Until recently, the consensus view of Brazil among investors and pundits was almost universally bullish. Under the landmark presidency of Luiz Inácio Lula da Silva, the country became known as a paragon of financial responsibility among emerging markets. Having contained hyperinflation and reduced its debt, Brazil weathered the 2008 financial crisis better than most, growing at an average annual rate of nearly four percent over the past five years. And in the last ten years, some 30 million Brazilians have entered the middle class, giving their country, according to Brazil’s promoters, the power to expand despite a turbulent global environment and to reduce income inequality even as it grew elsewhere in Latin America.

This decade of success has made Brazil one of the most hyped emerging-market nations, with one of the two top-performing stock markets in the world and receiving more foreign direct investment than most other countries. Over the past five years, the amount of foreign money flooding into Brazilian stocks and bonds surged to record levels, with inflows expanding from $5 billion in 2007 to more than $70 billion through this past January. Brazil’s rise has solidified its reputation as a leading member of the BRICS—Brazil, Russia, India, China, and South Africa—the world’s top emerging

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markets, which many expect to supplant the United States and Europe soon as the largest drivers of the global economy.

Yet this glowing image of Brazil rests on an extremely shaky premise: commodity prices. The country has grown largely in concert with surging demand for its stores of oil, copper, iron ore, and other natural resources. The problem is that the global appetite for those commodities is beginning to fall. And if Brazil does not take steps to diversify and boost its growth, it may soon fall with them.

**The Commodity Craze**

Over the last ten years, global markets have developed an insatiable desire to invest in emerging-market countries, particularly those in which China was purchasing energy supplies and natural resources (these commodities now account for roughly 30 percent of the money in international stock markets). According to the logic behind this trend, as China continued to boom, consuming ever-increasing amounts of oil, copper, iron ore, and other raw materials, nations such as Brazil, a leading exporter of those commodities, would thrive. As a stable democracy, Brazil seemed like a safe investment, and the discovery of major oil fields off the country’s coast added a golden sheen to the picture.

But problems loomed behind that veneer. For a nation supposedly taking its place as one of the world’s major economic powers, Brazil has proved strikingly cautious. To protect its citizens from the economic turmoil that plagued it throughout much of the late twentieth century, the country developed two signature policies—high interest rates to control inflation and a welfare state to provide a social safety net—that have placed a hidden cap on expansion. Indeed, since the early 1980s, Brazilian growth has oscillated around an average of 2.5 percent a year, spiking only with increases in commodity prices. Even in the last decade, when Brazilian growth rose above four percent and Lula hailed the arrival of his country’s “magic moment,” Brazil still grew only half as fast as China, India, and Russia.

High interest rates in Brazil stymie the country’s growth by making it almost prohibitively expensive to do just about anything. Providing an average return of about ten percent, those rates attract foreign capital,
but that influx of investment has driven up the value of the Brazilian real, making it one of the most expensive currencies in the world. As a result, restaurants in São Paulo are more expensive than those in Paris, and office space is pricier there than in New York. Hotel rooms in Rio de Janeiro cost more than they do along the French Riviera, bike rentals are more expensive than in Amsterdam, and movie tickets exceed the price of those in Madrid.

At the same time, the expensive real boosts the price of exports from Brazil, undercutting the country’s competitiveness in global consumer markets. Although many major emerging-market currencies have risen against the dollar over the last decade, the real is in a class by itself, having gone up 100 percent. This may help manufacturing in the United States, but it harms it in Brazil, where the manufacturing share of GDP peaked at 16.5 percent in 2004 and had fallen to 13.5 percent by the end of 2010. Few developing nations have sustained rapid growth for even one decade, let alone two or three, and virtually all of those that have did so by expanding their share of global manufacturing, not riding the tides of commodity prices.

Brazil, however, has taken the latter path. China’s growth over the last decade made it by far the world’s largest consumer of industrial raw materials, and Brazil has capitalized on that explosion: in 2009, China surpassed the United States as Brazil’s leading trade partner. Given China’s sustained success, few expected its economy to slow or considered what that would mean for Brazil. But that decline is now under way. This past March, Beijing stated that its growth rate in 2012 could dip below eight percent for the first time since 1998. Unsurprisingly, around the same time, Brasília announced that its growth rate had dropped to under three percent.

China’s lagging growth signals the end of an era in which emerging markets experienced unusually rapid expansion, spurred by the torrent of money that began gushing out of the United States in 2003 as the Federal Reserve sought to sustain the country’s recovery from the dot-com bust. Over the next four years, the average growth rate in emerging markets doubled, to 7.2 percent, and across the globe, the
average duration of economic expansions rose from four years to eight. Now, as the consequences of the 2008 credit crisis continue to unfold, the easy money is drying up. Investors will need to stop pouring money into emerging-market countries as a class and instead begin to evaluate which markets are likely to succeed in a new era of slow, uneven expansion.

**STUNTED GROWTH**

Given its tendency to limit its own growth, Brazil is a good place for investors to begin that evaluation. Brasília’s fear of economic overheating stems from the country’s long history of financial crises, in which government overspending produced humiliating defaults and devaluations. The cycle hit rock bottom during a painful decade of hyperinflation that peaked in 1994, when prices rose by 2,100 percent—so fast that checks would lose 30 percent of their value by the time businesses could deposit them and workers would cash their paychecks and run to the store to buy food before prices rose further.

In 1995, the Brazilian government finally stopped the spiral of hyperinflation by introducing the real and pegging it to the dollar. But the new currency did not eliminate Brazil’s vulnerability to regular inflation, thanks largely to the old Brazilian addiction to state overspending. The trauma of hyperinflation only deepened Brazil’s commitment to building a comprehensive welfare state. The constitution, passed in 1988, guarantees free health care and university education, and the country’s minimum wage is now so high that it applies to one in three workers. And during the 1980s, prices rocketed out of control in part because the government attempted to ease the financial burden on its citizens by linking wage raises to price increases. This generated a vicious cycle whereby price spikes triggered wage increases, which then forced employers to further increase prices. In 2003, under Lula, Brasília expanded these income protections when it launched Bolsa Família, perhaps the most generous welfare program among emerging-market countries. The initiative offers conditional cash income support to the poor and unconditional support to the extremely poor. Such assistance has reduced Brazil’s inequality, but at the expense of growth.
Since the era of hyperinflation, the Brazilian government has funded this growing safety net by increasing spending as a share of the country’s economy, from roughly 20 percent in the 1980s (a typical ratio for the emerging markets) to nearly 40 percent in 2010. It has underwritten this expansion by raising taxes, which now equal 38 percent of GDP, the highest level among emerging-market countries. This heavy load of personal and corporate taxes leaves businesses with less money to invest in new training, technology, and equipment, leading to sluggish improvement in Brazilian business efficiency. Between 1980 and 2000, Brazil’s productivity grew at an annual rate of 0.2 percent, compared with four percent in China, where businesses invested much more heavily. This is one way in which Brazil’s spending priorities make the country so inflation-prone; if productivity is flat—if, in other words, each worker is not producing more goods per hour—then businesses have to raise the prices of those goods to cover rising hourly wages.

**Beijing versus Brasília**

The best way to see how a paralyzing fear of financial pain holds Brazil back is to compare it with China. The two countries have taken opposite approaches to development. Whereas Brazil has tempered growth over the past generation, China has pursued it relentlessly. Beijing threw open its doors to global trade, setting low interest rates to provide inexpensive capital to fund the infrastructure critical to an export economy, such as roads, bridges, and ports. These rates also helped keep the value of the yuan low, making Chinese exports more competitive. China built this system largely at the expense of its citizens; it is only now beginning to launch welfare programs meant to protect them from the turmoil of these rapid changes.

Brazil, meanwhile, adopted the opposite model, focusing on stability and protecting its people rather than increasing productivity and growth. Brazil’s high interest rates attracted foreign capital and heightened the value of the real, which undermined Brazilian exports and slowed expansion. Brasília spent that capital not on roads and bridges but on a welfare state. That is largely why for the last three decades, China has grown four times as fast as Brazil.
Bearish on Brazil

The difference between the two countries’ investment strategies could not be more striking. Over the past decade, China’s domestic investment, in everything from factories to equipment and schools, climbed at a double-digit annual pace, reaching nearly 50 percent of GDP last year—higher than in any other major economy, ever. In fact, China now invests more than the United States and Europe combined. Brazil’s total investment, on the other hand, has remained under 19 percent of GDP, one of the lowest figures among emerging-market countries. And Brasília spends only two percent of its GDP on infrastructure—a paltry amount compared with the emerging-market average of five percent and the Chinese rate of ten percent.

That failure to invest is a major reason why the Brazilian economy is so lethargic and expensive. The failure to build roads and ports has made even simple tasks, such as moving around the country, a nightmare. Truckers taking sugar from plantations to Santos, the country’s largest port, must routinely wait two to three days at the port’s gates because of a shortage of warehouse space and automated cargo movers. A former executive of a major U.S. agricultural company told me that trucks carrying seeds from the Brazilian hinterlands to Santos would lose half their cargo to ruts and potholes along the way. Scavengers would follow the trucks, and the seeds would eventually turn up on sale in Paraguay.

Brazil’s economy suffers similar bottlenecks on every front. The broad measure of how fully an economy is employing its total stock of labor and equipment, a number known as the capacity utilization rate, now stands at 84 percent in Brazil—five points higher than the average in other emerging markets and a sign that the supply is inadequate. Underspending on schools has resulted in a massive shortage of skilled workers. Normally, as a country grows richer, students stay in school longer. But in Brazil, they remain in school for an average of just seven years, the lowest rate of any middle-income country; in China, which is much poorer, the average is eight years. As a result, although unemployment is now at a decade-low six percent,
businesses complain that they have no choice but to hire unqualified applicants. In manufacturing and services, a shortage of engineers and technical workers is already straining the economy.

In short, then, chronic underinvestment has made the Brazilian economy prone to cooling off at a relatively slow rate of growth compared with other emerging markets. If businesses must pay extra to hire competent workers or move goods across the country, then they will pass those charges on to customers. And as businesses start to compete for the inadequate supply of workers, warehouse space, shipping capacity, and other essentials, inflation will rise at an early stage of economic expansion. For Brazil, this happens when GDP growth approaches just four percent—half the rate at which it occurs in China. And because Brazil historically raises interest rates at the first signs of inflation, thereby restraining growth, the country tends to stall at that four percent threshold.

**STABILITY NO MORE**

Brazil was able to achieve four percent growth in the unusual global environment of the last decade, when the country finally began catching up to the West. Brazil’s average per capita income had fallen from a peak of 25 percent of the U.S. average in the 1960s to just 16 percent by the late 1990s. In the last decade, however, that number began to climb, and it has now risen to roughly 20 percent. But given the upcoming decline in demand for commodities, the rate could collapse again. Arminio Fraga, Brazil’s former central bank president, told me that he fears a “lost decade” of relative decline, similar to the 1980s, if Brazil does not shake off its “Iberian roots”—the sleepy welfare-state tendencies it seems to have inherited from its European colonizers.

The recent news that Brazil’s economic growth has begun to slow may prompt an overdue debate in the country about how to fix its high-cost, commodity-dependent economy. Although programs such as Bolsa Família have helped reduce income inequality, Brazil must realize that it could afford that initiative only thanks to the period of rapid global growth that started in 2003, the same year the initiative began. Brazil can and must find a way to balance stability with
expansion. But so long as Brazil relies on exports of oil, copper, iron ore, and other commodities, it will become increasingly vulnerable to violent swings in commodity prices and to the coming slowdown of China. So much of Brazil’s consumer boom has been driven by income from commodity sales that the domestic market will not provide much of a cushion in the event of such a slowdown.

Brazil must recognize that the era of easy growth in emerging markets and high commodity prices is ending. To avoid falling behind, Brasília needs to take risks and open up the economy. It can begin doing so by spending less on its welfare state, streamlining it by simplifying the tax code, broadening the tax base, and modernizing its inefficient pension and social security systems. It can then redirect that spending to education, research and development, and infrastructure projects. Brazil should also consider lowering its trade barriers to foster innovation in noncommodity industries. Despite its status as a major exporter, Brazil is one of the most protectionist economies in the world. This holds the trade share of its GDP to just 20 percent, the lowest among all the emerging-market countries. Ending that protectionism could bring competition to Brazilian factories, while also lowering the value of the real, creating the opportunity for a revival in manufacturing. For now, Brazil appears to be clinging to its hard-won stability. But if it fails to reform, its commodity-driven surge will soon begin to wash away.