

# Weathering the Storm

The specter of global stagflation looms, but in Brazil, things couldn't be better. How a socialist giant became the world's hottest market.





**T**HE SPECTER OF RISING FOOD AND FUEL PRICES NOW THREATENS to destroy an era of unprecedented global prosperity, with two notable exceptions: Brazil and Canada. Both countries produce and export enough food and fuel not just to offset the worst of global inflationary pressures but even to turn the price spike from a menace to a boon. They are the only two major economies where prices have not burst the upper limit of the central bank's inflation target. And of the two, Brazil is by far the more surprising success story. The country that suffered the longest and perhaps the most debilitating bout of hyperinflation in recent history is now a rare island of relative stability and prosperity. Brazil's inflation is running at 6.5 percent, a rate that worries the country's money minders but thanks to their zeal is still the lowest level in all the major emerging markets.

Luck has helped. Brazil is blessed with vast resources, including timber, fresh water, gold and the world's largest cache of iron ore. Farms stretch from horizon to horizon, and while most of the world is running out of arable land, Brazil has more than 70 million hectares still to plow. Plumbing deep water reserves, the country has announced massive oil finds that may total 30 billion barrels, the largest discovery in the Western Hemisphere in three decades. For Brazilians, who once joked that "Brazil is the land of the future, and always will be," this good fortune is a serious shock. "Brazil has had interesting moments before, but this is extraordinary," says Otávio Vieira, executive director of private banking at the Swiss-owned Banco Safdie, who has seen his portfolio swell by 150 percent since 2006. Although raw materials and semifinished goods still kick in two thirds of Brazil's export revenues, few nations have done as much to develop their natural bounty, whether in mining, energy or agriculture. Brazil has nearly doubled grain production in the last decade and is the only country producing cost-efficient biofuels without beggaring its food larder. Better yet, the economy has accelerated without overheating. There are other major emerging markets that are growing faster, but India and Russia both have double-digit inflation while China is just shy of that dangerous threshold. No emerging nation has moved earlier or more intelligently than Brazil to head off the cancer of inflation, as evidenced last week when the Central Bank raised the benchmark lending rate for the third time this year.

This comes after a half century of colossal mistakes. The postwar economy surged and plunged so wildly that Brazilians came to call their business cycle *o voo da galinha* ("the flight of a chicken"). Before the Plano Real, the economic-stabi-



**REVOLUTIONARY:** President da Silva set the stage for Brazil's recent economic revival

lization reform of 1994, Brazilians weathered 15 straight years of three-digit inflation—"the longest period of hyperinflation in the modern history," says Central Bank president Henrique Meirelles. Time and again, instead of solid reform, the government responded with ill-advised fix-it plans and price freezes that led only to massive shortages, strikes, riots and new bouts of hyperinflation that rendered the national currency worthless. The detritus is in display cases at the Brazilian mint outside Rio: cruzeiros, new cruzeiros, cruzados, cruzados novos, cruzeiros reais—all emblazoned with national heroes or fauna and flora, each note handsomer than the last. All forgotten now.

By 2001, Brazil's economy was stable but practically dormant. That year Jim O'Neill, the chief economist for Goldman Sachs, coined the term BRICs to describe Brazil, Russia, India and China—the emerging markets he expected to drive the international economy by midcentury. People laughed at the inclusion of Brazil. "I was told that I must have put the B in BRICs to make the acronym sound better," recalls O'Neill.

By 2002, Brazil seemed headed for yet

another crisis. The economy was flat, prices were surging and a hirsute former union man with surly words for the free market was poised to take office. But Luiz Inácio Lula da Silva artfully dissembled, playing to the gallery of his *companheiros* in the leftist Workers' Party, but also quietly breaking bread with business executives, foreign investors and lenders. Lula is not a maverick; he halted the privatizations that were the hallmark of the previous administration and despite his fabulous popularity ratings has failed to advance a single major reform—whether of the loss-making pension system or the corruption-addled political-party structure. He actually increased the already smothering tax burden, from 34 to 36 percent of the GDP, higher than any other re-emerging market.

But from the beginning he has held a steady middle course, becoming the unlikely paladin of economic stability. He appointed Meirelles, a BankBoston executive, to head the Central Bank and he forced the bureaucrats to slash spending and to build surpluses year after year; in June, he upped the target again from 3.8 to 4.8 percent of GDP. Against howls of protests from the left, industry and his own vice president, he also backed the bitter medicine of the Central Bank. As many developing nations flail at inflation by hoarding food and mandating price freezes, Brazil pre-empted the global food and energy spike by raising the benchmark-lending rate three times this year to 13 percent, one of the highest in the world.

Brazil's commitment to fight inflation signals an end to a history of false starts. In the 1950s, when bossa nova was on the world's Victrola, the ambitious civilian President Juscelino Kubitschek laid out a rosary of huge public works to make the nation grow "50 years in five." (Brazil boomed; so did prices.) In the early 1970s, the Brazilian miracle saw GDP grow by double digits under the marching orders of military leaders, which set the stage for hyperinflation. "Fifteen years ago, there used to be great debate about what to do," says Albert Fishlow, a Brazil scholar at Columbia University. "Today 90 percent of economists basically agree, and people sit down and talk about strategies for development instead of searching for miracles."

Brazil's new consensus marks the end of five centuries of state rule over the economy, and the emergence of a new private market economy. In 2007, Brazil hosted a record 75 initial public stock offerings, trailing only China, as companies including ethanol distillers and tech start-ups raised rivers of cash. The stock exchange





**COMING UP:** *There is still poverty, but Brazil has an uncommon level of economic stability*

itself, known as Bovespa BM&F, went public last October, raising \$3.7 billion, one of the biggest initial public offerings of 2007. Now the São Paulo stock market has eclipsed the giant state development bank BNDES as a source of cash for new businesses—a telling symbol of a country still molting from command and control to a market democracy.

Rising market competition acts as a defense against the return of inflation. This onetime drowsy rural nation now has one of the most diversified economies in the developing world, exporting iron ore, steel and soybeans, but also small commercial jets, banking services, custom-made buses, fine paper and equipment for air conditioners. Three years ago, Embraer overtook Canada's Bombardier to become the

world's largest maker of midsize commercial jets. Now Brazilian-Belgian InBev is poised to become the world's largest brewer after closing a deal to buy the American giant Anheuser-Busch in mid-July. The globalizing economy has helped drive up productivity growth, to more than 3 percent a year since 2002 and now accelerating. And productivity growth is what allows a nation to make more profits—without raising prices. Brazil is now the world's leading exporter not just of coffee but soybeans, beef, sugar cane, ethanol and frozen chickens.

Caging the inflation threat has also won Brazil a new standing in the financial markets. Fitch Ratings and Standard & Poor's recently elevated Brazil's debt from junk to investment grade. Brazil's foreign

reserves have risen from \$16 billion in 2002 to more than \$200 billion. The Brazilian real has climbed 20 percent against the dollar in the past 12 months, outperforming all of the world's most-traded currencies. Brazil attracted \$35 billion in foreign direct investment in 2007, doubling the figure from the year before, and is set to pull in more foreign direct investment than all nations but China in 2008. "We are giving Brazil one of our best weightings," says Mark Mobius, head of Templeton Management Fund, with \$5 billion in Brazil. "Brazil is in a good position moving forward."

Brazil's reputation has shifted so completely, many analysts now find favorable ways to compare Brazil with the other BRICs. While the booms in China and India are driven by poor peasants fleeing farms for factories in the city, Brazil's demographic revolution started decades ago; 85 percent of the country's 190 million people now live in cities. The result is potentially less dynamic, but already richer and more stable. The per capita income of \$8,450 is far higher than in India (\$1,100) or China (\$3,000). Russia, with more than \$12,000 per capita, is richer, but that is due almost entirely to the recent oil boom. Brazil is also the only BRIC country with both an established democracy (like India) and no rebel province equivalent to a

**The country's inflation rate is the lowest of any in the major emerging markets.**

Chechnya, Kashmir or Tibet. "In Brazil, progress is steady but slow," says economist Marcelo Neri, at the Getúlio Vargas Foundation, a leading business school. "It's like the fable of La Fontaine about the worker ant versus the noisy cicada. This is more a country of ants than of cicadas."

Brazil is still on the mend. Red tape, crumbling infrastructure, a chaotic public-health system and widespread illiteracy all threaten Brazil's competitiveness. With his rock-star ratings, Lula still has the clout to push the reforms the country needs. Until now, with the wind at Brazil's back, he hasn't had to bother. But banking on luck instead of reform is no business plan in the global economy. For Brazil it could be the difference between finally taking off and merely flapping in the wind. ■