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Boom or Bust

Whether or Not President Dilma Rousseff Wins Re-Election this Year, Economic Reform is On the Way

By João Augusto de Castro Neves

Darling of the new global economic order for much of the last decade, Brazil has fallen off the pedestal in the past few years. Broadly speaking, this bout of pessimism is partly due to the recurrent habit among international relations pundits and market commentators of viewing the world in terms of inexorable—and even faster—power transitions among major powers (or major markets). Until yesterday the countries of the BRICS grouping—Brazil, Russia, India, China, and South Africa—were construed as the building blocks of a new global order and a good place to put your money. Now, following the ebb and flow of financial markets, BRICS appears to have lost much of its appeal, opening the way for other catchy acronyms, such as MIST (Mexico, Indonesia, South Korea, and Turkey) or MINT (Mexico, Indonesia, Nigeria, and Turkey), to have their fifteen minutes in the spotlight.

Beneath the ever-changing and tenuous layers of tea leaves used to foretell geostrategic scenarios or suggest promising investment opportunities, lies a much more complex story of a country that has had its share of boom-and-bust cycles. Whether Brazil is undergoing yet another one this time around begs a more insightful examination of recent political and economic events. Uncovering some factors behind these events may allow us to have a clearer view of the country's trajectory.

The Middle Class Trap

Brazil's rise in the last decade or so had much to do with the favorable winds of the global economy, powered mainly by a boom in commodities—Brazil is a leading exporter of beef, sugar, corn, and soy—and Chinese growth. This growth cycle led to years of sustainable expansion of Brazil's economy and a material increase in the country's standard of living. A political by-product of that growth cycle was years of strong presidential popularity, especially during President Luiz Inácio Lula da Silva's

◁ Main floor of the BM&F Bovespa stock exchange, São Paulo, Oct. 8, 2008. *Paulo Whitaker/Reuters/Corbis* years in office from 2003 to 2011 and through much of President Dilma Rousseff's term since then. The tantalizing curse of the perennial "country of the future" was broken and Brazil appeared to finally catch up with its promising destiny.

But now, as the global economy slows down, the tide appears to be shifting for Brazil, which risks putting an end to both of these promising economic and political gains. One telling incident that may serve to reinforce this assumption occurred last year. Protests that began in the city of São Paulo in June 2013 over a modest bus-fare hike unexpectedly swelled and took on new proportions to become Brazil's largest demonstrations in nearly two decades. Much like the events in Tahrir Square in Egypt and Taksim Square in Turkey, millions of people went to the streets of Brazil's major cities to voice their discontent with the country's leaders.

There are many similarities between the urban movements in the Middle East and those in Brazil, but an important contrast needs to be clarified. While what generally became known as the Arab Spring consisted mainly of movements against government oppression, recent protests in Brazil were chiefly against corruption and what is perceived as government incompetence. The former usually targets the head of state and the ruling party while the latter is more diffuse, targeting all levels of government and blaming every major political party for many years of having disregarded the quality of public services.

It is difficult to pinpoint a single trigger for these demonstrations, but a demographic shift of major repercussions has been building over Brazil's political landscape in the last several years. Nearly a decade of rapid economic expansion in Brazil—and the accompanying rise in consumption—played a role in worsening a few urban problems, such as traffic congestion and pollution, which have started to generate dissatisfaction in society as a whole toward government officials. But more importantly, years of sustainable economic growth in many emerging markets and in Brazil have also led to the rise of a new middle class, which has high political expectations and demands.

What may have prompted protests to erupt at this time is the fact that the people are finally coming to terms with the cost of hosting major international sporting events. The lead-up tournament to the World Cup, the Confederations Cup held last June, unveiled a contrast between beautiful and expensive stadiums and lacking urban infrastructure. But the backdrop to the story is that an increasing proportion of Brazil's middle class is focusing on a quality of life agenda. Newly enfranchised Brazilians don't just want cellphones—they need cellphones that work well. They don't just want cars—they want cars that can ride on streets free of traffic jams and potholes. In other words, governing becomes less a matter of facilitating access to goods and more an issue of improving the services that make those goods more useful. It is not only about cash transfer programs and creating jobs, but also about providing better education, healthcare, and public transportation.

The protest movement has much more to do with a more comprehensive expression of discontent with the quality of public services and corruption that has slowly been building up from the recently enfranchised middle and upper urban middle classes than with the country's current sluggish economic cycle. From a public opinion perspective, the protest movement looks to have been a catalyst to make latent discontent over these issues much more salient.

Presidential Popularity

From a political perspective, this revolution will translate into governance challenges for the years to come. Leaders who were broadly bolstered by a decade of unprecedented economic growth face new demands from a rapidly changing society, and have fewer resources with which to respond given the slowdown in global and domestic economic activity. In other words, looking forward, Brazil's new leaders will have to keep delivering more to this new middle class, but with less.

This new political moment is already manifesting itself in terms of loss of popular support for President Rousseff and her administration—her approval ratings fell from the high 70s before June to somewhere in the low 40s after the protests, on a binary approve-disapprove scale. Pundits were quick to look at the dramatic drop in President Rousseff's approval ratings and surmise that she was in real political trouble, with her prospects for re-election in this year's October ballot looking increasingly dim. Nevertheless, while Brazil is headed to a more competitive electoral cycle this year, President Rousseff is still the frontrunner and likely to clinch a second term.

The reason stems from the fact that most people underappreciate how tremendously high Rousseff's starting point was in the polls, and that from 2006 through 2013 Brazil has gone through a political "super-cycle" characterized by absurdly high presidential approval ratings. It is important to have some historical perspective. From 1994 through 2006, which encompassed President Fernando Henrique Cardoso's two terms (1995–2003) in office and Lula's first term in office (2003–2007), "strong" governments usually had approval ratings that fluctuated anywhere from 30 percent to 40 percent. Still, both presidents won re-election.

But from 2006 onward, Lula's—and then Rousseff's—approval ratings skyrocketed to 70 percent or 80 percent. The reason is well known—a phenomenal economic growth cycle and expansion of the size of the middle class, which lead to a material increase in the standards of living of a large swathe of the population. Growth slowed during Rousseff's term—which started in 2011—but unemployment and wage growth remained robust. As a result President Rousseff's numbers, although relatively lower, remained considerably high—above 60 percent—throughout much of her presidency until the June protests, when they dropped close to 40 percent. Since then her numbers have been rebounding slowly.

The big picture that emerges is that the political super-cycle that has characterized Brazilian politics since 2006 is over. Not only is Brazil's economy going to continue to struggle with relatively low growth (not far from 2 percent GDP expansion in 2013 and 2014) and higher inflation (close to 6 percent in 2013 and 2014), but middle class demands and discontent will catch up to politicians. President Rousseff will probably not rebound to her prior levels of popular support before the election, and it looks like Brazil is returning to a more "normal" and competitive era of politics.

Demise of the Rest?

These economic, social, and political transformations of recent years spur broader questions on Brazil's status and future role in global affairs. The problem has less to do with the idea of power transition itself, but with the excessive expectations that followed the global financial meltdown of 2008–09. While the U.S. and other developed economies were in a downward spiral, emerging countries such as the BRICS kept growing and shouldering the weight of the global economy with them. To many, this process was a harbinger of a tectonic shift in geopolitics, or the "rise of the rest".

Brazil was never at the center of this process, at least from a geopolitical perspective, but several years of sustained economic growth gave more international visibility to the B in BRICS. Despite persistent social inequalities, the overall domestic situation (political, economic, and social) in the country has improved considerably, and Brazil, like other large emerging powers, became more assertive regionally and globally. As such, the country started to redefine its own national interests in ever-expanding terms. Brazilian multinationals conquered markets, more and more immigrants began flocking to Brazil for a better life, and decision-makers started to assertively flex their muscles on the global stage.

But three years of disappointing economic growth and questionable policymaking have sharply deteriorated expectations, not only towards Brazil but also with respect to other key emerging countries. As a result, broken BRICS or the "demise of the rest" have become the newest fads in pundit-land jargon to the point of being replaced by other opportunistic acronyms.

One of the many problems with these premature assessments is that they tend to view international relations fundamentally as a kind of a zero-sum game. If one country or market is down, the other has to be up. Not a lot of attention is given to the fact that some (but certainly not all) economic challenges that emerging markets endured in the past two years were influenced by ongoing difficulties in developed economies. Furthermore, part of the frustration has to do with misperception or excessive expectations. The BRICS never represented a new and emerging world order. What glued these countries together were not shared viewpoints of what the world should look like, but a slight overlapping of individual strategies aimed at better enhancing each country's international standing.

The economic situation in Brazil today is unarguably less favorable than before and is likely to remain so for coming years—at least when compared to the first decade of the 2000s. And for a country with limited military resources situated in a relatively nonstrategic region (from a U.S. perspective), global power projection is predominantly a function of long term economic activity. As such, Japan of the 1980s and even Brazil of the early 1970s serve as cautionary tales of countries that unsuccessfully seek a path to great power.

But while it is always prudent to talk about rising powers with a grain of salt, there are reasons to believe that the current pessimism toward Brazil is overstated. Despite all the problems, Brazil continues to be a vibrant democracy. The country also has a very promising future when it comes to energy resources, both fossil fuel and renewable. Furthermore, while growth is lackluster for now, unemployment remains at very low levels and the majority of the population is better off than they were a decade ago. Finally, the growth of the middle class is a sign that demographics have structurally shifted, with many—and many yet unfelt—repercussions to Brazil's political and public policy landscape.

Investing in the Future

As President Rousseff entered her fourth year in office, politicians in Brasília and across the country began focusing on the presidential elections in October. The candidates will be campaigning in a very different context than that of 2010, a year in which the economy grew 7.5 percent and the majority of Brazilians were optimistic about the future. Although the large demonstrations have diminished, the issues raised by protesters, including demands for higher-quality public services, will feature prominently in party platforms.

Moreover, the climate of plenty that prevailed during much of the last decade generated complacency about structural reforms while discouraging debate about the appropriate role for the state in the economy and where public resources would be best invested. The return of economic constraints, however, and the tradeoffs posed by limited resources—both in terms of money and political capital—promise to change that calculus in this year's campaign. Much of the electoral debate will revolve around Brazil's diminishing international credibility and the risk of the country retroceding to a not-so-distant past of discredit and instability.

The foundation of Brazil's macroeconomic stability—and ensuing international credibility—was put in place in the mid-to-late 1990s under former President Cardoso. Since then, the economy's stability has been based on three policies: an operationally autonomous central bank pursuing an inflation target, a floating exchange rate, and primary fiscal surpluses that are used to pay down public debt. These policies were maintained during Lula's two terms, despite his having criticized them while in opposition to the Cardoso administration. Lula's decision to maintain Cardoso's policies reflects the maturation of the Brazilian left, which has come to understand that maintaining macroeconomic stability is a prerequisite for political success.

But the commodity and consumption booms of the years between 2004 and 2010—the economic super-cycle—had its effect on policymakers and their incentives. The "Era of Plenty" not only pushed Brazil's structural reform agenda down the government's ladder of priorities but also generated incentives for a more complacent macroeconomic management and greater state intervention in the economy. Public banks swelled in size, generous credit lines boosted consumption, and many sectors of the economy saw competition diminish as a result of protectionism and an industrial policy that favored domestic players over foreign ones. Rousseff's critics in the opposition and elsewhere argue that these policy options—her tolerance for higher inflation and the deterioration of the government's fiscal accounts—represent the abandonment of the Cardoso/Lula legacy.

While there are elements of truth in this, the broader political and economic context suggests that it would be wrong to project the trends of the last few years into the future. With both economic and political super-cycles coming to a close, Brazil's policies are likely to move in a more constructive—and less statist—direction, regardless of who wins the election. The overarching hypothesis when it comes to economic policymaking in Brazil, is that when economic and political restrictions become more salient, the government tends to respond in a more constructive fashion. Under different administrations over at least the last two decades, the quality of policymaking has tended to improve when Brazil is faced with a harsher economic environment. Now this logic tends to be reinforced by the growing demands of a new middle class.

This is, however, a process that tends to be incremental and vary from sector to sector rather than being an immediate or even a perfectly direct correlation. After all, while it is safe to say that Brazil is entering a less promising phase under current forecasts for global and domestic economic growth, the country's political and economic structures are nowhere near the brink of collapse. Recent popular demonstrations posed no threat to Brazil's political institutions. And the economy, while overall in a less favorable situation, has not deteriorated into a recession or a default-prone environment. The risks, therefore, are not high enough to generate enough incentives for a more meaningful response.

Yet the Rousseff government has been able to implement a few market-friendly adjustments in order to respond to a deteriorating market sentiment over the past few years. This effort, however, has been mired by poor execution and low government credibility. Signs of this slow shift can be found in the government's aggressive turn to attract the private sector to invest heavily in transportation infrastructure, with a multibillion-dollar concessions package to build and revamp roads, railways, ports, and airports. But much of the success of this incremental strategy will be predicated on Rousseff's own political standing and the pace of economic activity. If the country's economic recovery remains tepid, such slow shift toward more constructive policies will probably not be enough to stem growing pessimism toward Brazil.

In this sense, Brazil's propensity to "correct the course" will most likely intensify as these challenges escalate. Changes will be driven by necessity rather than conviction. This process, however, is more likely to gain momentum after the presidential election and during the next administration that starts in 2015. Among the expected items of a new "adjustment agenda" will be more transparency to macroeconomic management, especially when it comes to fiscal policy; scaling down the government's presence in some sectors of the economy; unwinding of trade protectionism and resuming trade negotiations with major economies; and engaging more with the private sector to boost investments. In addition to the problems aforementioned, a laundry list of other structural reforms is long overdue, such as energy reform and measures to lower and simplify the cost of doing business in Brazil.

Any outcome of the upcoming presidential election will produce significant changes in Brazil. A victory by any of the major opposition candidates would most likely accelerate this shift towards more constructive policies. If Rousseff wins reelection, this shift is still expected, but at a slower pace. Until then, and despite the visibility that will come from hosting the World Cup, Brazil is likely to remain relatively lackluster on the global stage, both from a market and geopolitical perspective. But if this shift is confirmed, it won't be long until the B in BRICS is attached to another catchy acronym once again.