Rousseff Crisis Spurred by Lula Debts as Brazil Boom Diminishes

By Alexander Ragir - Sep 26, 2011 11:01 PM CT
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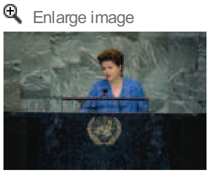
On a cool July evening, Brazilian President Dilma Rousseff hosts a cocktail party for 50 leaders of her governing coalition, Bloomberg Markets magazine reports in its November issue. Speaking from the foot of a red-carpeted staircase in the living room of Alvorada Palace, where she lives with her mother and aunt, Rousseff tells the gathered politicians that these are the best times for Brazil, according to four people who attended.

Enlarge image



Brazil's president Dilma Rousseff. Photographer: Scott Eells/Bloomberg

Attachment: Brazil Economic Indicators

Enlarge image

Luis Ignacio Lula da Silva, Brazil's former president, greets workers at the inauguration of the Petrobras P-51 oil platform near Angra dos Reis, Brazil, on Oct. 7, 2008. Photographer: Douglas Engle/Bloomberg News

"The world is going through economic and financial turbulence," says Rousseff, who's dressed in a black pantsuit. "But we're living through a great moment."

In a toast, Dilma, as she's known to almost all Brazilians, juxtaposes the task of managing the country's new economic prosperity with U.S. President Barack Obama's struggle with the Republicans to get the U.S. government budget under control.

"And up there, they only have two parties," she jokes.

Brazil has 27.

Rousseff, 63, inherited just about everything a president could want from her mentor and predecessor, Luiz Inacio Lula da Silva: an economy growing at a 7.5 percent annual pace and unemployment, at 5.3 percent, that was the lowest since at least 2001. Brazil's Bovespa stock market index rose six-fold during Lula's eight-year tenure, as iron ore, soybean and sugar exports boomed, driven in large part by demand from China.

Lula pulled 24.5 million people out of poverty in his years in office, according to data compiled by the Getulio Vargas Foundation, and Rousseff says that in the next four years, she will eliminate extreme poverty in Brazil.

A Miracle Subdued

Yet Rousseff took office in what has turned out to be a rocky period for Brazil's economic miracle. Her government and Brazil's economy have been hit with a series of setbacks. Brazil's subdued mood may be best captured by the swoon in its stock prices: The Bovespa index was down 22 percent in 2011 as of yesterday.

The bad news spills over into politics. From June to September, five of Rousseff's cabinet

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Type	Today	1 Mo
30-Year Fixed	4.09%	4.28%
15-Year Fixed	3.36%	3.45%
5/1-Year ARM	3.01%	3.11%
3/1 Year ARM	3.14%	3.23%
1-Year ARM	2.96%	2.96%

The bad news spills over into politics. From June to September, five of Rousseff's cabinet ministers resigned, four of them after the police or the press made allegations they had misused public money.

On Aug. 17, Agriculture Minister Wagner Rossi stepped down after Veja magazine alleged he had illegally used his influence for personal gain. Rossi denies wrongdoing. His PMDB party, with 80 deputies in the 513-member lower house, is a crucial part of the 15-party governing coalition led by Rousseff's Workers' Party, which itself has just 86 Assembly seats.

Inflation Affliction

On the economic side, Brazil is once again suffering from an old affliction: inflation. Consumer prices, as measured by Brazil's IPCA index, rose 7.2 percent during the 12 months ended in August. Though mild compared with the country's legendary hyperinflation -- which peaked at an annual rate of 6,821 percent in April 1990 -- the price increases are eroding some of the progress Lula and Rousseff, who used to be his chief of staff, have made at reducing poverty and building a middle class.

The dilemma for Rousseff's government is that officials don't want the fight against inflation to choke off economic growth. From January to July, central bank President Alexandre Tombini responded to the inflation threat by raising Brazil's benchmark interest rate five times.

Then, on Aug. 31, to the surprise of analysts, the central bank lowered the rate, to 12 percent from 12.5 percent. Even after the cut, Brazil's rate was the highest among the Group of 20 nations, representing the world's largest economies.

Global Downturn

The central bank's rationale for the rate cut was that a "substantial deterioration" in global economic growth will also slow Brazil's expansion and push down inflation.

"Even assuming that they're correct on their overly bearish view on Brazil's economy, they're clearly putting growth above their inflation target," says Tony Volpon, Latin America strategist at Nomura Securities International Inc. in New York. "The outcome in the long run will be higher overall inflation."

Despite the global economic gloom, Will Landers, who manages $8.5 billion in Latin American stocks at New York-based BlackRock Inc., sees only blue sky for Brazil's economy.

"The natural resources aren't going away, global food demand isn't going anywhere and the middle class will continue to develop," Landers says. "The domestic consumption story is unparalleled. It's still a great place to invest."

There are two immediate culprits behind what is the worst inflation in six years: skyrocketing credit and heavy spending by the government. Bank lending to businesses and consumers stood at 47 percent of GDP as of July, up from 24 percent when Lula took office in 2003, according to the central bank.

Lula's Mixed Legacy

And in the run-up to the Oct. 31, 2010, election that put Rousseff into the presidency, Lula spent lavishly. Government spending in 2010 jumped 22.3 percent to 700 billion reais ($378 billion).

To tame inflation, Rousseff pledged on Feb. 9 to cut 50 billion reais from the 2011 budget. She also needs to cut the government subsidies that allow the National Development Bank to lend money at cheap rates, says Paulo Vieira da Cunha, a former central bank director who's now a partner at New York-based hedge fund Tandem Global Partners LLC. The bank handed out a record $101 billion in loans last year for projects such as building nuclear power plants, dams and roads and improving the electrical grid -- 40 percent more than the $72.2 billion loaned to countries around the globe by the World Bank.

Carry Trade

Commercial banks have also contributed to the inflation spiral. With near-zero interest rates in the U.S. and Europe, banks have been borrowing at low rates abroad and then lending at higher rates in Brazil, prompting Tombini to tighten bank liquidity requirements, a move that he says has removed 61 billion reais from circulation and helped prevent a credit bubble.

Brazil's high interest rates have attracted speculative investors to Brazil's bond market, adding fuel to the 27 percent rise in the value of the real against the dollar since the end of 2008. The strong real makes exports more expensive and imports cheaper, which has resulted in a flood of Chinese goods filling store shelves, hurting local manufacturers.

The real has fallen 13 percent this month against the dollar as investors have fled emerging market assets on concern Europe's debt troubles will stall the global economy. The decline may improve Rousseff's image with exporters and manufacturers, although it will fuel inflation by increasing prices for imported consumer goods, says Mauricio Rosal, an economist with Raymond James Financial Inc. in Sao Paulo.

"The real fell because of problems with Europe, but if a solution is found, the currency will bounce back," Rosal says. "What's happening in Europe isn't going to solve Brazil's structural problems."

World Cup Costs Rise

Rising borrowing costs make government financing more expensive for the road improvements and other construction projects Brazil is undertaking to prepare for hosting the 2014 World Cup and the 2016 Summer Olympics. The government is building stadiums, housing and other facilities for the games and is also upgrading transportation and other infrastructure as part of an $886 billion investment plan through 2014.

Rousseff can attack all of her problems at once with a single measure: reducing the huge and growing government budget, says Alberto Ramos, a New York-based economist at Goldman Sachs Group Inc. (GS) specializing in Latin America. Since Lula took office, public spending has tracked GDP upward, with the economy growing to $2.1 trillion in 2010 from $552 billion in 2003.

Need for Austerity

"I've never seen an economy with so many macro issues that can be addressed with just one instrument," Ramos says. "If they would cut the fiscal budget significantly, they'd let the central bank loosen monetary policy. Lula rode the wave of rising commodity prices and forgot to make the reforms needed to make it sustainable."

By cutting government spending, Brazil could both lower taxes and reduce the cost of its $1.73 trillion debt by making more room for policy makers to cut interest rates, Ramos says. In 2008, the last year for which data are available, Brazil's federal, state and local governments collected taxes equivalent to 35 percent of Brazil's GDP, with half of the money spent on pensions, corporate subsidies and welfare programs and 16 percent spent on debt payments.

Both public and private projects are expensive to bring off because of what Ramos and other analysts call the Brazil Cost. The price of doing business is driven up by taxes, graft, a turgid bureaucracy and high borrowing costs, Ramos says.

Unfriendly to Business?

Brazil, the world's seventh-largest economy, ranks 127 out of 183 countries in the ease of doing business, according to the World Bank's Doing Business 2011 survey.

It takes an average of 120 days to complete the 15 procedures to start up a company.

Persuading the legislature to spend less will be an uphill battle, according to an Aug. 10 report on the economy by Bank of America Corp. The most Rousseff can hope for, the report says, are modest changes in the tax code and a rise in the time younger government employees need to work before they get their pensions.

The generous pension system is an important component of government overspending, says Simon Nocera, founder of San Francisco-based hedge fund Lumen Advisors LLC, who studied the subject while working as an economist at the International Monetary Fund in the 1990s.

Public servants can retire with 100 percent of their final salary after as few as 25 years of service, though men must be 60 and women 55 before they can collect. In 2010, the government spent 333 billion reais on pensions -- almost the GDP of Ireland.

Generous Pensions

"If they reformed the pension system, they could lower taxes and interest rates," Nocera says. "It's the easiest way to lower costs, but there's no political will."

Rousseff, who had never run for any office before being elected president, has little experience in negotiating the political deals that will be needed to reduce the budget and push down inflation and interest rates. And the recent cabinet resignations don't help.

One victim was Antonio Palocci, Dilma's chief of staff, an experienced Workers' Party leader who stepped down in June after a news report that his consulting firm had earned 20 million reais in 2010, most of it when he was running Dilma's electoral campaign. Opposition lawmakers claim he was selling access to the future president. Palocci denies wrongdoing.

Palocci Departs

Rousseff replaced Palocci with Senator Gleisi Hoffmann, a woman with almost no heft within the party, according to David Fleischer, a political analyst at the University of Brasilia.

Rousseff also lost her tourism minister -- who resigned on Sept. 14 after federal police arrested 38 people for the illegal use of money from his ministry.

Alfredo Nascimento, her powerful transportation minister and a leader of the Party of the Republic, also resigned amid allegations of kickbacks and overbilling in a ministry that doles out $15 billion a year for public works projects. He also denies wrongdoing.

With the pressure on to root out corruption, in the following two months Rousseff forced out about 20 more officials from the Transport Ministry, prompting Nascimento's party to pull out of the government coalition.

Rousseff's July cocktail party was one attempt to keep the government together so she has a chance to fight off the demon of inflation. At one point, Rousseff raised her wine glass for a toast to "fraternity" and "harmony" before noticing that not everyone had a drink. Waiters scurried to give glasses to those who were empty-handed before she continued.

Toasting Together

"It was very important for President Dilma to make sure we could all toast together," Minister of Institutional Affairs Ideli Salvatti says.

Her coalition might be fragile, but given the economic powerhouse that Lula bequeathed her, Dilma's glass is still more than half full.

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