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Brazil's institutions face the music

The happy land

Norman Gall

1. Many chances

Pessimism about Brazil coexists with the idea of Brazil as a happy land, the country of the future, a cornucopia of natural resources and many individual talents, with the wailing, throbbing pulse of its popular music that reaches many lands, with dreams of a world power in the 21st Century, the only nation to win the football World Cup five times, a continental archipelago of communities speaking the same language and flying the same flag, untouched by great wars, blending 200 million people of Amerindian, African, European and Asian stock, without outbreaks of religious or ethnic conflict.

Many people get few chances in life, while a few get many chances. Brazil is a happy land because it has had many chances. But Brazil's many chances have blinded Brazilians to limitations of time and resources. Belief in the elasticity of time and resources translates into a tolerance of repeated failure that produced an institutional quagmire, with consequences that may go far beyond events of the emblematic year 2014. If this quagmire is not addressed, it will degrade the quality of daily life as violence proliferates and infrastructure continues to deteriorate along with the skills needed to manage a complex society on a continental scale. While claiming a global role, Brazilian political leadership embodies the triumph of localism, which is invested in dense networks of patronage as the massive transfer of resources becomes an end in itself.

Adolar

2014 may be an emblematic year for Brazil because this resource-rich continental nation of eternal promise is to host the football World Cup in June and is to hold general elections in October that would celebrate the consolidation of democracy and major advances in social justice. Meanwhile, Brazil has plunged into a many-sided institutional impasse. The most visible features of this impasse are widespread infrastructure failure; endemic corruption scandals; fiscal parasitism; escalating inflation and violence; rising costs and institutional rigidity in labor markets and stagnant productivity. These institutional problems mitigate strategic advantages enjoyed by Brazil in natural resources, an aspiring population and a large domestic market. Brazil needs a new strategy to overcome these difficulties, which will take time, patience and political leadership capable of building a strategic consensus.

Where are the new leaders? Why haven't they appeared?

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Brazil has many talented and enterprising people. We see high levels of skill in corporate management, finance, advertising, marketing, agriculture, journalism, even oil exploration and production before Petrobras, after making huge discoveries in deep waters of the South Atlantic, was tasked with impossible missions for political convenience. Anyone watching the TV program *Globo Rural* week after week cannot fail to be impressed by the quality of innovation by small farmers deep in the interior. We recently published in *Braudel Papers,* our newspaper of research and opinion edited in Portuguese and English versions, an essay on “The Internet in Brazil” by Peter Knight, a founding member of our Institute who was the World Bank’s chief economist for Brazil. He tells of young internet entrepreneurs in remote areas of Amazônia providing farmers with enhanced access to the outside world. These internet entrepreneurs are among millions of striving young Brazilians, many of whom work at full-time jobs by day and attend high school and university classes at night, seeking to take advantage of opportunities that never existed for their parents and grandparents. However, while we hear many stories of individual achievement, Brazilians have shown little vocation for organizing collective action to strengthen institutions and raise the quality of public life.

Brazil has benefited enormously from the global expansion of trade and finance in recent decades, bringing to a climax what has been called the best phase of Brazil’s history. The decades since the end of military rule in 1985 have seen consolidation of democracy, curbing decades of chronic inflation and big improvements in millions of lives. Democracy, stability and rising consumption gave Brazilians a benign view of their prospects. In 2011 the Global Attitudes Survey of Washington’s Pew Research Center found Brazilians more satisfied with economic conditions than the citizens of any of 22 countries except the Chinese. Some 77% thought that Brazil will become, or already is, a world power, although that concept remains vague. However, the street protests that erupted in 352 cities in June 2013 over the quality of public life – corruption, urban transport, schools and hospitals – offered a more skeptical view of Brazil’s future.

Pivotal years

We may not believe in magic numbers, but history shows us some pivotal years. 1814 saw the defeat and abdication of Napoleon as Emperor of the French and negotiations among the European powers at the Congress of Vienna that created conditions for a century of peace. 1914 saw the sudden end of that peace with the assassination in Sarajevo of the heir to the throne of the Austro-Hungarian Empire, provoking the mobilization of military alliances that led to two decades of world wars, revolutions, hyperinflations and the Great Depression. We know not what 2014 may bring, but the runes are pregnant with historic dates of Brazil’s evolution and with the need for decisions. 2014 will mark 60 years since the suicide of President Getúlio Vargas; 50 years since the military coup that began two decades of dictatorship; 30 years since the mass campaign for direct elections that prepared Brazil for the return of democracy; 20 years since the launching of the Real Plan that stopped chronic inflation and stabilized our economy. 2014 also may be a year of decision, over whether Brazil can mobilize its human and physical resources for a more promising future.

A century ago

We have come a long way. A century ago, on March 18, 1912, a small coastal steamboat left Rio de Janeiro, carrying a team of public health specialists on a voyage of exploration into the expanses of Brazil’s drought-stricken Northeast. After 18 days on horseback crossing the thick, spiny bush of the *caatinga,* the travelers reached the town of São Raimundo Nonato in the state of Pìauí, where two of the researchers, Arthur Neiva and Belisário Pena, appraised the human condition:

> *Rare was the individual who knew that Brazil exists. Piauí was one country, Pernambuco another, and so with other states. Government for these pariahs is a man far away who gives orders. The existence of this government is known because the man sends his agents each year to collect taxes. When we ask these people if these lands (Piauí, Pernambuco, etc.) are linked to each other, forming a nation, they say they don't understand this. To them we were gringos,* lordaços *(foreign lords). Illiteracy embraces more than 80% of the people. Life is reduced to raising pigs, chickens, a few scrawny cattle, the vicissitudes of the drought, waiting for rain, and nothing more. After the winter rains comes malaria. Between the old and new towns of São Raymundo, there is a natural basin that floods during the rains, leaving water in stagnant pools during two or three months of drought as epidemic malaria spreads. The water is detestable, salty, taken from a filthy ditch dug beside the bed of a small stream, where people fill their buckets. Why not dig a well, lined with stones and covered, and draw the water using a pump? "It's not worth the trouble" is the answer. "People are used to this, and it does no harm."*

I visited São Raimundo to get a clearer idea of Brazil's progress over the past century. In those earlier days, life expectancy at birth of Brazilians was around 30 years, roughly the same as in India, against 74 years today. In 1900 Brazil's population was only 17 million, against 200 million today. So modern times have come to Brazil. By appearances, modernization even has reached the *sertão,* a corruption of the word *desertão,* or "big desert," coined by Portuguese settlers in the 16th and 17th centuries. The people of the *sertão,* no longer forsaken by government, now are bathed in public transfer payments and subsidies. Electricity reaches São Raimundo from the federal hydropower complex of Paulo Affonso, built in the 1950s nearby on the São Francisco River. There are modern hotels, paved roads, air conditioning, bottled mineral water, wi-fi internet and many clinics and commercial enterprises. São Raimundo is still poor and isolated geographically, but nearly everyone has a cell phone. Three times as many motorcycles as cars are registered, with sales of *motos* tripling over the past three years.

The town's mayor at the time was a priest, Padre José Herculano Negreiro, who told me that people are alive to opportunity, migrating to cut sugar cane in the plantations of São Paulo State and to work as maids and on construction sites in Brasília and Vitoria, bringing back savings that they invest in improving the family home and buying the good things of life. Yet back home there is mass underemployment, with scores of young men in yellow *mototaxi* T-shirts idling around the plaza of São Raimundo, waiting for customers, and scores of barber shops and beauty salons empty of patrons. Backward areas of Brazil still depend on government jobs, not least in towns like São Raimundo, one of thousands of *municípios* that get nearly all their revenue from transfers from the federal government with little effort to collect local taxes.

It would be hard to exaggerate these changes. As I walk in my neighborhood at dawn in central São Paulo, I pass a street sweeper, an anxious mother dressed in fluorescent green coveralls, calling home on her cell phone to check if her kids in a distant *favela* have woken up in time for school. In my apartment building, the young janitor has just returned from a two-week visit to his home town in the interior of the northeastern state of Paraiba, traveling there by airplane. He paid for the round-trip flight in five monthly installments. A few years ago, this journey of 2,000 kilometers would have to be made by bus, taking three days and nights each way, or not at all. In the communities of São Paulo's periphery, new amenities such as health clubs, pet shops, Internet cafes and English-language schools appear in the winding streets of former squatter settlements, while multi-story apartment buildings rise in their midst.

By the time Arthur Neiva and Belisário Pena visited São Raimundo Nonato in 1912, Brazil had emerged from the convulsions a crisis of financial speculation called the *Encilhamento* ("saddling the racehorse"). These convulsions involved conflicts between declining coffee-growing landowners and rising urban middle classes leading to the abolition of slavery in 1888 and the military coup in 1889 that ended the 49-year reign of Emperor Pedro II and created the First Republic (1889-1930). The great novelist Machado de Assis ironically called January 17, 1890, "the first day of creation," when Finance Minister Rui Barbosa launched the new republic's first "package" of economic decrees, creating new banks with licenses to print money and removing barriers for creating new companies. This was one of many "packages" decreed over the next century

Guilherme Kramer

with the escalation of chronic inflation.

Cascades of ideas

Machado described the *Encilhamento* as producing "the great array of enterprises of all kinds: cascades of ideas, inventions, concessions every day, beautiful visions of making hundreds, thousands, millions, billions! Shares come fresh and eternal from the printer: railroads, banks, factories, mines, shipyards, construction, exports, imports, walking the streets and plazas touting statutes, officers and lists of stockholders." The new banks were capitalized by public debt securities as they printed new money and financed new enterprises. Amid fraudulent land deals and stock market floatations, the number of listed companies grew from 90 in 1888 to 450 in mid-1891, until a crash caused a 22% fall in Brazil's per capita income, from which it took 21 years to recover. The *Encilhamento* also produced Brazil's first big inflation, with street protests against rising prices and the value of the currency falling by more than half.

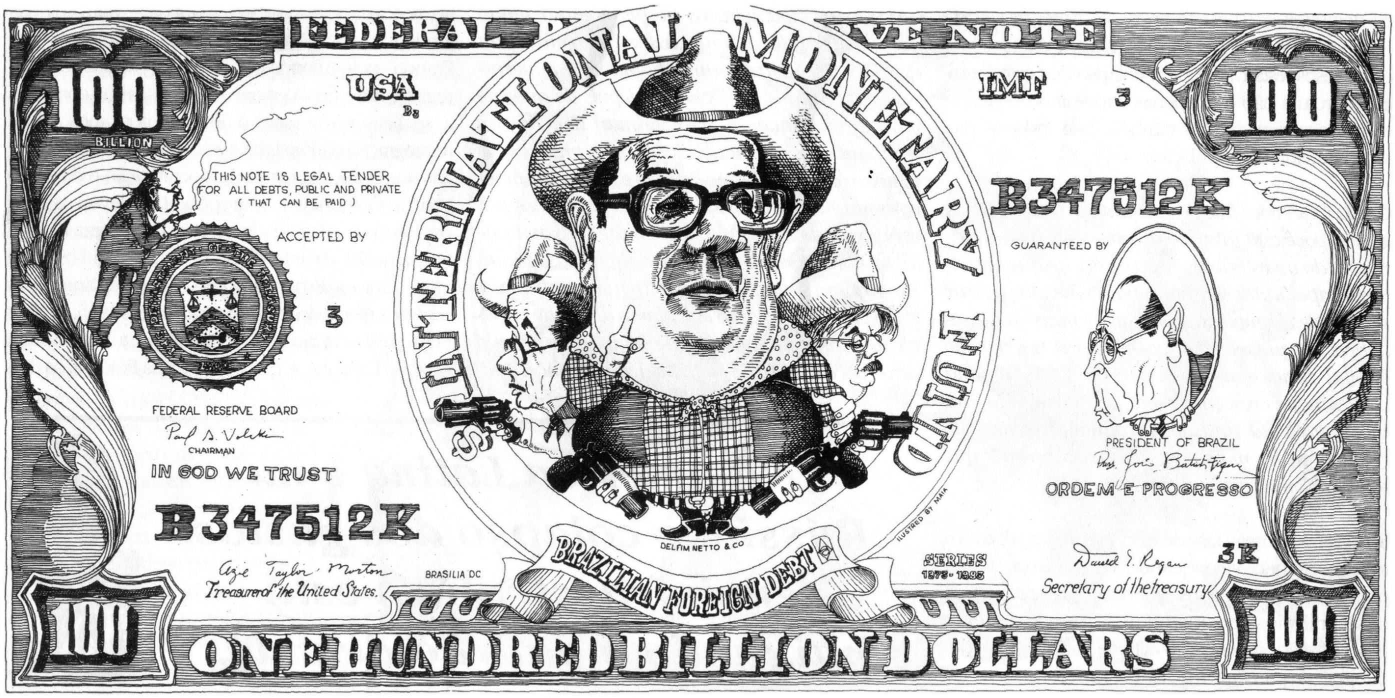
The ideas, inventions and beautiful visions evoked by Machado were part of an unprecedented expansion of the world economy between 1870 and 1914. The quality of daily life in many countries rose with technological revolutions in transportation and the production and management of energy, leading to surges in world trade and living standards. Brazil's economy doubled in size in the two decades between the *Encilhamento* and the outbreak of the First World War, with Brazilians eager to adopt foreign inventions. Only a year after Thomas Edison launched the first commercial electric power station in New York in 1882, Emperor Pedro II inaugurated South America's first urban electric lighting system, followed by scores of local initiatives by planters and merchants as electric power replaced horses in driving trolleys in Rio de Janeiro and other Brazilian cities. In the same vein, Brazil today is riding the crest of another global wave of improvement in living standards, even as protests multiply over the quality and priorities of public life as defined by elected officials. Today, despite stronger institutional protections and a larger and more complex economy, Brazil is threatened with another wave of inflation as it resorts to exotic fiscal practices in order to maintain stability in 2014.

Classic credit boom

Brazil now has entered the final phase of a classic credit boom bred by (1) an exchange rate that was overvalued in recent years by large capital inflows; (2) increased lending by public banks at subsidized interest rates; (3) loose fiscal policy; (4) low domestic savings; (5) easy government-induced credit, especially for consumption; (6) a real estate boom.

The past quarter-century in Brazil coincides with what may be a climax of human development that accelerated during the six decades after World War II. Prodigious advances occurred on a planetary scale in longevity, nutrition, productivity, communications, logistics, science, public health, scholarship and many other fields of endeavor. Middle-class patterns of consumption are proliferating throughout the world. The challenge today is to sustain these advances. Brazil has much to gain or lose from these contingencies.

We are entering a new age. Shadows of the future are painting the texture of our daily lives. Institutions are being restructured throughout the world as we deal with retrenchment from the biggest and fastest expansion of economic activity in human experience. The timing of crises in Brazil may surprise, but they usually are predictable by their dynamics, if not in time.



Cartoon by José Roberto Maia (1983) on the maxi-devaluation.

2. Brazil and the world

It was President Dilma Rousseff who first spoke of a "monetary tsunami" as the central banks of rich nations flooded the world economy with cheap money as a response to the global financial crisis, disturbing the economies of developing countries like Brazil. "The central banks of the developed countries persist in an expansionist monetary policy that distorts exchange rates," she told the United Nations General Assembly in September 2012. "In this way, emerging countries lose markets because of the artificial revaluation of their currencies, which aggravates the global recession."

Brazil may be a special case. Developing economies in general grew by 4.9% in 2012, faster than their long-term growth rates during their expansion in the decades following World War II, while Brazil grew by only 0.9% amid deepening economic disorganization, despite a consumption boom fed by a surge of bank credit. Now Brazilian officials worry about a slowdown in financial flows from abroad to cover growing current account deficits as their fiscal mess provokes pessimism over Brazil's short-term prospects.

A warning came from Antonio Delfim Netto, the 85 year-old former economics *supremo* of the military regime (1964-85) who gained fame as its youthful finance minister during the years of the Brazilian "miracle", when economic growth rates averaged 10% during 1968-74. Delfim later returned as planning minister in the 1980s during the Latin American debt crisis and Brazil's escalation toward hyperinflation. A bulky, owlish man with a flair for waspish irony laced with economic erudition, Delfim now is an informal adviser to the government,

Delfim warned that Brazil early in 2014 could be "punished with a 'perfect storm' produced by a conspiracy of simultaneous events: (1) a downgrade in our credit rating; and (2) beginning of the end of monetary stimulus in the United States. If this happens, we will have a rapid rise in world interest rates, a change in capital flows, a sudden and profound adjustment in our exchange rate, a reduction in bank credit, a dramatic fall in workers' real income and the return –in legitimate self-defense —of interest rates to the absurd levels with which we lived during so many years, accompanied by an increase in unemployment. It is not political fantasy that this would compromise the present comfortable position of President Dilma Rousseff in the electoral process." Leaders of the business community and the governing Workers Party (PT) had pressured Luiz Inácio Lula da Silva, its popular ex-president (2003-10), to replace Dilma as the PT's candidate in 2014.

Delfim's warning drew upon bitter personal experience. On the weekend of February 19, 1983, as Brazilians were recovering from their Carnaval festivities, Delfim shocked the country by ordering a 30% "maxi-devaluation" of the cruzeiro in a desperate move to revive declining exports during a world recession and to obtain a $4.9 billion stabilization loan from the International Monetary Fund (IMF). Occurring only six months after the eruption of Latin America's debt crisis, with Mexico's default in August 1982, the "maxi" increased the hard currency debts of Brazilian businesses by 30% after being encouraged by the government to borrow abroad to bring scarce dollars into the economy. The maxi shock led to a surge of Brazil's heavily indexed inflation from 100% in 1982 to 142% in 1983 and 200% in 1984, escalating into hyperinflation in 1990 and 1994. While inflation today is a small fraction of what it was in the 1980s and early 1990s, Delfim was advising prudence and warning against a loss of control.

People forget. Living standards have risen and stability is taken for granted today. Young Brazilians are, at best, only vaguely aware of the difficulties overcome in recent decades. The value of wages no longer falls so fast that families could not buy food at the end of each month. Yet in the annals of world inflation, no nation was as successful as Brazil in the early 1990s in avoiding economic collapse while juggling *monthly* price rises of 20% or more for so many months. Leading citizens told each other that hyperinflation still was far away, but hyperinflation came, with 12-month consumer price rises peaking at 6,390% in 1990 and 4,922% in 1994. The madness finally was stopped in 1994 by the Real Plan, the sixth time in eight years that three zeros vanished from all monetary accounting, each time that the name of the currency was changed. "It's like changing a baby's diapers," explained Gustavo Franco, a former central bank president, later adding: "The cost of living rose by 1% or 2% every day, so price increases had to be passed on to others. It was a tsunami, a chain reaction, a distributional conflict that imposed on us behavior of ominous portent, 'running ahead' of inflation, and thus we became accomplices to our vicious habit, if only in legitimate self-defense." Between 1980 and 1995, Brazil was served by 15 different finance ministers and 14 different central bank presidents as annual inflation for those years averaged 728%. Heterodox strategies were tried then in Brazil. Now they are being tested on a global scale.

Heterodox strategies

For now, the world's central banks persist in heterodox strategies for managing the financial crisis that erupted in 2007-08. Apart from keeping interest rates close to zero, the U.S. Federal Reserve, the European Central Bank, the Bank of England and most recently the Bank of Japan launched a new policy of quantitative easing (QE), buying large volumes of public and private debt securities to provide additional liquidity to financial markets. Famously, Mario Draghi, president of the European Central Bank, proclaimed that "I will do whatever it takes" to preserve the euro as a currency system. Lower interest on public debt and income flows from bond purchases by central banks in 2007-12 saved governments $1.6 trillion, two-thirds of this in the United States. The U.S. government saved $900 billion as the interest rate on its growing debt fell by half, at the expense mainly of households ($360 billion) and foreign creditors ($480 billion). Lower interest also reduced the burden of corporate debt and stimulated companies to borrow more while accounting for 20% of their profits since 2007, according to McKinsey Global Institute (MGI).

Brazil's government discovered a different path for QE. Instead of using the central bank to pump money into the economy by buying debt from the market, Brazil's finance ministry created liquidity by borrowing to enable government banks, especially the National Bank for Economic and Social Development (BNDES), Caixa Econômica Federal (CEF) and Banco do Brasil, to issue more credit, greatly expanding their market share in recent years. This difference is important. While central banks can create or reduce liquidity by traditional open market methods of buying or selling debt, loans by public banks cannot be readily traded and, when subsidized by treasury loans at negative spreads, require more budgetary fspending or more public debt.

The current global financial crisis generated a wave of research and reflection by economists, akin to the anguished search for causes and solutions provoked by the Great Depression of the 1930s, then lacking the sophisticated analytical and technical tools available today. In their classic *Monetary History of the United States, 1867-1960,* Milton Friedman and Anna J. Schwartz characterized the Depression as "The Great Contraction." Some economists are calling today's global crisis "The Second Great Contraction."

It is now widely understood that central bankers and politicians saved the world from an economic collapse in 2008-09 that may have been as calamitous as the Depression of the 1930s. Despite personal misgivings in overriding basic principles, they provided massive financial transfers to banks, companies and governments in crisis, leaving central banks with bloated balance sheets and governments with enormous debts.

This narrow and costly escape should inspire caution. In *This Time Is Different: Eight Centuries of Financial Folly,* Carmen Reinhart and Kenneth Rogoff warned in 2009 that severe financial crises tend to be long-lasting: "As cushions in foreign exchange reserves (built in the bonanza years before 2007) erode and fiscal finances deteriorate, financial strains on debt servicing (public and private) will mount. Given the tendency for sovereign defaults to increase in the wake of both global financial crises and sharp declines in global commodity prices, the fallout from the Second Great Contraction may well be an elevated number of defaults, rescheduling and/or massive IMF bailouts." Rogoff later argued that a wave of debt reduction or forgiveness may be preferable to further economic contraction. Of 12 countries that suffered severe systemic crises in 2007-08, only two (United States and Germany) recovered prior levels of per capita income six years later. The IMF warned in its April 2013 *World Economic Outlook* that "financial crises of the types that affected many deficit economies tend to involve permanent losses in the level of output relative to pre-crisis trends."

The world has changed. The global financial crisis of 2008-09 awakened ghosts of the 1930s, with fears of another Great Depression. But so much had changed in terms of economic and demographic structures that contingencies today are different and much more complex. In 1930 only 22% of global population lived in towns and cities against 52% today, a surge in urban population from 450 million to 3.7 billion in eight decades. Since 1930 levels of urbanization rose from around 20% to 85% in Brazil and 91% in Japan, two of the most dynamic economies of the 20th Century, exceeding the settled levels today of around 80% in Europe, the United States and most of Latin America. Waves of young adults migrating to the cities accelerated economic growth by increasing both demand and productivity, reinforced by the needs of urban living and by increases in life-expectancy as the world economy expanded. Governments everywhere acted more broadly in managing the greater complexity of economies and societies. These historic advances were one-time events, not to be repeated. Economies have matured and populations are growing older. Governments today have trouble sustaining their costly commitments. Productivity gains are stagnating worldwide, conspicuously in Brazil.

"It's like changing a baby's diapers"

What have we learnt?

Claudio Borio of the Bank for International Settlements (BIS), in an essay on *The financial cycle and macroeconomics: What have we learnt?,* found that financial cycles last longer (16 years on average since the 1960s) with greater impact than business cycles, which by traditional measurement last from one to eight years. Borio argued that "the length and amplitude of the financial cycle has increased markedly since the mid-1980s, a good approximation for the start of the financial liberalization phase in mature economies." In what may be an allusion to both the United States and Brazil, as well as to other countries currently in crisis, Borio observed that bank failures tend to occur at the peak of the financial cycle when "the link between saving and credit is very loose" as "the credit stock exceeds income by a considerable margin." He added: "The financial cycle is best captured by the joint behavior of credit and property prices."

The problem today is the enormous stock of financial assets that proliferated in recent decades, much of it backed by explicit or implicit government guarantees. This was by far the fastest global expansion of financial activity in human experience. Between 1980 and the start of the crisis in 2007, the volume of the world's financial assets multiplied nearly 20-fold in nominal terms to $198 trillion, according to MGI, calculations that include global stock market capitalization, bonds and other debt securities, securitized assets and loans, while excluding derivatives, gold, real estate, bank deposits and cash. International reserve assets of central banks multiplied 60-fold since 1990, from $200 billion to $12 trillion. Over those 27 years, the global stock of financial assets grew from a level roughly equivalent to the gross world product (GWP) to more than 3.5 times GWP. These holdings are highly concentrated. In the United States alone, banks, insurance companies and dedicated asset management firms – such as BlackRock, Fidelity and Pimco – together control some $53 trillion in financial assets invested worldwide, equivalent to nearly three-fourths of GWP. In a separate analysis, the IMF put the stock of global financial assets in 2011 at $259 trillion or 3.69 times greater than the world product, after nearly tripling in size since 2002.

Financial assets in Brazil also grew fast, but from a much smaller base. Total credit multiplied from only 25% of GDP in 2003 to 55% of GDP in 2013, with the stock of credit in Brazil still much lower than in advanced economies but growing extremely fast. Attracted by low international interest rates, Brazilian public and private borrowers raised $51 billion in foreign bonds in 2012, one-third more than in 2011, joining several other developing countries such as Turkey, Mexico, Lebanon, Indonesia, Dominican Republic, Mongolia, Rwanda and Ukraine. The Central American republic of Honduras, with fragile finances and one of the world's highest murder rates, was able to borrow $500 million for 10 years on international bond markets this year, thanks to the Fed's QE. While less indebted than richer nations, developing economies are scheduled to roll over $1.5 trillion every 12 months. Credit, mainly unproductive debt, has become a global addiction.

Seeking yields greater than the near-zero interest rates prevailing in advanced economies, foreign investors poured $394 billion into Brazil in the four years following the bankruptcy in October 2008 of the New York investment bank Lehman Brothers, a sum greater than Brazil's foreign exchange reserves, with three-fourths of these flows coming in the form of debt. These recent flows were more than four times the volume of financial investments in Brazil during the four years (2003-06) preceding the eruption of the current crisis.

For emerging markets generally, bond issuance by nonfinancial corporations surged from around $100 billion in 2008 to nearly $600 billion in 2012 while equity flotation stagnated. The IMF's April 2013 *Global Financial Stability Report* discussed "the possibility of too much money chasing too few emerging market assets," noting that "the rise of corporate debt-to-equity ratios in Brazil appears closely related to higher issuance of foreign-currency denominated bonds." This provoked "concern that floating-rate or short-maturity loans could represent vulnerability when policy rates start to rise." Although U.S. and European interest rates have yet to rise significantly, capital flows have reversed. Shrinkage of Brazil's exports, together with surges of imports and consumer spending abroad, led to widening current account deficits amid fiscal disorder. Rapid fall in the value of Brazil's currency triggered capital flight while again increasing the hard-currency debt burden of Brazilian corporate borrowers.

Giant state banks

The most dynamic area of banking activity in Brazil, and systemically the most dangerous, has been the rapid expansion of lending by government banks, raising their share of the credit market from 35% in 2008 to 50% by 2013. The combined assets of three giant state banks have been growing very fast and by now, at $1.25 trillion, are equivalent to half of Brazil's GDP, with annual asset growth averaging 28% since 2008. This expansion was funded by cumulative transfers in 2008-12 from the federal treasury to the state banks that by now exceed 9% of GDP. The scale and speed of the surge of lending by Brazil's state banks, increasing assets by $785 billion over the past five years, is extremely rare in global financial history. It is 57% bigger than the $500 billion lent quickly by China's state banks as a stimulus to cushion the impact of the 2008-09 global crisis, as the stock of credit to China's nonfinancial sectors grew from 130% to nearly 220% of GDP. "Since 2009, Chinese domestic debt has been growing so rapidly it approximates credit bubbles in the U.S., Europe, Japan and Korea that precipitated recessions," *The Wall Street Journal* reported. In 2013, the central bank and banking regulators curtailed funding to the interbank market, provoking rumors of bankruptcies and a spiking of interest rates, only to add liquidity when a panic ensued.

China's dramatic response early in the global financial crisis may have inspired Brazil's rulers. However, China's investment-driven economy is three times the size of Brazil's and is more competitive, with $3.5 trillion in foreign exchange reserves after earning large trade surpluses. Meanwhile, Brazil's investment performance has been weak while running trade and current account deficits bred by its consumption boom of recent years. While investment in China reached 48% of GDP, investment in Brazil stagnated at around 18%.

The McKinsey Global Institute (MGI)observes that "much of the apparent [global] financial deepening [assets/GWP] in the decades before the [2007-08] crisis in advanced economies was in fact due to leverage in the financial sector itself. Less than 30% of the growth in financial assets relative to GDP was from financing to the private sector." In the United States, the financial sector doubled in size, from 4% of GDP in the mid-1970s to nearly 8% of GDP in 2007, absorbing two-thirds of the net savings of surplus countries (China, Japan, Saudi Arabia, Germany and Russia). Meanwhile, the stock of credit grew from $3 trillion four decades ago to $56 trillion early in 2013, inspiring Bill Gross of PIMCO to describe a "Credit Supernova" as "a monster that requires perpetually increasing amounts of fuel, a supernova star that expands and expands, yet, in the process that begins to consume itself. Each additional dollar of credit seems to create less and less heat. In the 1980s, it took four dollars of new credit to generate $1 of real GDP. Over the last decade, it has taken $10, and since 2006, $20 to produce the same result." In Brazil, lending grew by 16.7% in 2012, but could produce only 0.9% of economic growth. By 2012, Brazil's gross public debt reached 68.5% of GDP, nearly double the level of all emerging economies (35.2%), according to the IMF. More recently, four states (Maranhão, Mato Grosso, Minas Gerais and Santa Catarina) borrowed $3.7 billion from foreign banks in loans guaranteed by the federal treasury, to pay debts to the treasury and other government agencies.

3. Public institutions and chronic inflation

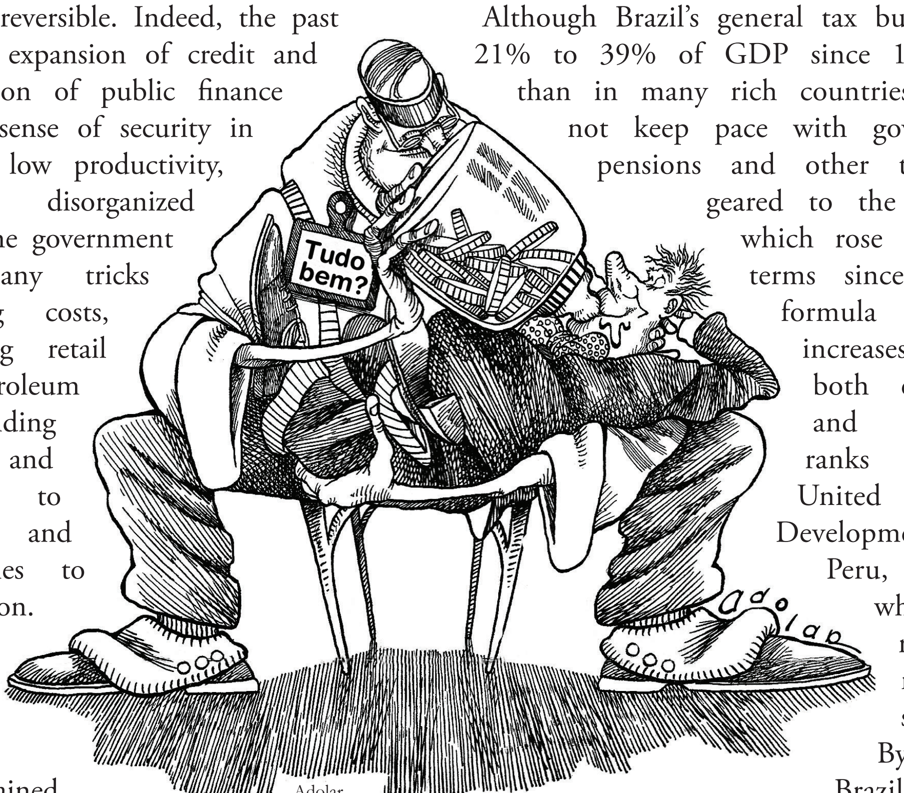
Brazil's government has been pursuing an old strategy of "reactivating" the economy by trying to gain electoral benefit in an attempt to grow its way out of the inflation threat, a strategy that was tried and failed in past decades by populist governments in Brazil, Argentina, Chile, Bolivia and Peru, ending in a fiscal quagmire. The same strategy is being applied desperately today by the populist governments of Venezuela and Argentina, trying to please voters by stimulating consumption while trying to contain inflation by imposing price and exchange controls. In recent years Latin America's major republics have been arrayed in two camps: the resource-rich populists (Venezuela, Argentina, Bolivia and Ecuador) and what I call the cautious republics (Chile, Peru, Colombia and Mexico), which in recent years have produced steady growth, low inflation and robust investment. Brazil has been sitting on the fence, but recently inclined toward the populist camp. As Brazil continues along this path, episodes of growth are proving ephemeral while risking erosion of the historic social and economic gains of the past generation through capacity limitations and resurgence of chronic inflation.

Chronic inflation is a behavioral culture that gradually produces escalating prices as well as claims on public resources that governments are unwilling or unable to contain. Once the rate of price increases reaches a certain threshold, and sustained over some years, chronic inflation tends to become politically intractable. In his study of *Chronic Inflation in Latin America* (1972), Felipe Pazos estimated that threshold of annual inflation to be 10%, which still seems reasonable today and which Brazil may approach in coming months or years. A 10% inflation rate would mean a doubling of the general price level in seven years. At Brazil's current inflation rate of roughly 6%, the price level would double in 12 years. Moreover, it would be incompatible with price levels in Brazil's main trading partners, creating more distortions, with inflation in the United States and the Euro area at only 1% and in China at 3%. Labor costs in Brazil have been rising fast, pressured by a skills shortage, while they have been stagnant or falling in the United States, Europe and Japan. In the 12 months through May 2013, the prices of 230 of the 365 items composing the main index of inflation rose by more than 10%. "Inflation is rising, with a general increase in prices," warned Affonso Celso Pastore, a former central bank president. "Price increases in services, such as in education, health and commerce, exceed 8% per year. This is an ominous situation. If we deduct the effects of tax cuts on electricity, automobiles and electrical appliances, as well as the subsidies on gasoline prices, inflation is moving far above the official target of 6.5%." The general price level has risen by 40% since 2008.

A historic choice was made by Brazilian governments in favoring growth of consumption over development of capacity. Over the past decade, Brazil's economic policy has been geared to what some analysts have called the three Cs: consumption, credit and commodities. Rapid growth of consumption became an acquired right, a sacred cow and a powerful political weapon, not to be questioned or challenged by any relevant political actor. Shopping centers became cathedrals of consumption and catalysts of the real estate boom, with 495 malls built in big and medium-sized cities, with jobs for one million people, as sales and service employment surged. Now the shopping boom has been curtailed amid worries over consumer debt burdens and uncertainties over the future.

Public investment is low because 86% of the big increase in government spending since 1999 (excluding interest on public debt) went for transfer payments. The average Brazilian retires at age 54 with a pension equaling 70% of final salary, costing the government 11% of GDP, more than in richer countries like Germany and Japan that have three times Brazil's share of old people. The *Bolsa Familia* program absorbs only 0.5% of GDP, granting small cash payments to 12 million poor families in return for sending their children to school and getting them vaccinated, but has become increasingly distorted by political patronage and corruption. Despite their failure to complete public investments, Brazil's federal, state and municipal governments nevertheless are efficient in distributing salaries, pensions and other benefits. Welfare and pension payments go to 50 million individuals, absorbing 60% of the federal budget. Governments are driven to increasing generosity, demanding little or nothing in return. Thousands of municipalities survive on federal transfer payments, collecting little or no local taxes and producing little except votes. Property taxes play a minor role in Brazil's public finances, with 1.7% of all tax revenue against 10% in developed countries, with near-zero levies in poor municipalities with weak administrative structures that are dominated by commercial and landholding oligarchies. As early as 1983, the year of Delfim Netto's maxi-devaluation, the World Bank observed that the volume of transfer payments "is such a unique feature of the Brazilian economy that one may refer to it as a transfer economy to distinguish it from the market and centrally planned economies." Chronic inflation can be described as the institutionalization of deranged economic transfers.

These dangers should not be dismissed lightly by saying that the culture of chronic inflation lies in our past, that the social and institutional gains of recent decades are irreversible. Indeed, the past is being revived by expansion of credit and deceptive manipulation of public finance that breeds a false sense of security in an environment of low productivity, high costs and disorganized economic activity. The government has employed many tricks to disguise rising costs, such as controlling retail electricity and petroleum prices, while expanding consumer credit and giving tax breaks to electrical appliance and automotive industries to stimulate consumption. From many years of low savings and investment, Brazil reduced its capacity for sustained economic growth. Because of Brazil's low levels of investment, said Olivier Blanchard, the IMF's chief economist, "the room for maneuver by using policies of stimulating demand is probably limited." The IMF later estimated Brazil's long-term potential growth rate at 3.5% yearly, much lower than previous assumptions yet much higher than the performance of recent years.



Adolar

Governments find it convenient to rely on central banks to stop inflation while neglecting fiscal policy, which is the real culprit, demanding painful choices by presidents and finance ministers. Brazil's central bank carried out an "intensification of the pace of adjustment of monetary conditions" in what the *Financial Times* called "the world's most aggressive tightening cycle," raising its basic interest rate seven times in eight months to reach 10.5% in January 2014.

Three decades earlier, as Brazilian inflation spiraled out of control, Thomas Sargent, a historian of inflations and a Nobel economics laureate (2011), wrote a "Letter to Another Brazilian Finance Minister (1987)," in which he observed: "A central bank cannot by itself stop an ongoing inflation against the will of a fiscal policy authority determined to run persistent budget deficits. Indeed, a central bank determined to 'go it alone' and to fight inflation with tight money in the face of persistent deficits can achieve only temporary gains in the battle against inflation, and at the cost of making inflation worse in the future."

Although Brazil's general tax burden surged from 21% to 39% of GDP since 1987, now higher than in many rich countries, revenues could not keep pace with government salaries, pensions and other transfer payments geared to the minimum wage, which rose by 115% in real terms since 1994 under a formula that guarantees increases greater than both economic growth and inflation. Brazil ranks lower on the United Nations Human Development Index than Peru, Mexico or Chile while collecting roughly twice as much tax as a share of GDP. By that measure, Brazil collects more tax than Britain, Spain or the United States, with little to show for it in public investment or the quality of public services. "The minimum wage readjusts three-fourths of pension and welfare benefits and more than 40% of government spending," observed Mailson da Nóbrega, a former finance minister. "This is madness." The nominal value of pensions and salaries are protected by Brazil's constitution. But inflation raised the cost of the *cesta básica* (a statistical basket of basic consumer goods) by 22% over the past year, while low-income salaries were adjusted by 9%.

Governing Brazil in this way is very expensive. Brazil's institutional difficulties are reflected in public finance but are exhibited most clearly in problems of infrastructure and violence.

4. Infrastructure

Brazil's slave-based mercantile economy hugged the Atlantic Coast for more than three centuries, disregarding its continental interior that produced few exportable commodities, except for the Minas Gerais gold rush of the 18th Century. The census of 1872 counted a combined population of only 220,000 in the vast western provinces of Goiás and Mato Grosso. Beginniing in 1869, ambitious infrastructure development plans were announced every few years that yielded little progress. That began to change with the Amazon rubber boom of the late 19th and early 20th centuries, when a telegraph line through the rain forest and savannahs was opened in 1915 to connect Cuiabá, the capital of Mato Grosso, with Porto Velho, the rubber boom emporium on the Madeira River, enabling travelers to walk the 1,200 kilometers between the two cities of the same province. Until then, the few travelers between these cities had to sail from Cuiabá down the Paraguay/Paraná river system to Buenos Aires, then sail along the entire Brazilian coast to Belem, then travel 2,400 kilometers along Amazon and Madeira rivers to Porto Velho. For centuries, Brazil's poor internal communications had prevented suppression of a long series of regional revolts that ate away at the power and credibility of the central government, leading the American geographer Preston James to report in 1939: "Even in the midst of patriotic proclamations there is an audible undercurrent of talk in Brazil about the possible breakup of this colossus among nations into smaller and weaker units." Only in the second half of the 20th Century, and especially after 1970, that modern agriculture began to penetrate these regions, making Brazil a leading exporter of foodgrains. This penetration intensified with the building of a new inland capital, Brasília, on the Central Plateau. But rapid economic development has left Brazil with a huge backlog of transport and energy infrastructure that weak public institutions are struggling to overcome.

The enormous task of overcoming this backlog is complicated by (1) the political choice of pouring more resources into consumption rather than public investment; (2) lack of technical skills, caused by weaknesses in public education, leading to poor design and execution of projects; (3) bureaucratic confusion in the selection and approval of projects. "The government is divided into self-contained silos with little coordination," observed Cláudio Frischtak, a leading infrastructure analyst. "A series of 'czars' compete for control. Pressure for short-term results drives the exercise of power, wrecking well-designed plans and sustainable solutions."

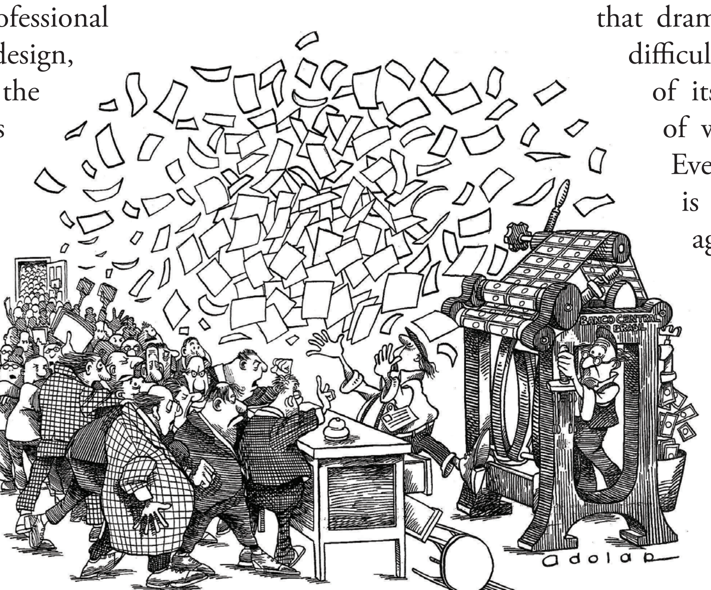
The World Economic Forum ranks the size and quality of Brazil's infrastructure as 114th among 148 countries. According to the McKinsey Global Institute, the value of Brazil's infrastructure stock has fallen to only 16% of GDP, against a global average of 70%. While the rest of the world has been spending 3.8% of global GDP annually in recent decades to build and maintain roads, ports, railroads, airports, water supply and telecommunications, Brazil has invested only 1.6% of GDP yearly in infrastructure, a trivial share of Brazil's heavy tax burden (39% of GDP) and is far below the levels of its Latin American neighbors. At best, this low level of investment can cover some depreciation. Demand for better infrastructure has intensified as agricultural exports, air passenger traffic, car sales and container flow at ports all have more than doubled over the past decade. With 22 cities each containing more than one million people, Brazil's rapid urbanization adds to claims for more public investment. However, because so many infrastructure projects are never finished, despite high cost overruns, public investment often becomes one more form of private consumption. And these failures, widely reported in the media, meet with indifference among the political class and the general public.

Big debts and few public works

In the three decades since the outbreak of the Latin American debt crisis in 1982, Brazil could carry out few major public works, except for the maintenance of its growing cities, leading to atrophy of human capital in the government agencies responsible for infrastructure investments. Over the past decade, however, as Brazil stabilized and won favor in world financial markets, an ambitious agenda of major projects was announced – highways, railroads, hydroelectric dams, ports, airports, deep-water petroleum exploration and development – that challenged the limited skills available in public bureaucracies as well as in private sector contractors. Thanks to the public works decline of recent decades, Brazil could not create a new generation of engineers to replace leaders such as Mario Behring and John Cotrim, responsible for the great hydroelectric dams of Itaipú and Tucurui in the 1970s. GEIPOT (Grupo

Executivo de Integração da Politica de Transportes), the elite team of technicians created by the military regime in 1969, was allowed to disintegrate until it finally was abolished in 2008. Private engineering firms disappeared. Big construction contractors, such as Andrade Gutierrez and Odebrecht, increasingly depended on business outside Brazil.

The federal bureaucracy is prodigiously staffed with 22,000 political appointees in 39 ministries, several of them created specifically to accommodate more than 20 parties belonging to the presidential coalition. But the government suffers for lack of planning and operational capacity. It struggled to build public works by granting concessions in a maze of restrictions, pricing issues, cross-subsidies, litigation and vagaries over future government decisions. Because of deficiencies in public education, there is a desperate shortage of professional and skilled manpower to design, engineer and operate the $1 trillion in projects needed to modernize Brazil's infrastructure. Plans were announced competitive bidding for private management and upgrading of nine federal highways, five major airports, extension of 10 railroads covering 12,000 km. and port concessions in 16 states, including dredging projects and creation of private ports, said to be worth R$ 334 billion (roughly US$165 billion), with generous financing from the BNDES.



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Project design and bidding edicts were outsourced to a private company, Estruturadora Brasileira de Projetos (EBP), leading to complaints by potential participants in public-private partnerships (PPPs) that the calls for bids underestimated investment needs, set uneconomic tolls and user charges and exaggerated the projects' rates of return. In opening bids for complex projects in difficult regions, government authorities offer rates of return little better than riskless investments in government bonds. Transport Minister César Borges, a former governor of Bahia, said that the government would subsidize road tolls on major highways where concessionaires also would get low-interest BNDES loans.

Internationally, the potential for public-private partnerships (PPPs) often is exaggerated, even in countries where some projects have been successful. Only 40% of the PPPs planned in the United States since 1985 were funded by 2010. In the European Union, PPPs accounted for less than 12% of infrastructure investment in recent years. In Brazil, of 177 PPPs announced over the past decade, only 19 had contracts signed and only 11 were operating by 2013. Among these were the major highways of São Paulo State, operated successfully as PPPs for more than a decade. These programs now will be tested on a much larger scale. Some examples:

- Among the leading challenges is the strategic highway, BR-163, over which the bulk of the grain harvest in Mato Grosso is trucked for export to the port of Santarem on the Amazon River and to southern ports. For decades now, an annual ritual plays out in the press and on TV screens that dramatizes Brazil's infrastructure difficulties. Brazil transports 60% of its domestic cargo on roads, of which only 14% are paved. Every year the same spectacle is repeated of trucks carrying agricultural produce bogged down in swamps of mud along BR-163 and other export corridors. "In Brazilian agribusiness, the main difficulty is not production but transportation," according to Marcos Jank, a leading agricultural economist and a member of our Institute. "This is the weak link that impacts agribusiness more than any other sector of the economy."

Large sections of BR-163 have been leased to construction companies who will struggle to overcome environmental adversity – months of continuous heavy rain, waterlogged soils, the bridging of dozens of rivers, the lack of paving materials nearby, the need for intensive maintenance – in order to turn BR-163 into a four-lane highway profiting from the tolls generated by heavy truck traffic. At the other end of this 3,500-km. logistical corridor, linking farms to their overseas markets, long lines of trucks wait for days to unload at Santos, Latin America's biggest port, while long lines of ships also wait for several days to load and unload cargoes. Delays in loading ships led to cancellation of orders from China of two million tons of soybeans in 2013. BR-163 is one of several highway projects auctioned late in 2013 to private contractors on 30-year concessions, supported by state banks and government pension funds. The contractors offered steep discounts from maximum toll charges set in the bidding process in order to profit from the heavy movements of trucks transporting commodities along these routes.

- One of the biggest projects is the diversion of waters of the São Francisco River through 622 kms. of canals to 12 million people in 391 water-starved municipalities in the Northeast, including the metropolis of Fortaleza, whose population has multiplied over the past half-century from 200,000 to 2.5 million. Construction began on the basis of a feasibility study without detailed geological surveys of the terrain. Although the project was to be finished in time for the 2010 presidential election, only 40% of the work has been completed by now, although the estimated cost has doubled. Many of the canals have cracked open with fissures invaded by sagebrush as contractors abandoned their sections after discovering that land along the route had not been expropriated and electricity pylons lay in their path.
- The same kind of problems have paralyzed three big railroad projects, each extending for over 1,000 kms., being built simultaneously: the Transnordestina, the North-South and the West-East crossing the State of Bahia as an export corridor for new areas in the *cerrado* region of Barreras producing soybeans and cotton. The ex-president of Valec, the state enterprise in charge of railroad planning and construction, was imprisoned under charges of embezzling R$ 100 million (roughly US$ 50 million) from the 2,255 km. North-South railroad, under construction since 1996. Valec also is building the Bahia railroad, which has been paralyzed by problems of sloppy engineering and environmental studies, legal and regulatory impasses and death threats to surveyors by landowners and squatters. Three years after construction was said to begin no track has been laid and half of the contractors have abandoned their work.

Comet

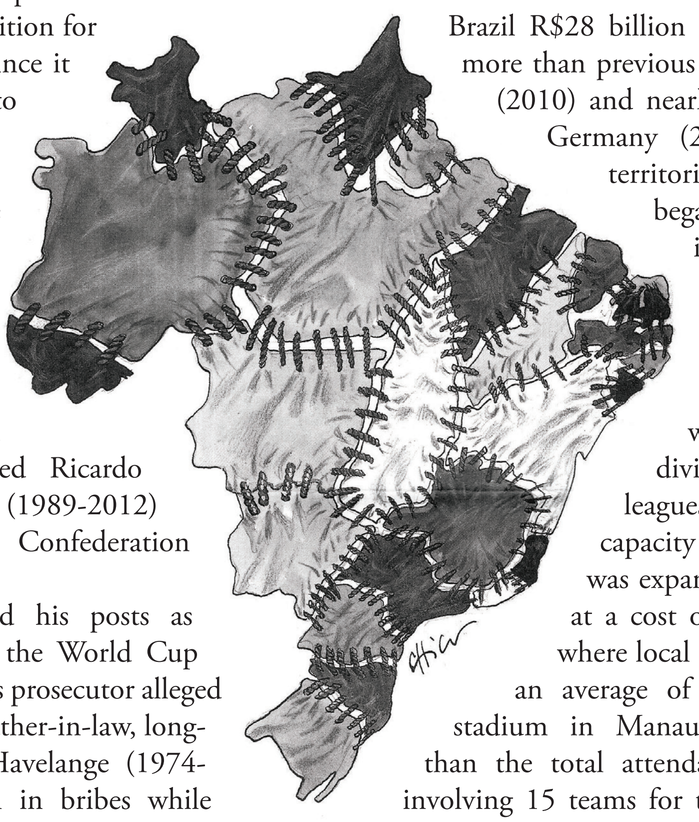
The saga of Eike Batista circulated widely in the international press, rising fast and then burning out like a comet, forming a kind of proxy for enthusiasm and then disillusion confronting Brazil's problems in financing and executing big projects. Eike earned his first fortune at age 21 trading gold in the wildcat mines *(garimpos)* of Amazônia in the 1980s. In a public stock offerings before the international financial crash in 2008, Eike's conglomerate of energy, infrastructure and mining companies gained market value of R$87 billion (US$54 billion), orchestrated by a blizzard of 105 announcements of "relevant facts" to the market, proclaiming after a discovery in the Campos Basin: "OGX (his oil company) is proof that it is worth betting on the competence of Brazilians and on the abundance of our natural resources. These recent successes will pave the way for our robust growth and social equality. Viva Brazil!"

Eike predicted in 2010 that OGX would produce 1.4 million barrels daily by 2019. Announcing his goal of becoming the world's richest billionaire, Eike formed a "dream team" of executives and geologists from Petrobras who celebrated big discoveries before completing half of the test wells needed to measure the size of reservoirs, burning through $5.3 billion before announcing in 2013 that the exploration program had ended in failure. Meanwhile, the mining and infrastructure projects of EBX were stalled by delays in regulatory approvals. After his holding company EBX invested $15.7 billion in 2011-12, fortified by R$5 billion in loans from BNDES and large shareholdings by BNDESPar, its investment banking subsidiary. *The Wall Street Journal* reported that "doubts have grown about Mr. Batista's ability to meet lofty goals for finishing massive infrastructure projects," implying reputational problems for Brazil.

Eike had given stock in his companies as collateral for loans raised to build oil platforms and develop offshore wells and iron mines. Struggling with debts totaling R$18.8 billion (US$9 billion), Eike announced that OGX will suspend offshore operations in 2014, some of them three months after they were declared commercially viable to regulators. Analysts at Bank of America reported that, in addition to BNDES's exposure, Eike's group obtained loans totaling R$1.4 billion from the Caixa Econômica Federal and another R$3.1 billion from Bradesco, Itaú Unibanco and BTG Pactual. Foreign bondholders claimed in vain immediate repayment of US$3.6 billion. Questions were raised on how large banks and government regulators of the petroleum industry and the stock market could have suspended critical judgment, exposing many investors to big losses. After OGX filed for bankruptcy in October 2013, in the biggest corporate default in Latin American history, creditors agreed to convert US$5.8 billion of debt into 90% ownership of OGX. Some 81,000 retail investors saw the value of each share collapse from a peak of R$23.27, losing 97% of their value. Eike lost US$30 billion in what was said to be his personal wealth while selling assets to pay debts. Meanwhile, the collapse of Eike's empire coincided with protests over wasteful public spending on infrastructure for the World Cup.

5. The World Cup

The shambolic preparations for the football World Cup in Brazil are reaching a climax amid escalating controversy, with playing conditions resembling the general state of Brazilian infrastructure. The lack of competition from other countries was in evidence when Lula in October 2007 led an entourage to Zurich that included 12 state governors to receive the mandate of FIFA *(Fédération Internationale de Football Association)* for Brazil, five times world champion, to host the World Cup tournament to be held in June-July 2014. As if this honor were not enough, Brazil was awarded the mandate to organize the 2016 Olympic Games in Rio de Janeiro. There was no competition for organizing the World Cup, since it was South America's turn to host the games with Brazil regarded since 2003 as the only logical candidate. "The model proposed for the Cup in Brazil foresees private investment for construction and renovation of stadiums, reserving public resources for modernization of infrastructure," announced Ricardo Teixeira, long-time president (1989-2012) of the Brazilian Football Confederation (CBF).



In 2012 Teixeira resigned his posts as CBF president and head of the World Cup organizing committee. A Swiss prosecutor alleged that Teixeira and his former father-in-law, long-time FIFA president João Havelange (1974-98), had taken $41 million in bribes while selling World Cup marketing rights. Meanwhile, preparations for the 2014 World Cup were in disarray. Urban infrastructure projects, would have benefited urban populations after the games ended, were abandoned. World Cup preparations became simply a race to build stadiums, financed with public funds, far behind schedule. Jerome Valcke, FIFA's secretary-general, told journalists in 2012: "I don't understand why things aren't advancing. The stadiums are behind schedule. The worry is that nothing is being done to receive many visitors. Things are not working in Brazil. You need more pressure, a kick in the backside to organize the World Cup." Valcke later said that FIFA considered transferring the 2014 World Cup to another venue outside Brazil during the street protests in several Brazilian cities in June 2013.

While other countries seeking to host the World Cup previously had to submit detailed proposals to FIFA for building and upgrading stadiums, urban infrastructure, public security, airports and hotel accommodations, Brazil was required to present no plan, being the only candidate to organize the 2014 tournament. By 2009 Brazil still had not chosen the cities where the games would be played and shifted the decision to FIFA, meaning Ricardo Teixeira. Under political pressure to accommodate local interests, Teixeira decided that the games would be held in 12 cities, some of them thousands of kilometers apart, instead of the traditional eight cities in previous World Cups.

The 2014 World Cup is expected to cost Brazil R$28 billion (US$14 billion), four times more than previous tournament in South Africa (2010) and nearly three times more than in Germany (2006), which have smaller territories and populations. A race began to build big stadiums in improbable places with few local fans, such as Cuiabá in Mato Grosso, Manaus in Amazonas and Brasília, the national capital, none of which fielded first or second division teams in domestic leagues. In Brasília, the seating capacity of the National Stadium was expanded from 45,000 to 72,000 at a cost of US$750 million in a city where local football league matches drew an average of 800 spectators. "The new stadium in Manaus has 48,000 seats, more than the total attendance of all league matches involving 15 teams for the whole season," said Juca Kfouri, a leading football commentator. "To add to white elephant stadiums in Cuiabá, Brasília, Manaus and Natal, they are building a new arena in Recife 40 kilometers from the city center with difficult access. All these stadiums are being built to host at most three games in a tournament that lasts one month and will have little use thereafter."

Spontaneous street protests about the quality of public life erupted in June 2013 on the eve of the Confederations Cup, a preliminary international competition among leading national teams that is held a year ahead of every World Cup to test the readiness of stadiums and other infrastructure. The protests were triggered by a small demonstration against a 20-centavo increase in bas fares in São Paulo that was dispersed violently by police. Street marches then spread to 353 towns and cities, organized by enthusiasts on internet social networks such as Twitter and Facebook, surprising the promoters of the original movement in São Paulo and upsetting many other calculations. Until then, a chorus of consensus forecasts had made linear predictions that things will stay as they are: that annual inflation will stay at around 6%, that the present government will survive economic deterioration to win reelection in 2014 and then announce some stabilization policies.

President Dilma Rousseff had been riding high in the polls, with approval ratings of 67%, and was so confident of reelection that she claimed: "My mandate is for eight years." Then the quality of public life came into play as people of different social classes marched night after night in the streets of the big cities, and in remote towns of Amazônia and the Northeast, protesting the cost and quality of public transport, endemic corruption, shoddy public education and health facilities and extravagant and chaotic public spending to prepare for the 2014 World Cup. By then, the Controller-General reported that the building and remodeling of "FIFA standard" stadiums for the World Cup would cost R$7 billion, enough to pay for the construction of 8,000 schools. The protesters demanded "FIFA standard" schools, hospitals and urban transport As the crowds in Brazil grew and multiplied, the political class panicked, then went into frenzied action, with Congress holding late-night sessions to suddenly approve long-dormant reforms as politicians praised the wisdom of the masses. Dilma's popular support plunged by 27% in opinion polls within a few weeks. Yet they continued week after week, as labor unions and professional associations took over the marches, blocking traffic in the major cities. Coming to the fore were amorphous so-called anarchist groups that vandalized bank branches, Macdonald's outlets and government buildings. The most conspicuous of the anarchist groups, known as Black Blocs, were youths wearing black ski masks who protagonized television images of vandalism as the middle classes abandoned the protests. The protests lost their focus and failed to develop a program and an organization to influence the quality of public life, while the politicians voiced pieties and then returned to their usual routines. On June 30 Brazil won the Confederations Cup with a 3-0 victory over Spain, the 2010 World Cup champion. Dilma's poll ratings slowly recovered. João Santana, her political marketing guru, called the protests "a temporary catharsis."

6. Violence

On that Sunday afternoon when Brazil's young national team defeated Spain in the Confederations Cup in before 74,000 fans who bought expensive tickets to watch in the remodeled Maracaná stadium in Rio de Janeiro, another football game was being played on an improvised rural field 2,000 kilometers further north in Campo de Melo, a village in the *município* of Pio XII in the Northeastern state of Maranhão.

In these regions pickup football games are one of the few Sunday recreations, often enlivened by alcohol and violence. Pio XII is in one of the poorest regions in one of Brazil's most backward states, with an adult illiteracy rate of 44%, against 28% for all of Maranhão and 13% for Brazil, while infant mortality in Pio XII was 72 per 1,000 live births, the same as in the Congo, against 54 for Maranhão and 13 for Brazil. Poverty in Pio XII is relieved by the government's *Bolsa Familia* program, which grants monthly stipends averaging R$ 166 (US$83) to 44% of its families.

In the pickup game in Campo de Melo, one side wore shirts and the other team went bare-chested, both scrambling to send the scruffy ball through wooden goal posts that had no nets. Otávio Cantanhede, 19, herded cattle and fixed fences by day and was finishing high school at night to realize his dream of becoming an accountant. On that Sunday he tucked a knife into his shorts before he rode his bicycle to the field where he played defense until he injured his foot and became the referee. Some 15 minutes into the second half, Otávio blew his whistle and showed a yellow warning card to Josemir Santos Abreu, 30, a former teammate who worked at the local post office and was watching the pickup game until he was recruited to play. An aggressive midfielder despite suffering from epilepsy, Josemir was incensed at getting the yellow card and dared Otávio to expel him with a red card, saying that both of them would have to leave the field together. Otávio called Josemir a clown and showed him the red card. Josemir called Otávio's mother a whore and sent Otávio sprawling with a kick. When Otávio got up he had a knife in his hand and stabbed Josemir twice in his side and once in his chest. Josemir died enroute to the local hospital as his friends attacked Otávio, tied him up, smashed his face with a bottle of *cachaça* (cheap sugarcane liquor), ran him over by a motorcycle and decapitated him after stabbing him in the throat. Octávio's head was left on a wooden fencepost across the road from the field.

Neighbors said they phoned the police, but there was no answer. Pio XII was staffed by seven local policemen and two patrol cars. On that Sunday the police were working in another village that lacked a cellphone signal and could not be reached from the football field at Campo de Melo. While the number murders in Maranhão multiplied five-fold over the past decade, the ratio of police officers to population is lowest among Brazilian states. At the Pedrinhas prison in São Luiz, the state capital, 60 prisoners were murdered in 2013 during fights between rival gangs, three of them beheaded in December. Wives of inmates visiting the penitentiary were repeatedly gang-raped by other prisoners.

In many regions of Brazil, living standards have improved but violence continues, reflecting institutional problems passively accepted by the population. In 2011 Brazil recorded 52,280 homicides, averaging 143 killings daily, equivalent to the death toll of a major airline crash every day of the year. Many killings are sudden and spontaneous, as in Campo de Melo. Between 1980 and 2011, more than 2.6 million Brazilians have met violent deaths, mainly in homicides and traffic accidents. As elsewhere in the world, most murders involve young men as both killer and victim. While the deaths of Otávio Cantanhede and Josemir Abreu in Campo de Melo were poor men's murders, done with primitive weapons, most homicides in Brazil are inflicted with guns. Some 15 million guns are said to be circulating in Brazil, less than half of them registered. Gun killings in Brazil multiplied six-fold since 1980, accounting for 70% of all homicides. While Brazil suffers neither from organized political insurgencies nor from ethnic or religious conflicts, the 147,373 Brazilians killed by gunfire in 2004-07 exceeded by far the combined direct fatalities in armed conflicts in Iraq, Sudan, Afghanistan, Colombia and the Congo, according to the *Global Burden of Armed Violence* report, published in Geneva under a diplomatic initiative supported by 100 countries and sponsored by the United Nations Development Program.

Brazil ranks seventh in the world homicide league tables, with 27.4 killings per 100,000 population, exceeded by El Salvador (62.4), Venezuela (36.4), Colombia (45), and Guatemala (38.7), among countries for which statistics are available, several times the homicide rate for the entire world population, estimated by United Nations agencies at between 6 and 8.8 per 100,000. Fourteen Brazilian cities are among the 50 most murder-stressed cities of the world, followed by 12 cities in Mexico, five in Colombia and three in Venezuela. Half of the world's 50 most murder-prone cities are in Latin America.

The surge in Brazilian homicides is unevenly distributed. While the number of killings over the past decade (2001-11) fell by 80% in São Paulo and by 55% in Rio de Janeiro, Brazil's two biggest cities, and by 37% in Recife, the biggest city of the Northeast, they have doubled and tripled in other big cities of Amazônia and the Northeast. The astronomical homicide rate of Maceió, capital of the poor and backward state of Alagoas, at 111 per 100,000 population, is ten times higher than São Paulo's. One-fifth of Brazil's 5,565 municipalities, mainly small towns, recorded no murders at all in 2009-11. But several others, of various sizes, report some of the world's highest homicide rates. Fifteen municipalities have homicide rates above 100 per 100,000 and 88 cities report rates above 60 per 100,000. Of these high-violence communities, 51 are in the Northeast, half of these in just two states, Bahia and Alagoas. Detailed reporting by Leonencio Nossa of the newspaper *O Estado de S. Paulo* chronicled 1,133 political assassinations since 1979, two thirds of them in the Northeast and Amazônia, escalating in recent years and peaking during municipal election campaigns.

This increase in homicides raises some questions. Why are killings increasing while living standards have been improving, with record low unemployment (4.6% nationally) and massive financial transfers to poor people? Why has the distribution of homicides been so uneven, with some cities being able to reduce killings dramatically while in others murders multiplied out of control? Do these differences reflect the structure of incentives? Is it because less than 10% of murders are investigated by police and tried in the courts? Can they be explained by unrealized human potential, with 23% of all young people ages 18-24 neither studying nor working? How may the frequency of killings be related to settlement patterns and presence or absence of public institutions in fast-growing cities? What is the influence of the narcotics trade? How much does the greater access to firearms in Brazilian cities explain their higher homicide rates when compared with Asian and African cities? All these questions deserve detailed research. However, I believe that the basic underlying issue is the quality of institutions.

The surge of homicides in Brazil clashes with the long-term trend that for centuries reduced civil violence in complex societies. Over the past 800 years, murders in western Europe, for example, fell from about 80>100 per 100,000 population, greater than in El Salvador and Venezuela today, to the current civilized levels of around 1>2 per 100,000. This secular decline in civil violence over the centuries is powerfully explained in a recent book, *The Better Angels of Our Nature: Why Violence Has Declined* (2011), by the Harvard psychologist Steven Pinker, describing the evolution since the late Middle Ages in Europe of what has been called the civilizing process:

> *The centralization of state control and its monopolization of violence, the growth of craft guilds and bureaucracies, the replacement of barter with money, the development of technology, the enhancement of trade, the growing webs of dependency among far-flung individuals, all fit into an organic whole. And to prosper within that whole, one had to cultivate faculties of empathy and self-control until they became second nature.*

This explanation follows a tradition starting with the philosopher Thomas Hobbes who argued in his great work *Leviathan* (1651), written during the English civil wars of the 17th Century, that only a state with a monopoly on the use of force, embodying the will of the people, can prevent anarchy, called by Hobbes "the war of all against all," when "men live without a common Power to keep them all in awe," leaving them in "continual Fear, and danger of violent death; And the life of man solitary, poor, nasty, brutish, and short."

Peace was strengthened by commerce. "Commerce attaches [people] to one another through mutual utility," the economist Samuel Ricard wrote in 1704. "Through commerce, man learns to deliberate, to be honest, to acquire manners, to be prudent and reserved in both thought and action." The civilizing influence of commerce was reinforced by the spread of literacy, technological advances in publishing, and mass circulation of newspapers and books, expanding the horizons of common knowledge and leading to important humanitarian reforms.

From this perspective, the weakness of public institutions created space for a tolerance of violence in many Brazilian communities. The state never achieved a monopoly of organized force and violence. Free circulation of weapons and relaxed law enforcement sometimes leads to cases in which police commit murders with impunity and cooperate with criminal gangs. But when the state is mobilized to reduce homicides it can achieve this purpose. Despite its imperfections, São Paulo's public security apparatus made spectacular gains in reducing murders in the city from 6,669 in 2001 to 1,347 in 2011, an 80% reduction in a single decade, faster and on a much larger scale than the famous campaign in New York City that cut homicides by 82%, from 2,262 in 1990 to 417 in 2012, which took more than two decades to achieve. In São Paulo police action was important, but it was part of a broader civilizing process: expansion of commerce in peripheral neighborhoods, more investment in public services, slower population growth, better adaptation of migrant families to urban life, improved living standards and employment opportunities and increasing literacy, both in reading and writing and the use of computers and the Internet. Other cities known for violence, such as Rio de Janeiro and Recife, made gains in reducing homicides, but on a lesser scale. Yet violence is merely one aspect of broader institutional problems that Brazil faces as it journeys into the emblematic year of 2014.

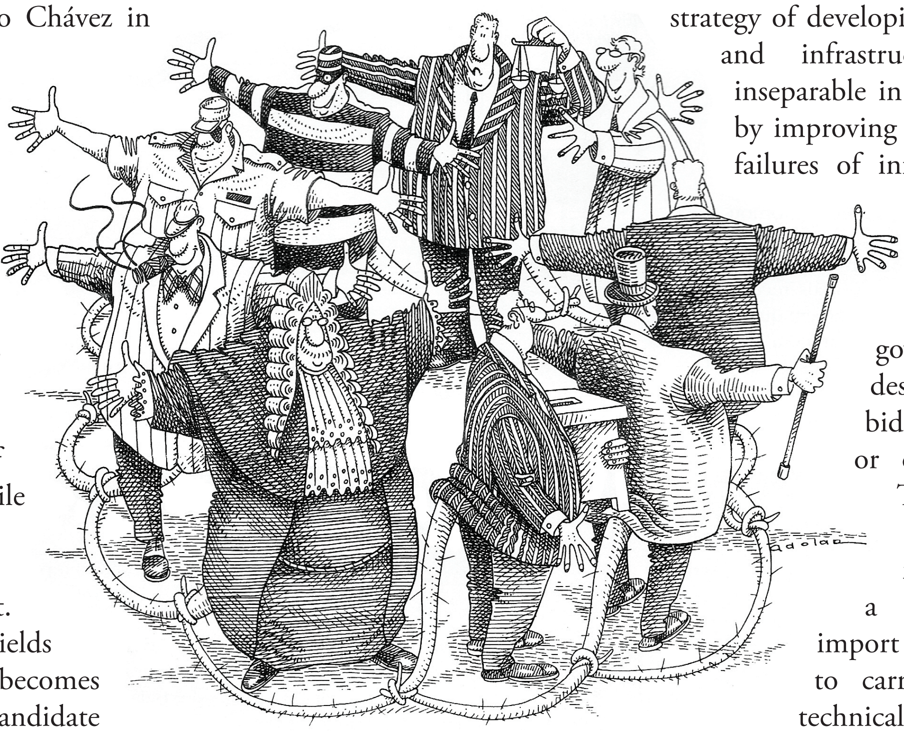
7. Brazil needs a new strategy

Institutional problems are not simple problems. They are knots or clusters of problems that can be overcome only by a strategic focus on priorities over sustained periods of time. This is why we have been arguing that Brazil needs a new strategy.

Brazil is living in two worlds. One of these worlds is a balloon economy of inflated promises. At the end of 2013, President Dilma Rousseff went on television to tell Brazilians: "I am happy to reassure you that you begin 2014 knowing that your standard of living will be even better than what you have today." The housing program *Minha Casa Minha Vida* "has become the most successful program of its kind in the world. We are reinforcing the program *Brasil sem Miséria* that is one step from abolishing absolute poverty throughout the national territory." The importing of Cuban physicians in the program *Mais Medicos* "has placed 6,658 new doctors in 2,177 municipalities, benefiting 23 million people. By next March there will be 13,000 doctors benefiting 45 million people." All this was part of Dilma's reelection campaign, leading the president to warn that opposition by "a psychological war could inhibit investments and delay initiatives. If some sectors sow distrust, for whatever motive, this is very bad."

The other Brazil is sinking into institutional disorder. The disorder is embodied in fiscal parasitism, failing infrastructure and public services, endemic corruption, chronic inflation, escalating violence and an unresponsive and irresponsible political class, entrenched in the system of "presidential coalitions." Outside the political class, misgivings and distrust are growing, draining the optimism and self-esteem of many Brazilians. There is no meaningful political opposition. As in other times and places, short-term benefits and promises, backed by the financial resources and propaganda machine of government, may win an election, but the institutional disorder will tend to deepen. Differently from the recent past, Brazil will be able to benefit neither from a buoyant world economy nor from an expansive global financial system.

Look toward Argentina and Venezuela, republics rich in natural resources providing opportunities wasted by populism, with populations endowed with a strong sense of privilege and politics dominated by the ghosts of populist leaders: Juan Domingo Perón in Argentina and Hugo Chávez in Venezuela, just as Brazilian politics was shaped by Getúlio Vargas in the quarter-century from 1930 to 1954 and may be shaped in the future by memories of Lula. Lula is said to command the loyalty of 50% of Brazil's voters, while his party, the PT, can claim only 17% of popular support. But if Lula yields to pressure and becomes a presidential candidate again in 2014 at age 69, he probably would be limited to transitional influence while Brazil's deeper problems remain to be addressed.



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Brazil needs a civic movement, originating outside the political class, if our deeper institutional problems are to be addressed. An embryo of this kind of civic movement may be the street protests that arose throughout the country in June 2013 and may be revived in 2014. This civic movement would create opportunities and challenges for a new generation of leaders. While lacking specific proposals, the issues generated by the protests are clear: overcoming institutional failures in public life, going beyond urban transport, health and hospital services and public education. These protests need to outgrow their spontaneous and romantic phase, expelling violent elements, to develop capacities for leadership, organization and communication. A younger generation of potential leaders with these skills has arisen in business, the professions, journalism, religious institutions and social movements. These skills may be mobilized by new leaders during the emblematic year 2014. Civic movements need a positive agenda. This agenda should embrace the drive to build human capacity.

Brazil needs a new strategy to build a knowledge base and a structure of incentives that would enable Brazil to move forward. The promotion of consumption is approaching the limits of its political and economic potential and will become harder to sustain in the future. Brazil's other institutional problems would tend to solve themselves if the political leadership could concentrate on a long-term strategy of developing public education and infrastructure, which are inseparable in practice, since only by improving skills can the recent failures of infrastructure projects be avoided in the future. At current levels of literacy and numeracy, governments cannot design projects, draft bidding conditions or oversee contractors. This is why the federal government recently announced a crash program to import foreign engineers to carry out these basic technical tasks in states and municipalities**.** But crash programs are not enough. Only coherent long-term efforts, sustained over decades with popular support, can develop the human capital needed for Brazil to strengthen the civilizing process that produced great benefits in recent decades.

Learn more and achieve more

Despite isolated progress in some states, such as Ceará, Goiás and Espirito Santo, public education in general is stuck at low levels. There are few performance standards for teachers and pupils. Math and science teachers are scarce throughout the country. In many schools, pupils get as little as two hours of classroom instruction every day. In the OECD's international PISA tests for 15 year-olds in 2012, two-thirds of Brazilian students are ranked "below basic" in math skills, a gain over the 75% classified as low-performing in 2003, while only 1% were top

Marcos Muller

scorers among 510,000 students tested worldwide. Half of Brazilian students tested below basic in reading, better than the 56% in 2003, with this gain "entirely" explained by better social and economic conditions rather than better teaching, according to the OECD. Dropout and failure rates remain high. Frequent repeating of grades means that students take 12 years on average to complete eight grades of primary school.

It is very hard to operate a complex society at current levels of literacy and numeracy. The only alternative to deepening disorder is a strategy of human development that would give millions of Brazilians opportunities to learn more and achieve more. These opportunities can be realized only by strengthening the quality of teaching and learning. While there is much talk of raising public education spending to the extremely high level of 10% of GDP, using revenues from a petroleum bonanza that do not yet exist, there is little talk of how all this extra money would be used. There is no substitute for better selection, training and rewarding of teachers, especially in the critical areas of science and mathematics. The Fernand Braudel Institute has some ideas on how this may be achieved, having conducted field research since 2000 on school reform in Brazil and the United States as well as Reading Circles in public schools of São Paulo's periphery and states of the Northeast, reading and discussing the classics of world literature with many ambitious and talented students. Detailed proposals will come in a future issue of *Braudel Papers*.

By focusing on priorities of education and infrastructure, Brazil could achieve the efficiencies that would enable us to gradually overcome other institutional problems such as violence, public health, the judiciary and the devastation of Amazônia, as well as the plague of corruption. However, working to achieve long-term goals demands a combination of trust and urgency. Brazil needs a new strategy that embraces clear incentives and priorities to meet long-term objectives that reflect a consensus on where we want to be. Trust is needed because meeting these goals will take time. As the events of 2014 unfold, the urgent need for a new strategy may become clearer. The critical element in these contingencies will be the quality of institutions. As Fernand Braudel might say, the challenge lies in the quality of structures rather than in situations. Only strong and adaptable institutions can deal with unexpected events and new tests of resilience. ■

Dilma's dilemma

Rubens Ricupero

President Dilma Rousseff's government is caught in a dangerous dilemma. To win reelection in 2014, Dilma needs to maintain a sense of well-being among voters through full employment, gains in real wages and more consumption. But the pursuit of those goals recently has proven incompatible with high economic growth and low inflation. This pursuit has aggravated fiscal deficits and dependence on inflows of foreign money, making economic adjustment a pressing necessity.

If electoral considerations delay economic adjustment, Brazil may be exposed to a "perfect storm" even before the elections. Adjustment would become more painful. The goals of robust employment and wages needed for election victory may have to be sacrificed,prompting accusations of an "electoral swindle."

Electoral success itself is not without risks. One can argue whether Dilma Rousseff's government is market-friendly or not. However, there is no doubt that markets are not friendly to Dilma. If at some point in the campaign it appears clear that she is going to win, or after her victory were confirmed, there may be a repetition, albeit in a much weakened form, of the market panic that greeted Lula's triumph in 2002.

It took much political wisdom, supported by invaluable help from Finance Minister Antonio Palocci and Central Bank Governor Henrique Meireles, to overcome the period of turmoil and recover the trust of important economic actors. That was perhaps Lula's finest hour, the moment when he began to be seen no longer as a successful trade-unionist-turned-politician but rather as a statesman.

What caused this impasse?

At the time of her 2010 election, Brazil was growing at 7.5% a year, nurturing a delusion that the country had discovered an formula for irreversible progress. Fighting the twin social scourges of poverty and inequality, it was thought, could be the opportunity to accelerate growth.

A generous array of social programmes articulated around Bolsa Família, a conditional cash transfer programme that reached about 50 million people, a quarter of the population, would create a mass consumption market. This in turn should generate ever expanding demand capable in time of summoning the investment needed to increase production and satisfy that new demand.

From 1999 to 2012, not less than a staggering 84% of the increase in non-financial governmental expenditure has consisted in income transfer to families in the form of unemployment insurance, Bolsa Família, salary allowances and a myriad of other social programmes. Significant results were achieved: 25 million people rose from the most abject poverty and an equal number rose from a slightly better kind of poverty.

For each of the social programs, there was of course a price to be paid. Public investment in infrastructure, which had already been radically reduced during successive crises from the 1980s onwards, dwindled even more and fell to just a third of what it had been in the 1970s.

Consumption of the new "middle class" thrived at the expense of savings. Gains in the minimum wage and real increases in salaries did little to improve economic productivity. Feelings of well-being supported by currency appreciation had to be financed by growing current account deficits and by losses of markets for high-cost industries no longer able to compete in our traditional export markets and with imports in our own market.

Despite weak public and private investment, the economy was able to grow for a while thanks both to the inclusion on payrolls of millions of workers who previously had been unemployed or underemployed and to the utilization of spare capacity in industry. Today this process has run its course as the country reached virtual full employment and the supply of more labor has been slowed by a sharp reduction in population growth.

Productivity growth has slowed to about 1% a year lately, partly as a result of an accelerated expansion of the labour market with nominal wages increases above productivity, partly because of the lack of skills of many workers.

The mix of economic and social policies adopted over the last few years appears unsustainable. At the current economic growth rates, there will be no fiscal room left for expanding and perhaps even maintaining some social benefits. The day is fast approaching when hard choices must be made.

This time the choices will touch a raw nerve: the tension between immediate gratification of socio-political aspirations and intractable economic constraints. In some cases, policies considered by the government and its political and trade union allies as irreversible lie at the very heart of the controversy. One of these policies is Lula's formula for real increases in minimum wage above inflation and its impact on public expenditure, particularly in social security. Another is the explosive growth in the cost of unemployment insurance and salary benefits.

From now on Brazil will only be capable of growing by improving overall productivity through quality education, health and research as well as by tackling the one trillion dollar backlog in urgent infrastructure projects through private investment from inside the country or abroad. At the same time, the government that emerges from our coming elections will have to implement a well-designed adjustment programme to control inflation, rein in the abuse of Treasury resources to replenish official banks, liberalise the trade regime, and undertake badly needed tax, labour markets and institutional reforms.

Is it possible to do it with a political system plagued by dysfunctional evils, among them patronage, pork barrel politics, proliferation of parties and widespread corruption? Will Brazilians prove capable of such daunting tasks despite the current poor level of public education?

This is the object of Norman Gall's *Braudel Papers* essay. He provides some insightful comments about the role of institutions, quality education and renewed political leadership in the process of overcoming Brazil's dilemma. Nevertheless, it is encouraging to remember that Brazil was able to reach our current stage of development with political institutions that were no better than they are now and with illiteracy prevailing among 85 per cent of the population at the beginning of the 20th century.

A dilemma, says the dictionary, is any situation demanding a choice between equally unpleasant alternatives. In the past, particularly over the last quarter of a century, Brazilian society proved capable of making such choices, in fighting hyperinflation, in consolidating an inclusive democracy, in resolutely facing the challenge of poverty and inequality. Is it too much to hope that the country will prove equally capable of making the right choices in the immediate future?

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