his own—not a meagre accomplishment given that for the past seven years his own party has been trying to drag him to the left.

Lula is often mocked for beginning his sentences with the phrase, "never before in the history of this country". What his political opponents find even more infuriating is that he is often right. Brazil was able to cut interest rates and inject money into the economy as the world economy faltered at the end of last year, the first time it has been able to do this in a crisis. Whereas others predicted that world events would tip Brazil into recession, Lula reckoned that the crisis would amount to nothing more than a small tide breaking on his country's beaches. The economy shrank for only two quarters and is now growing again. The contrast with Brazil's performance in previous crises could not be more stark (see box, next page).

Plenty of problems remain. The central bank's headline interest rate is 8.75%, one of the highest real rates anywhere in the world. If the government wants a long-term loan in its own currency it still has to link its bonds to inflation, making debt expensive to service.



► Productivity growth is sluggish. That may not seem the end of the world, but it reflects realities such as the two-hour bus journey into work endured by people living on the periphery of São Paulo, the country's largest city, during which they often risk assault before arriving too tired to be very useful. The government invests too little and has longstanding gaps in policing and education to fill. The legal system is dysfunctional. And so on.

Yet other countries face similar problems, and Brazil has made real progress. In a country where businesses became used to headline interest rates of 30% or more, a rate below 9% comes as a relief. "It's like the difference between running a marathon with 50 kilos on your shoulders and 20 kilos," says Luis Stuhlberger of Credit Suisse Hedging-Griffo, one of Brazil's most successful fund managers. Mr Stuhlberger thinks that Brazil's recent past was so awful, and its expansion of education and credit is so young, that the coun-



try can reasonably be expected to continue on its current trajectory, even without further big reforms. Even so, he argues, "we are not going to have a Harvard or a Google here." The blame for that, he says, lies largely with government policies.

Brazil's economic story could certainly

be made more exciting with some reforms to its business environment. The country's potential growth without a risk of overheating can only be guessed at, but it is probably below the 6.8% it reached in the third quarter of 2008. Most economists put it at 4-5%. This suggests that interest rates will not be coming down to levels considered normal in other countries soon.

Still, stability has its own rewards. Edmar Bacha, one of the economists who worked on the introduction of the real in 1994, is pleased that the debates about Brazil's economy have become so narrow. Back in 1993, when he joined the ministry of finance, inflation at one point hit 2,489%. Nowadays, he notes with a wry smile, "the big debates are about whether interest rates could come down from 8.75% to 8.25%; or whether the central bank should have started cutting a month earlier than it did." That change has been good for Brazil, and particularly good for its banks and its financial system. ■

Breaking the habit

FOR most of the past few decades Brazil has been one of the first places to go into a tailspin when things turn nasty elsewhere, as the following list demonstrates.

• **1973-79: Oil shocks.** The first oil shock doubled Brazil's import bill within a year. The second set off uncontrolled inflation, which reached 110% for 1980. The next 15 years were a continuous struggle to bring that number down. They also saw a sharp increase in short-term foreign debt denominated in dollars to pay for oil, heralding a decade and a half of instability.

• **1982: Default.** As Mexico defaulted, Brazil, which had also borrowed a lot from foreigners, found itself mistrusted too. The government tried to engineer a trade surplus to reassure creditors, forcing importers to obtain licences and buy dollars at an inflated official rate, but failed. In 1983 it defaulted on its debt and the cruzeiro plunged against the dollar, making inflation even worse.

• **1986: The Cruzado Plan.** Three zeros were chopped off the currency, and at first Brazil seemed to have got on top of inflation. But it was also in the process of becoming a democracy (the first civilian

president in two decades was chosen by Congress in 1985), and conquering inflation required holding down wages, which Brazil's new democrats found hard to do. The Bresser Plan (1987) and the Verão Plan (1989) fared no better. By 1990 inflation was running at more than 70% a month.

• **1990: The Collor Plan.** The worst of the lot, this one involved an immediate freeze for 18 months on bank deposits making up 80% of the country's financial assets. The idea was to force prices down by reducing liquidity. Wages were frozen, financial transactions were subjected to punitive taxes and foreign exchange and trade were liberalised. The policy set off a mini-recession, causing panic that led to a reversal. High inflation returned.

• **1994: The tequila crisis.** Another Mexican devaluation and debt crisis that had a knock-on effect on Brazil. The central bank responded to an outflow of money by increasing interest rates to nearly 50%.

• **1997: The Asia crisis.** Brazil's commodity exporters were hit by a fall in demand from Asia. Once again confidence plummeted as money left the country. The central bank fought hard to defend the real

A brief history of Brazilian meltdowns

which had been introduced in 1994, increasing overnight interest rates to an annual 40% and killing growth.

• **1998-99: The Russia and LTCM crisis.** While still trying to get back on its feet, Brazil was hit again after Russia defaulted on its debt and a team of Nobel economics laureates nearly fused the financial system. The government was forced to let the real float freely, which was economically correct but highly unpopular as the currency's value dropped.

• **2001-02: The dotcom crash and Argentina's default.** Once again the real dropped on fears about Brazil's neighbours and general unease about the world economy and the election of President Lula. Inflation rose to 12.5% and the headline interest rate went up to 25%.

• **2007-?: The global financial crisis.** What appeared to be the worst global recession since the 1930s left Brazil relatively unscathed. It was able to cut interest rates and the real held its value. Brazil turned out to be one of the last countries into the downturn and one of the first out, causing national celebration and not a little surprise, given what had gone before.

Survival of the quickest

Frequent crises have made for strong banks and nimble financiers

BRAZILIAN businessmen often say that the country's recent economic past has strengthened companies, and especially banks. The argument goes like this: you need to be good, or at least inventive, to survive and make money when you have no idea whether inflation next year will be 50% or 500%. Bankers and finance directors have had to be particularly nimble. One example is Souza Cruz (a subsidiary of BAT), Brazil's largest tobacco company, which in the days of high inflation did no better than break even on its cigarette sales. Its profits came from the interest on the cash it held between being paid by retailers and paying tax fortnightly. Companies used to operating in such unusual circumstances flourished when life became more predictable.

There is some truth to this argument, even though it brushes aside the fact that until the 1990s Brazilian companies did not have to worry about foreign competitors. No big companies went bust in the recent financial crisis, despite losses on foreign-exchange derivatives that the Bank for International Settlements estimates at \$25 billion. Moreover, no big banks wobbled, let alone had to be rescued, though there were some mergers.

One reason was that a previous round of bank failures, in 1994, had already cleared out the bad ones. Until then banks made their profits by taking deposits from customers, lending the money to the government overnight and pocketing the difference. With inflation at several hundred per cent a year, many banks' balance-sheets were hard to decipher. When inflation came down, it became clear that a number of them were insolvent. These folded or merged with other banks, leaving only the stronger ones.

Brazil's financial system got a further boost from reforms carried out when Arminio Fraga was governor of the central bank from 1999 until the start of 2003 (he is now at Gávea Investimentos, an investment firm). The country's bank-settlement system now operates in real time, so all banks know their cash positions at any given moment and the central bank has an overall picture of what is happening. Before this system was introduced the central

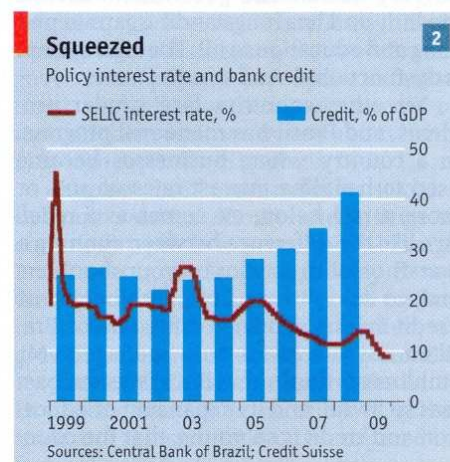
bank often ended up honouring the debts of banks that went bust, creating a dangerous incentive to be careless. Both Mr Fraga and his successor as governor, Henrique Meirelles, have made sure that banks report what is going on in any off-balance-sheet vehicles they have funded. This has helped to keep under control the special investment vehicles, conduits and other mysterious creatures that have caused so much damage in other countries.

This transparency extends to financial markets too. All fund managers must disclose the net asset value of their funds to Brazil's Securities and Exchange Commission (CVM) daily, though with a 48-hour delay. At the end of every month funds must disclose what they were holding 90 days ago. Anyone can go to the CVM's website and look up these numbers. Fund managers may grumble about too much disclosure, but most are happy with the rules. Maria Helena Santana, who chairs the CVM, explains that they make it harder to pull off a scam of the sort run by Bernard Madoff, whose pyramid scheme was hidden behind a veil of secrecy.

Created equal

Equity investors, for their part, have benefited from new rules for publicly traded companies brought in by the São Paulo stock exchange (Bovespa) in 2002. Big Brazilian companies used to be notorious for abusing shareholders with minority stakes. Under current guidelines, it is illegal to issue shares that pay out different amounts to different holders in the event of a takeover. Any disputes between shareholders are judged by the CVM. With these rules in place, foreigners have been happy to buy shares and Brazilian companies that were unable to borrow in capital markets are now able to finance their expansion.

A boom in initial public offerings (IPOs) followed. At its height, in 2007, 80% of the money for IPOs came from foreign investors. This undoubtedly led to some excesses: at one point there were more listed housebuilders in Brazil than in America. But some of the companies that floated will do well. And the message conveyed by the new rules—that better corporate governance allows people to make money



by selling bits of their companies on the stock exchange—has been good for the family businesses that make up the bulk of Brazil's medium-sized firms.

Santander Brasil's recent IPO was a test of whether investors' appetite for Brazil had returned. It proved to be the world's largest IPO this year, valuing the bank's Brazilian subsidiary at more than the whole of Deutsche Bank worldwide. The government is so worried about foreign portfolio investors pushing up the value of the real that it imposed a 2% tax in October to discourage them. IPOs have a wider benefit because companies that want to float all or part of their stock need to get their accounts in order, pay their taxes and make sure their workers are not part of the black economy.

All this has brought sophistication and liquidity to Brazil's financial markets. São Paulo's futures and options market is one of the five largest in the world by volume traded. Well-developed markets have been good for consumers too. High interest rates, high inflation and dysfunctional courts once made consumer credit rarer than snow. Thanks in part to a series of reforms carried out in Lula's first term, credit has grown steadily. Loans for bigger items, such as cars and apartments, have become available for the first time, thanks to a new law under which a lender remains the owner of the asset acquired with the loan until the last repayment is made, whereas previously the money would have had to

► be chased up through the courts.

Lula's first administration also introduced a new bankruptcy law that is credited with making it slightly easier to salvage something from companies that go under. There was room for improvement: a few years ago a World Bank study found that bankruptcy proceedings in Brazil took an average of ten years and left creditors with just two cents in every dollar owed.

Yet for all this progress, two glaring problems with Brazil's financial system remain. First, credit is very expensive. Second, only the government will lend for long periods, and not to everyone.

Tax and lend

Brazil has a hybrid retail banking system, with state-controlled and private-sector banks competing directly. It is highly concentrated: Itaú Unibanco, the largest private bank, is among the world's 15 biggest on several measures and yet has almost no presence outside Brazil. Banco do Brasil, the largest state-controlled bank and one of the world's oldest financial institutions, vies with it for the title of the country's biggest bank. All told, credit from state-controlled banks makes up 37.6% of the total and has recently been growing.

Despite their different owners, the state-controlled and the private banks seem to be behaving in a remarkably similar way. Aldemir Bendini, the chief executive of Banco do Brasil, talks enthusiastically about international expansion. The bank will soon open five agencies in America to serve Brazilian expatriates. It also wants to help Brazilian multinationals abroad with local-currency financing. Meanwhile it will keep up its role as an instrument of public policy that does the bidding of the federal government, its biggest shareholder, and also look after the 22% of its shareholders who own traded stock. It looks like an incongruous mixture, but it appears to work. Itaú Unibanco too is keen on expansion abroad, but makes so much money at home that it does not seem to be in a rush.

In theory, all this should provide plenty of competition, with the two types of bank keeping each other honest and making sure that Brazilians have access to credit. In practice it does not quite work like that. Even though Itaú alone has 25,000 cash points, more than 500 municipalities in Brazil lack even a single bank branch. The two kinds of bank compete most fiercely in the comparatively wealthy south and south-east of the country. Banco do Brasil recently added to the geographical concen-

tration by buying Nossa Caixa, a São Paulo state savings bank, and a large stake in Banco Votorantim, a private-sector bank.

The government has raised the limit for foreign participation in Banco do Brasil to 20% to attract more capital, but the state-controlled banks are not as well run as the private-sector ones, so the hoped-for competition has not materialised. The clearest sign of this is spreads—the difference between a bank's cost of borrowing and lending. The Institute for Industrial Development, a lobby group, calculates that average lending rates are 35% higher than deposit rates, against less than 10% in the other BRIC countries. The bankers' lobby disputes these figures, but nobody thinks that banks' spreads are thin.

Among the things that make them fatter are a curious tax on bank funding that increases costs, and high reserve requirements which mean that banks must squeeze more revenue from what they are able to lend. Bad-loan provisions are high too, reflecting the fact that consumer credit is concentrated among people who are already stretched. And a lot of credit is subsidised, which pushes up costs for the rest.

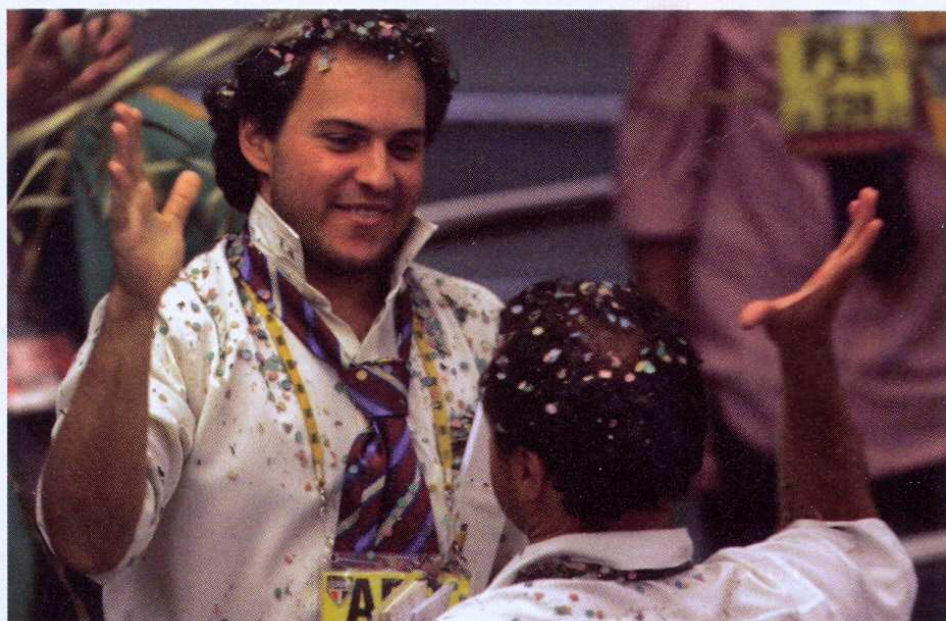
Brazil's banks have many things to recommend them; indeed they seem to exemplify what might happen if regulators elsewhere got their every wish. They are safe and their lending is well-capitalised and profitable. Two-thirds of Brazilian deposits are in local banks, which is unusually high for Latin America and a big change from the past, when anyone who had money kept it out of the country and

in dollars. The banks also offer some things that would surprise American or European customers. Many ATMs provide a wide range of financial services, from dispensing cash to providing loans. Even so, for now credit is likely to remain too expensive for the country's good.

For companies trying to get credit, the problems are much the same. To make up for the absence of a market in long-term debt Brazil created a giant development bank, the BNDES, with a balance-sheet larger than the World Bank's. This is financed by an impost on labour and lends predominantly to Brazil's biggest companies—the opposite of what you would expect from a left-leaning country.

Because its large loans to Brazil's big names carry so little risk, the BNDES is profitable. It also does some more adventurous lending, although trickier credit assessments are farmed out to private banks, which collect a fee for their pains and also assume the risk of loans going bad. The BNDES was useful to Brazil during the recent crisis as a stable source of funding, but its scale as the lender of choice for Brazil's best credit risks is probably impeding the development of markets in long-term debt, and the way it is funded seems fundamentally unjust.

Still, compared with the bank failures, frauds, market manipulation, volatility, disregard for contracts and near-absence of credit of the past, Brazil's financial sector has come a long way. Foreign investors have noticed, and have recently started pouring money into the country. ■



Plenty to celebrate

Arrivals and departures

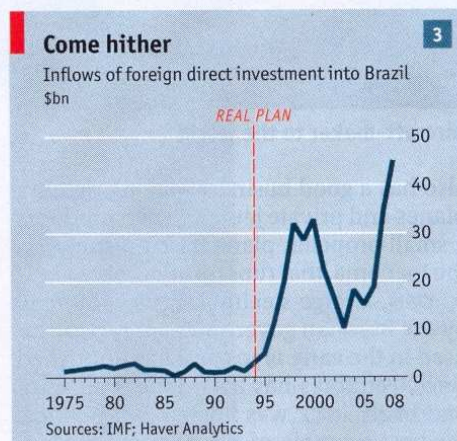
Foreigners are investing in Brazil, Brazilian companies are going shopping abroad

TRADING with Brazilians has not always been easy. Jean Lery, who visited the country in the 1550s, wrote an account of the trading practices of the Ouetaca people, who liked to exchange goods by placing them on a rock 200 paces away and then retreating. The trading partner did the same, and the dance was repeated as each group got what it wanted. "As soon as each one has returned with his object of exchange, and gone past the boundaries of the place where he had first come to present himself," wrote Mr Lery, "the truce is broken, and it is then a question of which one can catch the other and take back from him what he was carrying away."

That would have rung a bell with some of Brazil's foreign investors in more recent times, from Daniel K. Ludwig, who repeated Henry Ford's jungle folly a few decades later, to the Japanese banks that tried to enter the market, to US Steel, which discovered Carajás, the world's largest iron-ore deposit, before being forced into a joint venture with a government company and then selling out of a mine that is still going strong 30 years later. Lots of other foreign investors have done well, however, and Brazil is enjoying a new wave of trust and optimism as the world pours in money (see chart 3). It has become the second-largest destination for FDI flows into developing countries after China.

Foreign investment in Brazil has a long history. British investors built railways at the end of the 19th century to get commodities to ships and then to market. GE first entered this emerging market in 1919. Its local CEO, João Geraldo Ferreira, likes to point out that GE's light bulbs illuminated Rio's famous statue of Christ the Redeemer when it was put up in the 1930s. A wave of foreign investment arrived in the 1950s, when China and India were closed and the Korean peninsula was at war. The car companies that have been in Brazil for a while, such as Fiat, GM and Volkswagen, have done particularly well recently: for the past two years Brazil has been the world's fastest-growing car market.

Earlier this year the Brazilian and Chinese governments announced that China Development Bank and Sinopec, a Chinese oil company, will lend Brazil's Petro-



bras, a state-controlled but publicly traded oil company, \$10 billion in return for up to 200,000 barrels a day of crude oil from the country's new oil fields for ten years. Given China's hunger for commodities and Brazil's openness to investment, more of this sort of thing is expected.

Investments in Brazil that have failed tend to have one feature in common. Foreign companies arrive in Brazil full of optimism, pay too much for a local firm and then leave when things turn sour, often selling the same company back to a Brazilian firm for a small fraction of what they gave for it. One example is Molson, a Canadian beer company that bought Kaiser, a Brazilian brand, in hopes of refreshing Brazil's hordes of beer drinkers (though the company ended up selling to a Mexican firm rather than a Brazilian one). Goldman Sachs, the investment bank that invented the term "BRICs", has been in and out of Brazil a couple of times. UBS bought Pactual, a Brazilian investment bank, before selling it back to André Esteves, a former boss of the bank, earlier this year.

Let's do the jeitinho

Now that Brazil has become more predictable, fewer foreign investors will fall into this particular trap, but there are others. Because of the unsatisfactory legal system, commercial disputes with other companies are best avoided. This makes personal ties especially important. And once the boss's children are safely married to the offspring of the firm's business partners,

any company wanting to succeed in Brazil will still have to learn the art of the *jeitinho*—a Brazilian knack for getting around obstacles to doing business which would make European or American compliance departments shudder.

Even as foreigners have been piling into Brazil, a number of Brazilian firms have been entering markets overseas. For the first time Brazil has a crop of companies that can be described as multinationals. Some of them are already well known outside Brazil: Petrobras; Vale, one of the world's largest mining companies; and Embraer, the world's third-largest maker of passenger jets.

Others may be familiar only to those who follow these sectors closely: Gerdau and CSN, two steelmakers; Marco Polo, a bus builder; Perdigão and Sadia (soon to merge into Brasil Foods) and JBS-Friboi, all food companies; WEG, which makes electrical components; Odebrecht and Camargo Corrêa, two construction firms; Natura, a cosmetics-maker; Votorantim, an industrial conglomerate; and Coteminas, a textile firm.

In the most recent list of 100 companies from emerging markets that are evolving into multinationals compiled by the Boston Consulting Group, 14 are based in Bra- ➤



Iron rations at Carajás

► zil. At the last count, the Fundação Dom Cabral, a business school, reckoned there were more than 40 large Brazilian firms undertaking value-adding activities in different parts of the world. Many of these companies began their expansion into foreign markets decades ago. Most turned first to markets in neighbouring countries that were fairly familiar. Their main motive seems to have been to hedge against Brazil's ups and downs, rather than excitement at the potential for growth beyond their borders.

The latest wave of expansion is different: both more ambitious in geographic terms (Vale alone has a presence on five continents) and more self-confident. Most of the companies concerned feel that, much like Brazil's banks, they have survived and prospered through difficult decades in a harsh business environment and are ready to operate in risky markets.

Some of the success stories have benefited from privatisation, or at least part-privatisation. One of the puzzles about Brazil is why politicians should feel unable to talk about privatisation despite so many successes. In the most recent presidential election, in 2006, Lula accused his main rival, Geraldo Alckmin, of wanting to privatise anything that whirled or beeped, and Mr Alckmin promised that he would never sell off anything.

A private treasure

Embraer is a good example of what privatisation can achieve. Like many of Brazil's industrial giants, it was created by the government. In a joint venture with Italy's Alenia Aermacchi that gave Brazil access to jet technology for the first time, it produced the AMX fighter jet in the 1980s. But by the 1990s the company was struggling, producing models that nobody wanted to buy. Since privatisation in December 1994 Embraer has turned itself into the world's biggest manufacturer of mid-range passenger jets. In the company's factory in São José dos Campos, where sheets of aluminium are fed into one warehouse and 100-seater aircraft come out of another some months later, planes are waiting for delivery to commercial airlines in China, India, Poland and Britain. Some 96% of the company's revenue now comes from exports.

Although Brazil's main domestic carriers use aircraft built by Boeing and Airbus, Embraer's machines have proved popular with American carriers for short-haul flights—so much so that the company is probably more exposed to the fluctuations of America's economy than of Brazil's. It



Aircraft-maker to the world

also has a good business making military planes and private jets and even produces a small propeller plane for crop-spraying, the Ipanema, that runs on ethanol.

CSN, a large steelmaker, was founded by the Brazilian government in 1941, privatised in the early 1990s and has flourished since. Petrobras has also done well since part of its stock was floated. But perhaps the best example of privatisation and international expansion is Vale, which started off private but was nationalised during the second world war to help America's war effort by supplying iron ore.

It took its first steps abroad in the 1980s and 1990s before being privatised in 1997 (though as with Embraer, the Brazilian government still holds a golden share that would probably prevent it from being taken over). At the beginning of this decade Vale was a medium-sized mining company with a strong iron-ore business in Brazil and some interests in forestry and other bits and pieces. Now it is one of the world's four biggest mining companies.

Thanks to the commodities boom, Vale would have grown almost whatever it did. But it is doubtful whether it would have come so far, so fast, had it remained in public hands. Under Roger Agnelli, who had previously been an investment banker, Vale has sold off its peripheral businesses and is now concentrating on metals, with a sideline in electricity generation and, in Brazil, railways. Vale's \$19 billion acquisition of Inco, a large nickel producer based in Canada, allows the company to provide all the raw materials that steelmakers need. In 2005 Vale was able to raise prices for its iron ore by 71.5% in tough negotiations. It is hard to imagine the old state mining company pulling that off.

If Brazil's current government seems hostile to the notion that privatisation tends to improve companies, it does like the idea of having a number of national champions succeeding abroad. BNDES has backed up the government's rhetorical

support by lending \$8 billion so far this year to help the expansion of Brazilian multinationals. This is a big change from 15 years ago. Carlos Arruda of the Fundação Dom Cabral recalls that shortly after he began compiling an economic-competitiveness survey for the World Economic Forum in 1996, he received a letter from a government minister informing him that it was not in the government's interest to have Brazilian companies expand abroad: capital was scarce and jobs had to be created at home. This view was reinforced by laws that made it impossible to send profits from foreign subsidiaries back to Brazil or to recognise losses made abroad in company accounts.

This change in attitude has helped, but Brazilian multinationals are not immune to the kind of problems that have sometimes caught out foreign investors in Brazil. Petrobras has had some of its Bolivian assets nationalised by that country's president, Evo Morales. Odebrecht has had a similar experience in Ecuador. These, however, are relatively trivial compared with Embraer's current difficulties in China. The company opened a factory in Harbin in 2002 where it has a joint venture with the snazzily named China Aviation Industry Corporation II (the only way of gaining access to this big new market). Embraer had planned to make only older models in China for fear of losing control of its intellectual property. But the Chinese company is insisting that Embraer produce its newest models there, and there is now a chance that Embraer will withdraw from making aircraft in China altogether.

No doubt many of Brazil's new multinationals will encounter similar problems as they venture abroad. But even if they do, companies that are essentially commodity producers, consumers or traders (which make up a majority of the new multinationals) can rest assured that their built-in comparative advantage is unlikely to be eclipsed soon. ■

Condemned to prosperity

Brazil has learned to love its commodity sector

NOT many countries are named after commodities. There is Argentina, from the Latin word for silver; Côte d'Ivoire, a reminder that nature's endowments do not always lead to prosperity; Panama and Uruguay, whose names may come from indigenous words for fish; and also Brazil, which became known for its Brazil wood, the source of a valuable dye. Prior to that Italian merchants apparently called it the land of parrots. Brazil has already lived through several commodities booms: precious metals in the 17th century, sugar in the 18th and coffee in the 19th. Yet none of them benefited the country as much as the current one.

The large discoveries of offshore oil made by Petrobras in 2007, which have generated so much excitement recently, have made it easy to forget that Brazil is already the world's largest exporter of coffee, sugar, chickens, beef and orange juice. It also exports vast amounts of soya and iron ore, as well as other ores and metals. Its commercial forests are the source of much of the world's pulp. If other countries opened their markets, Brazil would supply them with ethanol to fuel their cars too. A history of booms and busts in the markets for raw materials is written into the country's landscape.

Yet for a long time Brazil did not capitalise properly on all this wealth. Brazilian intellectuals used to argue that the country's role as a commodity producer permanently consigned it to the periphery of the world economy. Then two things changed.

First, improvements in the country's financial system and greater economic stability allowed businesses to invest without fear that some economic catastrophe was likely to befall the country. This is reflected in the large share of investment going into the commodity sector. Second, the worldwide boom in commodities this decade made it more profitable to plough fields and dig holes, bringing about a big change in Brazil's terms of trade (see chart 4).

Plough, scatter, repeat

It is safe to assume that the world's hunger for protein is not going to abate. People start eating lots of meat when they reach an income of about \$10,000 per person. Some 80% of the world's population have yet to get to that point. As they do so, finding spare land and increasing the efficiency of farming will become ever more important. Brazil has plenty of spare land, even without destroying its forests to create more, and much of its farming is done by small, family-run businesses that could increase production with more capital and better management.

Brazil has already pulled this off once. Largely thanks to the work of Embrapa, a government research agency, Brazilian farmers in the 1960s and 70s steadily increased the area in which crops could be cultivated. Acidic soil, with little phosphorous and lots of toxic aluminium, was re-balanced, and crops were specially bred for Brazil's tropical environment. Between 1968 and 1997 a total of 116 new varieties of soyabeans were launched. In the past few years new ones have been added at the rate of almost 100 a year.

Among other things, Embrapa, working with private-sector companies, is trying to develop a variety of wheat that will grow in Brazil. At the moment, reckons Julio Pisa of BrasilAgro, which owns 166,000 hectares of farmland in Brazil, the country has 20m spare hectares of good productive land. Not all of this will be as sumptuous as in Rio Grande do Sul state, where some farmers can harvest a tobacco crop, a corn crop and a bean crop from the same land in a single year (culminating in a lively bean festival in January), but it will be pretty good. Perhaps more importantly, Mr Pisa

points out, when Brazil exports food it is also exporting water, and Brazil is fortunate enough to have a surplus of fresh water per head of population.

But before Brazil's agriculture can reach its full potential, there are a few problems to overcome. The first is a long-running argument about who has the right to what piece of land. Land tenure becomes less and less certain as you approach the equator. In the Amazon this results in deforestation as farmers cut down trees to establish de-facto ownership of land. In other parts of the country the disputes take the form of farm invasions by the Landless Movement (MST), which has many ideological sympathisers in the government, including the president himself.

The MST tends to go for farmland that is not too far from cities, but Fibria, a big producer of wood pulp, has had trouble with invasions of forests it owns in remote parts of Bahia state. These invasions can be colourful: one group, made up entirely of women, likes to arm itself with pitchforks before descending on farms.

As might be expected of a loosely organised movement in a big country, the MST appears in lots of different guises, depending on the place. One of its oldest settlements, at Pirituba in São Paulo state, now looks a bit like a kibbutz tinged with new-agey environmentalism. By contrast, in the northern state of Pernambuco MST members shot and killed four men earlier this year.

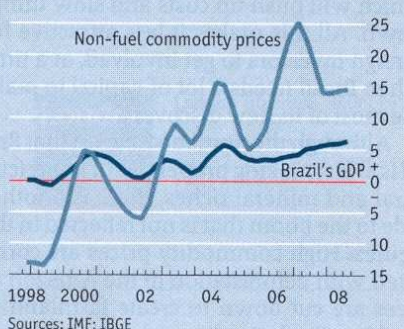
Lost highways

A second problem holding commodity producers back is Brazil's patchy infrastructure. After much sifting through data, the World Bank's Growth Commission concluded that, in order to keep growing fast, developing countries should invest around 25% of their GDP, of which about 7% should go on infrastructure. Brazil's investment level has been creeping up towards 20% in recent years, but in 2007 the government invested just 0.1% of GDP on improving transport.

For some of the biggest companies this is not a problem. Vale has its own railway lines, which allow it to get its iron ore from Carajás to market without much trouble. ➤

Grist to the mill

% change on previous year



► The company is also a shareholder in MRS Logística's railway network in the south of Brazil, along with CSN and Usiminas, another steel company. Just as in America in the late 19th century, when Standard Oil and Carnegie Steel used the railroads under their control as a weapon against their competitors, these companies are able to maintain a system that works well for them but not for others. Some 60% of freight in Brazil goes by road and only 20% by rail, compared with an even split in the United States. América Latina Logística's rail network is open to whoever wants to use it but covers only part of the country.

Once goods are loaded into trucks, everything slows down. Brazil's lorries, on average, are 14 years old. Their bumpers are usually adorned with foot-high letters declaring that the driver has put his trust in God, which is just as well given the state of the roads and some of the overtaking that lorry drivers do.

Brazil has the world's third-largest road network, but only 12% of it is covered in asphalt. IPEA, a government economic-research agency, reckons that road deaths per vehicle on the road in Brazil (some 35,000 in 2006, the latest available figure) are six times as frequent as in Japan.

When the trucks eventually make it to the port, often after spending hours in traffic jams, everything slows down again. Brazil's ports tend to be run as offshoots of the civil service rather than as private companies, with all the problems that entails. To speed up the loading and departure of ships, companies sometimes find they are required to make extra payments, which publicly listed multinationals struggle to explain in their accounts—and to justify to their shareholders.

Brazil's ports are both more profitable and less efficient than their peers elsewhere. Competitors who want to enter the market are discouraged. When Eike Batista, the most swashbuckling of Brazil's current crop of entrepreneurs, applied to build a new port in São Paulo state he was unable to secure an environmental permit for his project. There is also a suspicion that Brazil occasionally uses its sluggish customs service to influence trade data. Strikes have sometimes coincided with periods when the real has been particularly strong and imports have been rising fast.

Many people seem to believe that all this can be turned around. At the start of 2007 the government announced a "programme for accelerating growth", concentrating on infrastructure, which most agree is a small step in the right direction. Several



Running out of road

state governments have subcontracted the expansion and improvement of existing roads to private consortia which are allowed to collect tolls. Infraero, the state company that runs Brazil's airports, is stepping up its investment. Pablo Haber of McKinsey, a management consultancy, reckons that in four or five years' time Brazil's airports will be better than those of the United States.

But even when the federal and state governments are behind new infrastructure projects and money has been allocated, often nothing happens. The prospect of hosting the football World Cup in 2014 and the Olympics two years later should inspire some action. But it would be a stretch to argue that the roads, airports and stadiums that will be built or renewed for the benefit of sports enthusiasts will be exactly what Brazil's exporters need.

Below the salt

These problems have been with Brazil for some time, and companies mostly find ways around them. But the discovery of abundant oil off the country's coast poses a different set of challenges.

To begin with, the oil sits three to four miles below the sea, between layers of salt. This is deeper than any company has tried to drill before. Because it is so deep down, the oil will come out hot and then cool rapidly as it nears the surface, leaving deposits of paraffin that will clog up pipes. Gases under high pressure will come out at the same time as the oil. The drilling platforms will be 185 miles out to sea, out of range of helicopters. Some combination of boats, floating platforms and helicopters will have to be employed to get rig workers there and back.

To solve these problems, Petrobras has announced the world's largest capital-expenditure programme, worth \$174 billion over the next few years. This is a boon to companies such as GE, which has a \$250m

deal with Petrobras to supply Christmas trees (the part that anchors an oil rig to the sea bed). The government has said that it expects Petrobras to work with oil-services firms like Schlumberger and Halliburton, as well as with foreign oil companies that want to boost their reserves.

No doubt many foreign oil companies will come to Brazil and partner Petrobras in the new fields. Compared with many places where they do business, Brazil is a model of predictability, good regulation and respect for contracts. However, the calculation has just been made more complicated for them by the federal government's announcement that it is getting rid of the regulatory framework that has served the country well for ten years and helped to bring about the new discoveries.

The existing system, in which royalties are paid to the state, could be tweaked to reflect the risk of exploration in the fields below layers of salt (though this appears to be low). But the government wants to replace it with a new set of rules that would involve it more directly in the management of exploration and production. Under the latest proposals a new state oil company, Petro-Sal, will take part in all new ventures. Petrobras will also have a guaranteed stake in each block. Other companies can come in as minority partners. Lula is also insisting that everything used to extract the oil should be made in Brazil, which will push up costs and slow things down. All this makes it less attractive for foreign investors to get involved, at a time when Brazil needs a lot of capital to make the most of its new discovery.

Although the numbers suggest that Brazil is at last making proper use of its agricultural and mineral riches, there is another side to the boom that is not reflected in the figures. High commodity prices are correlated with deforestation in the Amazon as trees are cut down to create farmland to feed Brazil's domestic market. It is a dread- ►

► fully wasteful process because the thin soil is quickly exhausted and ranchers move farther into the jungle, leaving a devastated landscape behind them. The forests of the Cerrado, an area of savannah punctuated with trees that once covered much of central Brazil, are disappearing even faster.

As for mining, for every multinational like Vale that collects data on injuries and deaths in its mines there are plenty that do not seem to care much about what happens to their workers. Of the ten largest

mining companies operating in Brazil contacted by *The Economist*, only a couple had numbers on deaths and injuries in their mines. In the informal part of the mining sector, from wildcat gold-miners in the middle of the Amazon to the guseiros who dig for pig iron in Minas Gerais state, things are even worse.

Where intellectuals once worried that Brazil's natural resources would confine it to a marginal place in the world economy, now they are concerned that Brazil's com-

modity wealth will condemn the country's currency to getting ever stronger, making life impossible for manufacturers with their sights on exports. They probably have a point. But it could be dealt with much more easily if Brazilian companies did not find themselves squeezed between two walls that are constantly pushing in on them. On one side is a public sector that taxes too heavily and spends badly. On the other is a large black economy that they find it hard to compete with. ■

The self-harming state

Companies are squeezed between an obstructive government and black-market competitors

IT IS easy to become depressed when confronted by the waste, incompetence and downright obstructiveness towards people trying to make a living contained within Brazil's three layers of government. So perhaps it is best to start by saying that the Brazilian state does some things very well. It has prevented an AIDS epidemic by deploying sensible public policies. Some of its ventures into research and development have helped the economy. It has the highest share of renewable energy in power generation of any big economy.

The state of Minas Gerais has employed private-sector expertise to bring about what it calls a "management shock", eliminating deficits and measuring the performance of its various departments. Some of the people who worked on this project in Minas have been trying to do something similar in Rio de Janeiro state. The Centre for Public Leadership, a charity based in São Paulo, is running courses for mayors who want to learn more about management techniques.

Even in Brasília, the capital, which tends to hold out longest against such improvements, things are happening. "When I arrived at the ministry of mines and energy there were three engineers and 25 chauffeurs," Dilma Rousseff, one of the front-runners in next year's presidential election, told a gathering of foreign reporters recently. "We need to make our civil service professional and meritocratic."

The Brazilian state's problem is not so much that it is overbearing and incompetent, a common complaint, but that it is weak where it ought to be strong and strong where it should be weak. It can withhold environmental permits for new

hydroelectric dams or ports, preventing them from being built, but it cannot stop raw sewage from being pumped into the river that runs through the country's largest city, or keep illegal loggers from despoiling its forests. It can make it extremely difficult for large companies to hire and fire employees or to pay their taxes, but it cannot prevent some 45,000 of its citizens from being murdered each year.

Brazil's government has a lot of resources to draw on. Tax revenue has climbed to 36% of GDP, compared with America's 28%. Yet its public institutions sometimes resemble nothing so much as the laboratory of a lunatic alchemist in which gold is transformed into lead. Brazil spends about three times as much per person on health care as China does, but its basic health indicators are slightly less favourable. Spending on education is respectable, at 5% of GDP, but Brazil's pupils routinely come near the bottom in the OECD's international comparisons of how much they know.

Admittedly Brazil was a late starter in public provision of both health care and schooling. As late as 1930 only one in five children went to school. Because of high inflation in the second half of the 20th century and chaotic government finances in 1980-94, there was not enough investment in schools and hospitals. It is something of a platitude for Brazilian bosses to say that getting hold of skilled people is the biggest long-term challenge their businesses face, but almost all repeat it.

Yet Brazil is prevented from spending more in these two important areas by odd rules governing public expenditure. The constitution, written in 1988, after the re-

turn of democracy, in parts reads like a budget rather than a description of a set of institutions to govern the country. Written before inflation had been brought under control, it is a monument to indexation. Social-security benefits are guaranteed under the constitution "to the end that their real value is permanently maintained". The OECD estimates that nearly 90% of the federal government's total revenue is earmarked in this way. Public-sector pensions, which account for over half of social spending, disproportionately benefit the (relatively) wealthy. Civil servants and politicians alike complain that this denies them the flexibility they need to improve services, yet inertia consistently wins out.

Easy does it

Meanwhile the government imposes high taxes on companies and makes it hard to pay them. The World Bank's most recent survey on doing business ranked Brazil 150th out of 183 countries on how easy it is to pay taxes. It took the bank's hypothetical average Brazilian firm 2,600 hours' work to pay its taxes every year. Any large company operating in Brazil has upwards of 30 people struggling to comply with the tax code. And tax rates are fairly crushing too: the World Bank's hypothetical company faced cumulative taxes amounting to 69% of its profits.

Hiring and firing people is complicated as well, and if a case is brought to court it almost always finds for the employee rather than the employer. Brazil's current labour laws were conceived in the 1940s, at a time when it seemed that in future all workers would be employed making things in big factories belonging to stable ►►

► companies that would keep them on for life. Things have not turned out like that, but Brazil has consistently failed to update this legislation. Companies must pay high taxes and compulsory contributions for each employee on their payroll (over and above salaries) which in the World Bank's hypothetical company added up to 47% of profits. Directors of companies in industries with high staff turnover, such as IT services, complain that they are held personally liable in dozens of lawsuits brought by former employees, and may find their bank accounts frozen by the courts. This happens in the public as well as in the private sector.

On other measures, from starting a business to closing one down, Brazil also fares badly. When the World Bank releases its annual business survey, the federal government sometimes grumbles about a foreign conspiracy. But the international competitiveness survey conducted by the Federation of São Paulo Industries (better known as Fiesp) tells a similar story, placing Brazil 37th out of 43 countries surveyed.

If a contract is broken or payment withheld, it is better to give up than rely on the courts for redress. Brazil's laws permit almost limitless appeals, so even fairly trivial cases can eventually end up in the Supreme Court. Between them, its 11 justices received over 100,000 cases last year. The backlog is enormous, and a good lawyer can often delay a judgment indefinitely, even in serious cases. Antonio Pimenta Neves, a journalist who was found guilty of the murder of his former girlfriend nine years ago, has yet to go to jail.

The problems that ail the courts are clear from behind the large desk of judge Luiz Zveiter, the current president of Rio's Tribunal of Justice. The courts employ 20,000 people in this state alone (about 75 of them just pushing trolleys of sandwiches for sale along the two-and-a-half-miles of corridors in the various buildings). Some 800 cases are pending before the courts of second instance and 800,000 before the courts of first instance (which are least able to cope with the flow of cases). The oldest case outstanding dates from 1911. "The state often does not want these cases to end in case it has to pay up; the citizens often don't want them to end in case they have to pay fines. So the courts end up paying the bill," explains Judge Zveiter. And yet Rio's state legal system is the most efficient in Brazil. By the end of this year it aims to have no cases outstanding from before December 2005. In the context that would be a triumph.

Given how difficult life is for companies that pay taxes and comply with labour laws, it is unsurprising that Brazil has a large informal economy (see chart 5). Its black economy is a place of wonderful invention. The quality of the juice bars and restaurants in even the most miserable slums often surprises first-time visitors. But a large black economy is bad for a country, and normally it fades away with rising affluence. This has indeed been happening in Brazil: between 2003 and 2007 the number of formal-sector jobs grew by just over 5% a year, a remarkable feat given the strength of the forces working against it. But given Brazil's level of development it should be happening faster.

Living in the shadows

Thus many companies in the formal economy find themselves squeezed between a set of rules that makes it expensive for them to operate, and competition from informal competitors who do not abide by those rules. This is not much of a problem in the car industry: nobody has started making Volkswagens at home yet. But in other areas it can be, retailing being the worst offender.

A study of Brazil's informal sector by McKinsey suggests that informal businesses in Brazil are about half as productive as their competitors who follow the rules. This is partly because they lack access to capital, and partly because they find it cheaper to add more workers than to buy machines, so long as they pay no taxes on employing people. Yet despite their relative inefficiency, these businesses are typically more profitable than rivals in the formal economy, which is another benefit of not paying tax or obeying product-market

regulations. There is little incentive for them to grow, because bigger firms tend to attract the attention of the taxman. But they are hard to compete with.

That competition makes it harder for law-abiding companies to grow. This reduces the government's tax revenue and creates two unequal classes of workers: one vociferously defended by unions and enjoying generous benefits and job protection in addition to their salaries, the other with nothing beyond the cash handed out to them at the end of the week.

All this helps to explain why many parts of Brazil's economy are so fragmented. The ethanol business is a good example. You might expect it to be dominated by perhaps ten or 20 big companies, but instead it is splintered into hundreds. What stops consolidation is that formal companies seldom agree with informal ones about what their farms are worth, because profits look lower when all the costs of obeying the law are factored in. "In sectors that employ three-quarters of the labour force, not counting the government, there is everything to do," says Bill Jones Jr, who advises clients of McKinsey on deals. "But mostly it is tough to actually do any of it." This fragmentation holds back Brazil's growth too.

Some companies in the black economy are finding life less comfortable than they used to. Informal pharmacies, for example, were hit when suppliers rather than retailers were made responsible for paying tax on their goods. São Paulo's system of giving people a tax rebate when they ask for a receipt that the state government can trace is having an effect on shops and restaurants. A new law introduced in July allows very small businesses with just one employee to be given formal status at the cost of 50 reais a month. The development of equity markets also encourages formalisation, since companies that want to float need proper accounts. But the best way to turn informal companies and their workforces into taxpayers and citizens would be to make the rules easier to follow and the taxes less onerous.

All serious politicians in Brazil (as well as a few who just pay lip service) talk about changing this. A tax reform has been near the top of the government's agenda for as long as anyone can remember. But it is still not happening, leaving many businesses utterly frustrated. Why, then, do companies and economists around the world see Brazil as such an exciting place just now? The answer has a little to do with shopping and a lot with social climbing. ■



A better today

Brazil's growing middle class wants the good life, right now

ON A Saturday night in Canudos, a town of 15,000 people in the interior of Bahia state surrounded on all sides by parched, silvery forest, there is a lot of consumption going on. Everyone has a mobile phone, a few people have new cars, and early-evening courting is fuelled by branded beers and hot dogs. This place was once a byword for poverty, sitting as it does in the middle of Brazil's drylands. But this part of the *sertão* at least has become more bearable over the past decade or so. There is a large banana plantation that provides jobs, a fresh-water-fishing industry and plenty of commerce.

Carlinhos Silveira has returned to Canudos after some time spent working in São Paulo and now runs a small hotel. For decades internal migration in Brazil worked in the opposite direction, as people escaped the hardscrabble north-east for menial jobs in the more prosperous south and south-east. Now it is possible to find members of Brazil's burgeoning middle class even here.

The recent growth of this species has excited companies, politicians and sociologists alike, and rightly so. Using data from a giant series collected by IBGE, based on monthly interviews with 150,000 people in the six main metropolitan regions, the Fundação Getulio Vargas (FGV), a business school, calculates that the share of people in social class C increased from 42% of the population in 2004 to 52% in 2008. Class C covers households with a monthly income ranging from 1,064 to 4,591 reais (about \$603-2,603 at current exchange rates). In Brazil that makes them middle-class, even though in richer places these income levels would not buy that description. They mostly have jobs in the formal economy, which also brings access to credit, and probably own a car or a motorbike. Remarkably, their numbers remained steady through the financial crisis, says Marcelo Neri of FGV, as people moved down from class B to replace the drop-outs.

Perhaps more impressively, Brazil's recent progress seems to have been evenly shared. The growth of the middle class, combined with a 100% increase in the minimum wage over recent years and Bolsa Família, a programme of cash trans-

fers to those lower down the income scale that benefits some 12m families, has caused inequality to decline. In a country famous for its skewed income this is a big achievement. According to IPEA, extreme poverty halved between 2003 and 2008. Brazil's score on the Gini coefficient, a measure of inequality, is falling, getting closer to that of the United States (see chart 6).

The north-east of the country, whose poverty has prompted successive governments to come up with plans for its revival, in fact grew slightly faster than the rest of Brazil between 1994 and last year, at an average annual rate of 3.3% (compared with 3.1% for the country as a whole). The main reasons were a large expansion in public-sector employment, pensions and income redistribution. The drylands have also benefited from an expansion of fruit and grain farming and of light industry, says Gustavo Maia Gomes of the Federal University of Pernambuco.

Shopping down to Rio

Brazilians like to spend. Tiffany, a jeweller, has more stores in São Paulo than anywhere else in the world. Louis Vuitton, which makes expensive bags, until recently got its biggest profits per square foot from its São Paulo shops. But it is the scale of the mass consumer market that is opening up—the 1m points of sale for beer, the 165m mobile phones—which is raising the biggest hopes. “If the world is looking for savers, Brazil is not much good,” says Illan Goldfajn, chief economist of Itaú. “But if it

is looking for consumers, then we might be able to help.”

David Neeleman, who has launched an airline, Azul, to serve all these new consumers, sums up the optimism that the new entrants to the middle class are creating. “America has an excess of everything: cars, credit,” says Mr Neeleman. “Down here people are getting their first car, first credit card, owning their first home. It feels like the beginning of the cycle.” He is talking about people like Eduardo Lins, who left his eight siblings in the interior of Bahia and followed a girlfriend to Salvador, the state capital, when he was 15. Now, 20 years later, Mr Lins has a new car, bought on credit, which he is paying off by driving a taxi, and has recently bought an apartment in the city. Life has got better.

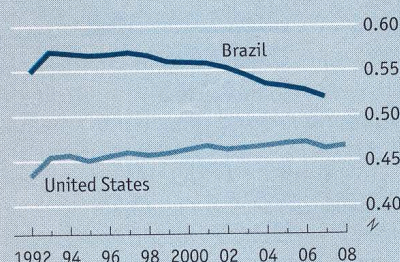
What Brazil's middle class wants is largely shaped by what the characters in the ubiquitous *telenovelas* (TV soap operas that reach audiences measured in tens of millions) are wearing, consuming and driving. These programmes are mostly made in Rio and tend to feature characters who are richer and whiter than average and flit around the place dressed in casually expensive clothes and conducting indiscreet love affairs. They do a good job of feeding the burning desire for more and different stuff that a market economy thrives on.

Luxuries are popular, even in places where there is not much money around. The highest whisky consumption per person is in Recife, capital of the poor north-eastern state of Pernambuco (where the drink is often referred to as professor, a nod to Teacher's whisky). Retailers have also discovered the importance of flattering their new customers. Walmart, home of everyday low prices, employs people at its checkouts to pack shoppers' groceries for them. Casas Bahia, a chain of shops selling white goods and furniture on credit, sits customers down and serves them coffee while they discuss how they will pay for their new television.

Consumer credit has grown by 28% a year in nominal terms over the past three years. The middle class also needs apartments and houses to put its new purchases in. At the moment mortgage finance ac-

Unequal contest

Gini index of income inequality*



Source: US Census Bureau

*0 indicates perfect equality (everyone receives an equal income); 1 indicates perfect inequality (all income is received by only one person)

► counts for only 2% of GDP, a tiny sum even compared with, say, Mexico (9%), let alone America (85%). Brazilian housebuilders believe that as mortgages develop, the housing market will be a profitable place to be. They seem to have convinced foreign investors, who have provided most of the capital for Brazil's listed housebuilders. The government reckons the country needs 8m more houses, half to allow families to move out of shared living quarters and half to replace squalid homes. But most builders are even keener to provide apartments for Brazilians who are somewhat better off.

Interest rates will have to come down a lot further before the mortgage market really takes off, but already some companies are securitising mortgages with maturities of three or four years and selling them to investors. In addition to the need to house Brazil's existing middle class, says Wilson Amaral of Gafisa, a large listed housebuilder, Brazil needs to look to the future: it will have 35m new families by 2030, all of whom will need somewhere to live. Brazil's population is comparatively young and still growing, mainly through natural increase rather than immigration.

If the next ten years see as much social



Going for a bit of froth

and economic progress as the past ten, Brazil will become a very different place. A good place to see how this might work is Diadema, a formerly rough neighbourhood of São Paulo. In 1999 the murder rate there reached 141 per 100,000 people (compared with 37 per 100,000 in Baltimore, one of America's more violent cities, last year). Diadema became so notorious that people who lived there felt they had to lie about their address in job interviews.

But since then the murder rate has dropped steeply. Earlier this year, on a plot of land that was once a cemetery, a six-sto-

rey shopping mall opened in Diadema, complete with neoclassical flourishes and the odd piece of what looks like marble, a secular monument to less violent times. The mall is still fairly empty, perhaps because it was built so quickly that potential shoppers are scared to go in case the roof falls in. But many of the elements of the lower-middle-class Brazilian dream are here: the jewellery on credit, the multi-screen cinema due to open soon, the air-conditioned atrium. It is a fine place to eat a *pão de queijo* and reflect on what this spot was like only a short decade ago. ■

Two Americas

Brazil and the United States have more in common than they seem to

LIVING in Brazil, it is easy to imagine that you have been transported into one of those novels with alternative endings—in this instance, about how the United States might have developed if a few things had turned out differently. Both are continent-sized countries in the western hemisphere with federal democracies in which state governments have considerable power. Both were colonised by small European seafaring nations before gaining independence within 50 years of each other. Their populations are made up of the descendants of their original inhabitants, early colonists and African slaves, topped up later by European and then Asian migrants. A recent influx from neighbouring countries completes the mix. Brazil's melting pot is, if anything, even more successful than America's. There is no such thing as a hyphenated Brazilian.

Both countries seem surprisingly religious to European eyes, with different

Christian sects competing vigorously for believers. The most successful Brazilian multinational of all may be the Universal Church of the Kingdom of God, a Pentecostal outfit that keeps being investigated for overenthusiastic marketing and opaque book-keeping. Both places show a strong preference for consumption over saving when times are good. Brazil has a culture all of its own, but it looks for inspiration to America more than it does to its Spanish-speaking neighbours.

A place of paradoxes

And yet the differences are stark. America is rich, Brazil poor. Brazil is more left-wing. America fights wars, Brazil does not. America likes its capitalism as unbridled as possible, Brazil prefers its markets with a strong government presence.

Look more closely, though, and some of these distinctions become blurred. Brazil is more left-wing in theory than in practice.

Next year's presidential election is likely to come down to a choice between a candidate from the left-wing Workers' Party and the centre-left Party of Brazilian Social Democracy. Even so, most of the money the government spends goes to people who are comparatively wealthy. The biggest single reason for the difference in income distribution between Brazil and America is more regressive public spending in Brazil. "We live in a paradoxical situation of a government that spends a lot and benefits a few," said Antonio Palocci on becoming finance minister in 2003.

Since then some more public money has found its way to Brazil's poorest, but proportionately the amounts remain small. In fact, Brazil has rather a lot of public policies that would be considered unfair and regressive in America. Children whose parents can afford to send them to good private schools tend to get the pick of places at good publicly funded universi- ►

ties, whereas children from poorer families often have to pay to go to less good places. The BNDES transfers money from low-paid workers to the balance-sheets of Brazil's large companies. It has supported JBS-Friboi's transformation into the world's largest producer of protein, which the company has accomplished through acquisitions in America. Yet the group remains privately owned: a bizarre appropriation of public resources that would cause an outcry in other countries.

Brazilians also have a more American approach to capitalism and free markets than they might appear to at first sight. Many of their country's success stories of the past 15 years, from the free-floating real and the autonomous central bank to the privatisation of state-controlled firms that have since flourished, are products of a similar way of thinking about what economic arrangements work best. To his credit, President Lula has not reversed these changes, as many feared he might.

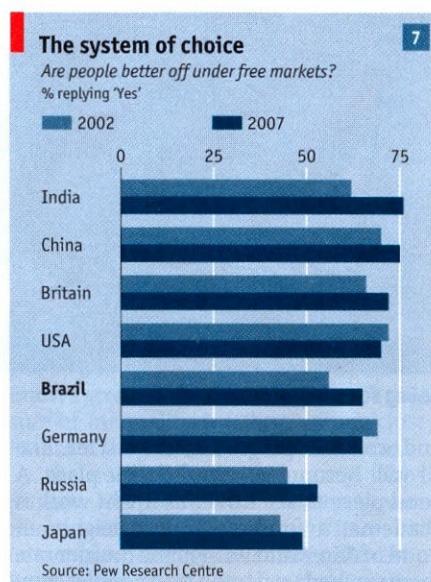
The clash between a growing middle class and a government that often seems to be blocking its aspirations is creating a rather American story about the determined little guy being constantly pulled back by the dead hand of bureaucracy. Many of the younger businessmen and bankers in Brazil have postgraduate qualifications from American business schools. Quite a few hold views that would not be out of place at the American Enterprise Institute or other free-market think-tanks.

If America's doubts about free markets and Brazil's confidence in them both continue to grow, the two may shortly meet (see chart 7). Even President Lula now denounces protectionism, though many foreign governments, noting Brazil's still fairly high import taxes, are unconvinced. Brazil's imports and exports taken together were equivalent to 22% of its GDP in 2007, compared with 23% for America. Above all, Brazil now seems confident that a more open economy will not condemn it to a role as coffee-maker to richer countries.

The future of the country of the future

Yet if Brazil has at last discovered a formula for releasing its wealth, it is also true that most of the country's economic successes are clustered around the commodity sector. Brazil has created no car or computer companies with big sales abroad. Embraer is an isolated example of a big high-tech exporter. The same can be said of the services sector. That is a pity for a country vibrant with creativity and invention.

Pockets of the commodity sector, such



as Petrobras's deepwater drilling, do require high levels of technical expertise. But Brazil's obstructive government seems to confine its businesses to competing internationally only in sectors where natural advantages make them close to unbeatable. Judged against its own past, Brazil is doing astonishingly well. Judged against its potential, it still fares poorly.

Allowing for its size, Brazil spends much less than the OECD average on research and development, and most of that spending comes from the government: the public sector accounts for some 55% of investment in technological innovation. South Korea, with a population a quarter the size of Brazil's, registers about 30 times as many patents. Brazil needs to do some-

thing about this: in order to live with the strong currency that comes with success under a free-floating exchange rate, it must raise productivity.

Like America, Brazil is so big and varied that it often seems to contain at least two separate countries. One of these is a place with ten land borders and no wars where people speak a single language in compressed time zones; where there is no religious conflict; and where three-quarters of the population turns out to vote, with election results announced the following day. This country has sophisticated economic policymaking and financial markets, as well as a growing collection of world-beating companies. It runs on sushi and is usually untanned.

The other Brazil has a stubbornly high murder rate and a violent police force. Many of its politicians see nothing wrong with stealing public money or appointing relatives to jobs within their private kingdoms, and refuse to resign when found out. It is a place of misery where 17% of homes do not have running water and too many families live in home-made shacks by motorway bridges. A place where many people convicted of serious crimes go unpunished, and those in prison live out a brutalised existence. And a place of environmental devastation that government is powerless to stop.

Because this special report deals with business and finance, it has concentrated on the first place, but both Brazils are part of the great green elbow that sticks out into the Atlantic. What makes the country so exciting at the moment is that, thanks to its newfound stability, Brazil's better self now has a much greater chance of prevailing. ■

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