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Brazil: Credit to redeem

By Joe Leahy in São Paulo

An economic programme that has capitalised on the commodities boom is in danger of running out of steam



In a painted portrait and an array of photographs, the bearded image of Luiz Inácio Lula da Silva beams down repeatedly from the walls of the modest city hall in Lauro de Freitas. Divided between plush seaside villas and sprawling favelas, or slums, this district of Salvador, capital of Brazil's north-eastern Bahia state, has plenty for which to thank the man who this year stepped down as the country's president.

Nearly 40 per cent of the municipality's households receive Bolsa Família, the signature welfare scheme of Mr Lula da Silva's government – one of the highest concentrations in Brazil. They have access to a range of other government programmes, such as subsidised housing and the Restaurante Popular, which serves cheap lunches aimed at the needy.

The sense of greater prosperity is evident in the proliferation of discount department stores offering white goods and television sets on installment plans – and in the relative peace prevailing in Itinga, the city's giant favela and usually one of the region's most violent. "Lula had greater vision than any economist, any sociologist, any analyst or any financier," enthuses Moema Gramacho, the mayor.

Lauro de Freitas is hailed as one of the most successful examples of "Lulismo" – the former president's trademark combination of social welfare hand-outs, generous pay rises, easy access to credit and stable economic management. It is a model credited with lifting 33m out of poverty during his eight years in office.

Households ahead

Since 2003, when Luiz Inácio Lula da Silva came to power, nearly 49m Brazilians have risen to the middle and upper-middle classes, according to a study by Brazil's Getúlio Vargas Foundation. The number of people in Brazil's so-called D and E classes – the working class and the poor, who earn less than R\$1,200 (US\$760) a month – has declined from 96m in 2003 to below 64m. Mean household income has grown by 1.8 percentage points above gross domestic product per year since 2003 – the reverse of China, where GDP has grown above household income by 2 points a year.

But even as Lulismo is lauded across Latin America as a possible solution to the continent's centuries-old ills of inequality and stunted development, there are concerns that it is reaching its limits in Brazil. Like China and India, its large emerging market peers, Brazil has risen over the past decade to become an important power. But just as China and India are starting to show the strains of rapid economic growth, Brazil is also displaying signs of overheating.

"The longer it continues to grow like this in Brazil, the harder the adjustment will be as and when it does come – and it inevitably will come at some point," says Neil Shearing at Capital Economics in London. "So we are now into the kind of realm of soft versus hard landing."

Despite riding one of the world's strongest commodity price cycles, Brazil spends more than it earns and invests little. Inflation and consumer leverage are rising and Brazil's currency, the real, has strengthened by 46 per cent in two-and-a-half years. Bearish commentators warn that the Lula model is at risk of degenerating into a credit bubble.

More optimistic voices dismiss such predictions. But they agree that Brazil faces crucial choices and that deeper reform is needed if Latin America's largest economy is to sustain rapid annual growth rates. "The Lula model is incomplete," says Arminio Fraga, a former central bank president and co-founder of a hedge fund, Gávea Investimentos. "We don't invest enough to grow fast, so we are hitting some bumps."

NEIGHBOURLY EMULATION

The new orthodoxy of

No one disputes Mr Lula da Silva's record of success. On taking office in 2003, the former firebrand trade unionist placed technocrats in the central bank and the finance ministry to ensure macroeconomic stability. He launched Bolsa Família and sharply increased the minimum wage, laying the foundations for a mass expansion of the middle class. He reformed bankruptcy laws, making it easier for banks to

'Lulismo' captures a continent's imagination

Some call it the "Brasilia consensus", a cheeky jab at the "Washington consensus" of the 1980s. Uruguay, Paraguay and El Salvador are among its adherents. Many Mexicans would like their country to follow as well. So too Peru: the first foreign trip made by Ollanta Humala as president-elect was to Brazil to meet Luiz Inácio Lula da Silva – "the man", as US President Barack Obama once described him.

"Lulismo" has become the acceptable face of leftwing politics in Latin America, the new orthodoxy. The plan implemented by Brazil's president in 2003-10 offers a pragmatic political strategy for any aspiring leader. It addresses urgent social needs. It is broadly popular across the social classes. It patently works, unlike the ideologically driven leftism of Cuba or Venezuela. Yet many may have drawn incorrect lessons from its success.

Many regional leaders "think the secret to Lula's success was the adoption of redistributive policies, the shelving of structural reforms, while pandering to Wall Street", says Walter Molano of BCP Securities. "Unfortunately they are completely wrong. The key was a combination of luck and low expectations."

Mr Lula da Silva came to power just as China re-entered the global economy and pushed commodity prices into the stratosphere. This allowed Mr Lula da Silva to coast on the favourable external environment and a continuation of the enormous reform efforts of his predecessor, Fernando Henrique Cardoso. Few countries are fortunate enough to have two such remarkable presidents in succession.

Old-fashioned credit also played a role. Allowing banks to deduct their interest charges on consumer debt directly from workers' payroll slips was a financial and political masterstroke. The boom in lending that followed gave the economy another shot of adrenalin.

Lula-wannabes, such as Peru's Mr Humala and Uruguayan president José Mujica, have also been lucky to inherit well-run economies and a favourable external environment. So they may yet repeat Mr Lula da Silva's success and lift millions out of poverty.

Yet should the commodity boom pop, doing "more of the same" may make that luck evaporate. Lulismo, at least in Brazil, was often an excuse for

lend and spawning a near-doubling of real credit to the private sector since 2007.

In addition, Mr Lula da Silva enjoyed his share of good luck. China began sucking in Brazil's exports of iron ore, soya and other commodities. In 2009 it overtook the US as Brazil's largest trading partner, helping the country to emerge strongly from the global financial crisis.

As president he also pumped in billions of reals of subsidised loans from BNDES, the state development bank. When he handed over in January to Dilma Rousseff, Brazil was growing at an Asia-like pace of 7.5 per cent. The man who lacked even a primary school education had achieved something few of his predecessors had managed – he had given Brazilians a sense of common purpose. Rich, middle class, poor – all were suddenly pulling in roughly the same direction.

"He really in many ways changed the trajectory of Brazil and, what is more important, he strengthened the pride that many Brazilians feel about being Brazilian," says Susan Segal, president of the Americas Society/Council of the Americas, a US-based political and business forum.

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Yet Mr Lula da Silva also handed Ms Rousseff an economy fraught with imbalances. The global boom in commodity prices has brought a 30 per cent improvement in Brazil's terms of trade – the difference between what it earns from exports and pays for its imports. But rather than use some of this to reduce debt and boost savings, the country has been spending it all and more on additional imports – such as home appliances from China.

That has led to a current account deficit of about 2.3 per cent of gross domestic product in the year to May. The gap is being funded by global investors keen to tap into Brazil's high growth – further pushing up the real and reducing the competitiveness of the country's manufacturers. "The Lula model depends on export prices going up and up and up, so imports can go up and up," says Tony Volpon at Nomura in New York. "It's a model that works if you have this commodity boom."

Brazil has tried to limit foreign investment inflows through capital controls, engaging in a "currency war", but it now has another, more pressing problem – inflation. Consumer price rises have topped the central bank's target ceiling of 6.5 per cent. The bank has increased interest rates four times this year, to a current 12.25 per cent. Although this attracts investment flows from developed countries, further strengthening the real, Ms Rousseff's government has little choice. Any return to Brazil's dark history of runaway inflation could cost it the next election. As Guido Mantega, finance minister, told the Financial Times last week: "Inflation is my permanent preoccupation."

Part of this inflation has come from rapid credit growth, particularly consumer borrowing. Observers such as Paul Marshall and Amit Rajpal at Marshall Wace, a London-based hedge fund, argue that Brazil is at risk of a full-fledged consumer credit crisis. Retail borrowers are on average spending one-quarter of their disposable income on debt servicing, compared with only about 16 per cent in the US. Defaults are rising. Serasa Experian, a credit monitoring agency, this week said its index of consumer delinquencies rose 22 per cent between January and June, the biggest increase in nine years.

"The consumer faces a reduction in purchasing power and rising indebtedness," the agency said, blaming inflation and the central bank's tightening cycle for the rise.

Other analysts are more sanguine. The mortgage sector is tiny and about 60 per cent of consumer loans are secured against payrolls, cars or property and are at fixed rates – making them safer, according to Roberto Attuch and Fabio Zagatti at Barclays Capital. Most loans are short term.

But even if consumer credit poses no risk to the financial system, how long can it continue to power the economy at the same rate? While the central bank is forecasting credit growth of 15 per cent this year, no one agrees on how much debt households can bear. "What's the limit that people can pay in terms of interest charges plus amortisation? When it's getting to a third of their income, it's pretty high," says Mr Volpon.

postponing needed structural reforms.

Nobody has advocated that other countries embrace the corruption that also flourished during his presidency. Nor is social democracy exclusive to Lulismo, even if it goes under other names in Chile and Colombia. The conditional cash payments to the poor, for which Lulismo is best known, were invented in Mexico.

Democracy and prosperity do not always go together. But in Latin America countries with more effective constitutional democracies such as Brazil also have better prospects for prosperity. Nations with the soundest economic policies, including Brazil, are also those where democratic practices are strongest. These are perhaps the most encouraging lessons from Brazil's recent success, as they are repeatable everywhere. **John Paul Rathbone**

With consumer credit growth expected to lose steam, economists say Brazil must increase investment in infrastructure and education to relieve bottlenecks in logistics and improve productivity. The government is seeking to invest billions of dollars in infrastructure through its "accelerated growth programme". Yet progress so far has been slow. Gávea's Mr Fraga estimates that the country needs to increase the investment rate from 18 per cent of GDP to 25 per cent – or by about \$150bn a year. Greater private sector involvement is needed, he argues. "Brazil needs to invest more. I've got nothing against some growth in credit and consumption: that's how people participate in the growth. But that alone won't do it."

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The best way to fund investment, say economists, is to increase the efficiency of the public sector, which expanded during the Lula years to approach 40 per cent of GDP. That is about the same proportion as in advanced economies but without corresponding levels of productivity.

Yet while Ms Rousseff has clamped down on costs this year, more ambitious reforms to cap civil service pensions and make labour laws more flexible seem unlikely, as she is struggling to control a 10-member coalition. "The government has grown inexorably, which makes it less flexible if Brazil ever again has a crisis and needs to tighten its belt," says Ken Rogoff, a Harvard University professor. "That's a weakness, I think it's actually *the* weakness, in the model."

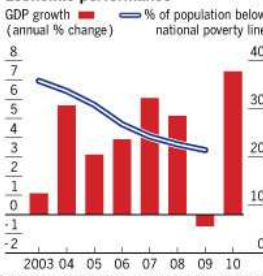
To be sure, Brazil's economic miracle remains intact for now. Growth is expected to be a respectable 4 per cent this year – matching the average for the Lula years. With the football World Cup to host in 2014 and the Olympics two years later, the nation has rarely had a better chance to shake off the cliché of being "the country of the future that always will be". But Ms Rousseff's government will first have to show how it plans to increase investment while reducing the economy's reliance on volatile commodity prices and an overstretched consumer.

Even in Lauro de Freitas, the heartland of Lulismo, one does not have to look far to find signs of fatigue in her predecessor's much-fêted economic model. In Insinuante, a department store that accepts Bolsa Familia cards as a guarantee against loans, Joilma Santos de Oliveira, a self-employed baker of savoury snacks, is shopping for a sofa. She says her husband's name is already on a blacklist of defaulters at a credit agency.

Yet the couple still borrows – using her income instead. "We can spend up to 60 per cent of my monthly earnings on paying our installments," Ms Santos de Oliveira adds blithely as she tries out the comfortable upholstery on display.

Real results

Economic performance



Consumer price inflation
Annual % change (latest values)



Brazil trade



Sources: IMF; World Bank; Thomson Reuters Datastream; Haver Analytics.

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