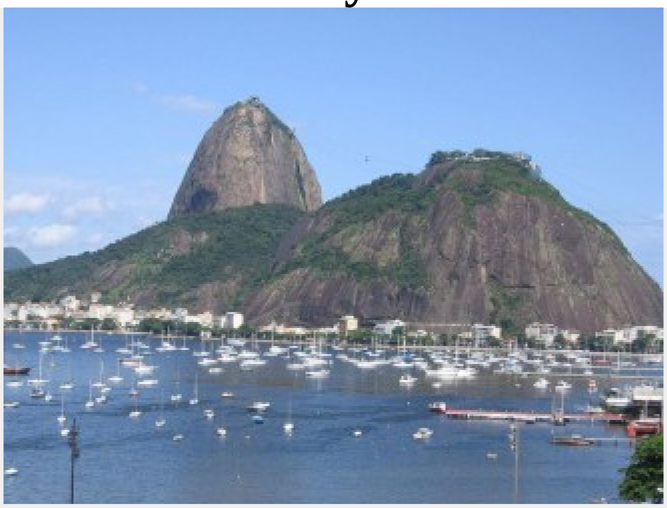
Latin Business Chronicle

Wednesday, August 20, 2014
Special Reports

Brazil: A Rocky Road Ahead?



By Jerry Haar

Is Brazil's calamitous performance in the 2014 World Cup a symbolic metaphor for its economy next year and beyond? Many will immediately dismiss the question itself as preposterous, having succumbed to the warmth, friendliness, joie de vivre, and unbridled optimism that Brazilians exude. However, investors, traders, financiers and corporations that do business in or with Brazil must be more sanguine in assessing risk, despite the fact that many of the signs emerging in Brazil's economy, and business environment are indeed troubling.

A number of economists and analysts who follow Brazil have reduced their 2014 growth estimate for the 10th consecutive week, from 1.63 percent at the end of May to 0.90 percent. In fact, some economists believe Brazil's $2.25 trillion economy will expand by only 0.70 percent this year, less than any time since the recession of 2009. With benchmark borrowing costs already the highest among rate-setting nations in the Group of 20, rising consumer prices, and shrinking household spending and investments the road ahead for Brazil looks pretty rocky. Just look at the bellweather consumer confidence numbers. In São Paulo, Brazil's biggest city and the nation's business capital, consumer confidence dropped in June to its lowest level in nearly 11 years. Inflation, stagnant wages, and higher interest rates have eroded Brazilians' purchasing power.

On the labor front, even the tight job market is beginning to totter, with job creation at the end of May registering the worst in 22 years as 30,000 industry workers lost jobs.Late last month General Motors announced that is wants to put nearly 20% of its workers at major factory in Brazil on paid leave. Volkswagen and PSA Peugeot Citroen have already done the same. Car, truck, and bus production in Brazil is expected to drop 10 percent in 2014, its largest decline in 16 years. Weak demand and falling exports to Argentina are slamming sales and profit margins.

Perhaps most troubling of all is the precarious situation in which the middle class finds itself. Thanks to the policies of former presidents Fernando Henrique Cardoso and Lula da Silva, Brazil now has a large middle class; and this socieconomic group has truly reaped the benefits of their status. New York, Los Angeles, Orlando, and Miami have certainly benefited from Brazilian tourism. Miami especially has seen middle class and upper middle class Brazilians fuel the rebound in the real estate market (mainly condo purchases) and boosted retail sales, as well. However, large swathes of the Brazilian middle class have taken on more debt than they can possibly pay back, or even service. Even new shoppers rapidly succumb to credit card fatigue and defaults are not surprising, given credit card interest rates that can exceed 80 percent annually. It is not surprising, therefore, that banks have become far more stringent in their lending policies after contributing to a doubling of consumer loans to around $600 billion in the last five years.

While consumer lending rose at an annual rate of 25 percent in the four years after the global financial crisis of 2008, this spending created merely the illusion of economic growth coupled with China's huge demand for soybeans, iron ore and other commodities. Whereas U.S. build-up of consumer debt went largely for housing, which can appreciate in value, Brazilians piled on debt for appliances, autos, and other consumer goods.

However, the fatal flaw in Brazil's economic development model is twofold: (1) the failure to modernize infrastructure; and (2) the abysmal "custo Brasil"-the burdensome regulatory, tax, and legal environments that make it costly and difficult for business to operate (especially small business) and which erodes the country's competitiveness. In the first instance, the World Economic Forum ranks Brazil 114th out of 148 countries in infrastructure, with that nation spending 1.5 percent of GDP on infrastructure-40 percent of the worldwide average. Poor roads, rails, waterways, and bottlenecks at Brazilian ports raise the costs of both exports and imports. In the second instance, the World Bank's Doing Business ranks Brazil 116th out of 189 countries for the "ease of doing business," far behind those economic powerhouses and bastions of democratic capitalism Albania and Mongolia.

Brazil has innumerable assets, including abundant agricultural and natural resources, skilled labor, research and development facilities, a huge internal market, multinational subsidiaries operating there, and globally competitive multinationals of its own. Nonetheless, its public is disenchanted with Dilma (who may or may not win the next election), angry over cronyism, corruption, poor public services and continuing inequality, and doubtful that the two outrageously expensive beauty contests hosted by Brazil- the World Cup and the 2016 Olympics-will do anything more for the country than mire it in greater debt.

Whoever is elected president of Brazil in October will face the arduous task of rebooting the Brazilian economy and addressing the myriad structural problems mentioned above. With investors shifting their attention to other emerging markets, time is of the essence.

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