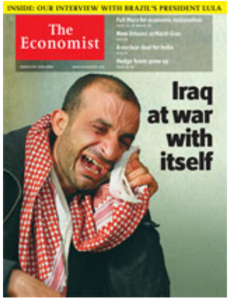

The Americas

Brazil

Lula's leap

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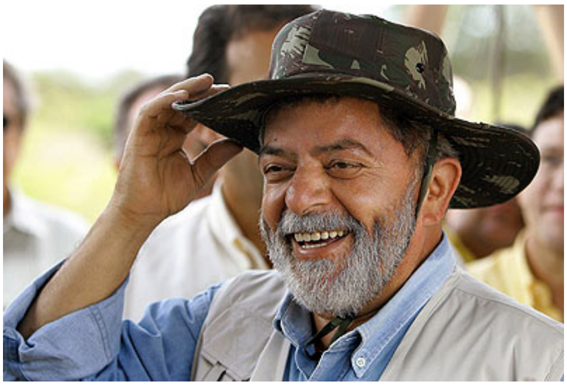
The Economist talks to Brazil's president

AFP



THE press says he's shed 14 kilos (30lb). His aides confirm more than ten. But there is no doubt about the improvement in the political fitness of Brazil's president, Luiz Inácio Lula da Silva. Last year, Brazil's worst scandal in a dozen years nearly finished him. The polls now predict his victory over likely rivals in next October's presidential elections. Lula does not admit to being a candidate: he may wait until June to declare himself, while his main rivals must leave their current jobs by next month. Yet his frenetic trips around the country inaugurating crowd-pleasing public works make his intentions plain.

Why is he now likely to win? Speaking to *The Economist* in a rare interview, Lula cited over and over what he regards as his twin triumphs: economic stability plus social progress. “How many countries have achieved what we have: fiscal responsibility and a strong social policy at the same time?” he asks. “Never in the economic history of Brazil have we had the solid fundamentals we have now.” Brazil is ready for “a leap in quality”, he says.

Such a leap is what Brazil—a country with a population (186m) equal to that of the whole of the rest of South America and a land area bigger than all 25 EU countries combined—has been waiting for since the early 1970s, when it was one of the world's fastest growing economies. Then its economy stumbled into debt and inflation, while other emerging economies like China and India began to take off, generating more global buzz. In his interview at the presidential ranch, Granja do Torto, Lula defended a slow and steady approach to growth and promised further reform in a possible second term. “The future”, he says, “will be built on strong investment in education and training, with tax relief to encourage new investment, notably in science and technology.” Since becoming president in January 2003, he has achieved much of what he set out to do, but has not yet cleared all obstacles to Brazil's great leap forward.

Popular, but no populist

Solid fundamentals are not what the world expected from Lula. His pre-presidential career consisted mainly of leading a trade union that defied Brazil's military dictators, and a political movement, the Workers' Party (PT), that denounced the “neo-liberal” policies of the dictators' democratically elected successors. The victory of a worker born dirt-poor in Brazil's poverty-stricken north-east was celebrated as a victory for poor people everywhere. Yet Lula did not turn out to be a populist like Venezuela's Hugo Chávez. Instead of spending recklessly, reigniting inflation and perhaps defaulting on debt as Argentina has done, Lula clamped down on inflation and saved extra money to pay the debt. “I will not throw away the opportunity the people gave me,” he says.

Lula sees himself as a negotiator, not an ideologue. He has befriended both Mr Chávez and the Venezuelan leader's American antagonist, George Bush. On a state visit to Britain next week, he will try to prod the Doha round of global trade negotiations into life.

For a leader adept at reconciling opposites, Lula has proved a surprisingly polarising figure. Disappointed with his orthodox economics, the left wing of the PT has harried the government with “friendly fire”, deterring Lula from reforming as boldly as he might have done. Yet, for his foes, Lula remains the party's creature. He allowed the PT to replace experts from the government bureaucracy with loyalists and to abort programmes that had proved their worth. Then came the *mensalão*, revelations that the PT had been funnelling money illegally to both its own congressmen and those from allied parties. Millions had voted for the party because it proclaimed itself above the grubby norm of Brazilian politics. That image is now in tatters. Lula is popular among the poor, say the polls, but has lost ground among Brazilians from the middle class up.

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That the mass of Brazilians seems prepared to overlook these misdeeds suggests that Lula got two big things right: the economy and poverty alleviation. Comparing Brazil's vital indicators when Lula took over with the same ones now "is like looking at two different economies", says Vinod Thomas, former head of the World Bank in Brazil. In the autumn of 2002, Brazil's currency, the *real*, plunged, largely because the markets feared Lula's arrival. Inflation, already in double digits, threatened to spike higher and the yield on Brazil's dollar bonds was 25 percentage points above that of American Treasuries. The new government swerved away from disaster. The finance minister, Antonio Palocci, raised the target for the public sector's primary surplus (before interest payments) by half a percentage point to 4.25% of GDP, persuading the markets that Lula could be trusted to pay Brazil's public debt. The central bank steadied the *real* and raised interest rates to choke inflation.

An economy that swooned every time confidence in emerging markets wobbled now looks steadier. Spurred by a devaluation in 1999 and buoyant demand for commodities, exports have boomed, turning a current-account deficit into surplus. Mr Palocci has used the inflow of dollars to pay off foreign creditors, including the IMF. Soon, Brazil will no longer have to worry about a falling *real* driving up its debt burden. The risk premium has fallen to a record low of two percentage points.

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Much of the grumbling is about the price Brazil has paid for stability. Under Lula, economic growth has averaged just 2.6% a year, barely better than the dismal average of the last 15 years. There are at least three culprits. At around 11%, Brazilian real interest rates are among the highest in the world. Government grabs an estimated 38% of GDP in the form of taxes and contributions, well above the tax take of most other Latin American economies. Even with all that revenue, central government investment has shrunk to a derisory 0.5% of GDP.

Barely a day has passed since Lula came to office without shrill denunciations of the central bank, often from his own vice-president, José Alencar. Tight monetary policy has stifled investment and pushed the *real* to levels that threaten exports and scare local producers. But Lula insists that "you can't make the central bank the villain", not least because the government sets the inflation target. The government is doing its part, for example by reducing import tariffs "on products that we know are increasing in price more than they should", such as steel, he says.

Steady as she goes

Turning to Brazil's crushing tax burden, Lula points out that the government has not raised a single tax rate yet. Revenue is up because profits are higher and tax collection is better. As this improves, "we'll be able to reduce the tax burden by cutting rates and expanding the base of contributors". For Lula, sure growth is worth more than fast growth. "I don't want to grow 10% or 15% a year. I want a lasting cycle of growth averaging 4% or 5%." There will be "no magic in the economy", he says. This year growth should be around 3.5%.

Reuters

Survival, but no exit from poverty

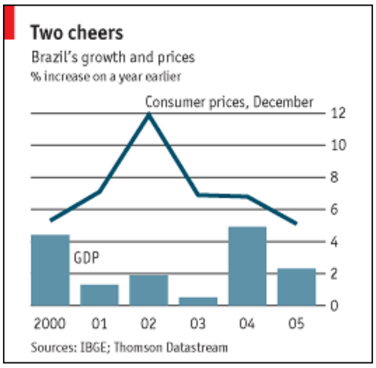
But stability has its own subtle magic. It protects the value of salaries and encourages business to plan long term. "The capital market is now an option" for financing infrastructure, says Paulo Godoy, president of the ABDIB, a group representing infrastructure firms. Despite high interest rates, consumer credit surged after the government let banks lend to consumers against their paycheques. This contributed to what will no doubt be the PT's favourite campaign statistic: 3.5m jobs created in the formal sector between 2003 and 2005.

This points to a second achievement: a reduction in poverty and inequality—the blight that Lula was elected to combat. A poverty index tracked by the Fundação Getulio Vargas (FGV), a business school, fell from 27.3% of the population in 2003 to 25.1% in 2004. Strong economic growth in 2004 helped. More important, says Marcelo Neri of FGV, was a sharp drop in inequality, which is "now at its lowest level in the past 30 years, and still falling."

The reasons for this are complicated and only partly down to Lula. His predecessor, Fernando Henrique Cardoso, universalised primary education, which accounts for much of the reduction in inequality. He also tweaked Brazil's job-killing labour law, encouraging formal employment. Declining informality and inequality are "new elements on the Brazilian scene which analysts don't fully understand," says Mr Neri.

After a stumble, Lula has helped. Upon taking office, he unveiled an anti-poverty programme called *Fome Zero* (zero hunger), which was clearly unworkable. Lula retreated, replacing it with *Bolsa Família* (family fund). This consolidated five pre-Lula programmes that transferred cash to poor families, raised the benefit and expanded the number of beneficiaries so far to 8.7m families, roughly a fifth of Brazil's population. This makes it "the most important income transfer programme in the world", says Lula. In the poor north-east, with the largest concentration of beneficiaries, the programme can mean the difference between hunger and sufficiency and sustain small-town economies.

Bolsa Família draws sneers, too, notably that it provides subsistence, but no exit from poverty. Lula retorts that the conditions attached to the transfer—beneficiaries must keep their children in school and



vaccinate their babies—make it more than a handout. “It's an emergency programme,” he says. “My dream is that one day we won't need *Bolsa Família* any more because it will have generated employment and aided income distribution.”

More lasting is Lula's other gift to the poor, a real 25% rise in the official minimum wage, which also affects publicly financed pensions. Lula claims this is necessary to ensure “that the poorest part of the population has the right to eat”. But it does so inefficiently, with a bias toward the elderly. Just 3% of poor families include a pensioner, while 85% have children.

This points to the Lula government's blind spot. The rise in the minimum wage is symptomatic of an overall increase in government spending, one of the main reasons debt, taxes and interest rates are so high. Non-financial spending by the federal government rose from 17.7% of GDP in 2002 to an estimated 18.8% last year, says Raul Velloso, a budget expert. That is part of a deeper failure: to come to grips with a state that is overgrown but is neither efficient nor fair. That omission may well be one of the roots of the *mensalão*, which has blotted the second half of Lula's mandate. Reinventing the state is no simple task, but it is probably the most urgent one facing the winner of October's elections.

Mr Palocci recently proposed a “social accord” to reduce spending and improve its quality. Although he did not spell it out, this would probably involve capping spending as a proportion of GDP, breaking the link between the minimum wage and pensions, and reforming the pension system, Brazil's version of welfare for the rich. Lula's chief of staff, Dilma Rousseff, scorned one version of this idea as “rudimentary”, a hint of the resistance it will face from within the government.

Lula says that Mr Palocci and Ms Rousseff differ only over timing. “In an election year it's hard to achieve a social accord,” but “in a quieter period everyone will agree that we need a commitment not to spend more money than we can.” Lula says that he started the job by reforming civil-service pensions (taxing them, for example) and that a campaign to strike fraudsters from the benefit rolls is paying off. But he may not swallow Mr Palocci's ideas whole. Delinking the minimum wage from pensions, for example, “is easy to say and very difficult to do”. As for raising the retirement age, “as longevity increases, the pension system will have to adapt”.

The *mensalão* revealed defects of a different sort. It remains a sea of supposition dotted with islands of fact. What is known is that the PT channelled millions of *reais* to friendly congressmen, mainly through an intermediary who doubled as a campaign consultant. Off-the-books campaign financing is illegal, but common. Still unproved are more sensational claims that congressmen accepted the *mensalão* (monthly stipend) in exchange for backing the government and that the money came from state enterprises or their pension funds. A report by a congressional committee later this month may back these claims. Fact and suspicion forced a purge of the PT's top officers along with the resignation and subsequent expulsion from Congress of Lula's chief aide, José Dirceu.

Lula blames two groups of people: those who perpetrated a “massacre” of the PT with unfounded accusations, and a few bad apples in the PT itself. “You can't judge a party because a half-dozen people made mistakes.” Yet he admits that the massacre was “justifiable”. The PT “will have a lot to explain to society”, he says, avoiding explanation himself.

The *mensalão* crystallised a belief that the PT's historic rise to power was a setback for Brazil's institutional development. Its rise seemed to confuse party with government, injected ideology where expertise was needed and pushed government into areas where it had no business. Lula says encouraging things about withdrawing the state from the economy and professionalising the civil service, but has not done much of either. More disappointingly, “Brazil has done less than expected on education and health,” says Mr Thomas. Lula has tended the orchard but planted no new trees, critics say.

There are examples enough to justify these criticisms, from the needless scrapping of the *provão*, an exam used to evaluate universities, to a hare-brained proposal to install government-appointed auditors in independent regulatory agencies. But this demands qualifications. One is that the Lula government sometimes learns from its mistakes. It spent years tinkering with a concession law, during which time no new federal roads were handed over to private management. But under the new law, disputes will be submitted to arbitration, which investors like. The orchard analogy misses some trees. A bankruptcy law, for example, has lowered leasing costs for airlines. A judicial reform should speed cases through the notoriously slow courts.

What other trees might Lula plant? The next president should disentangle state sales taxes, restructure trade unions and “update” labour law to make it “less burdensome for an employer to hire a worker”, Lula says. Political reform would discourage future scandals. If “you create a public fund for elections, prohibit private money and you have better control by the electoral authority, you can reduce the errors that a political party can commit.” Could it be Lula's destiny to preside over a transition to cleaner politics?

A transcript of our interview with Lula appears at www.economist.com/lula