October 1st, 2012

How the BRICs Stack Up
Brazil: Country of the Future?

In 2001, Goldman Sachs economist Jim O'Neil dubbed the emerging markets of Brazil, Russian, India, and China as the BRIC's. He surmised that these countries, which comprise nearly 42% of the world's population, would be significant drivers of future global growth. (Figure 1)

He grouped these countries together because they have attractive demographics, commodity wealth, a growing middle class, and improving fiscal and monetary policies. However, these markets also have risks that influence the attractiveness of investment opportunities. One must be wary of widespread corruption, faulty information dissemination, damaging fiscal policies, and ongoing disruptive political struggles.

Although the BRIC's share some characteristics, the investment climate for each country is unique. Below, we will explore a few of the opportunities and risks in Brazil as it tries to avoid fulfilling the Brazilian proverb that states, "Brazil is the country of the future and always will be." (Figure 2)

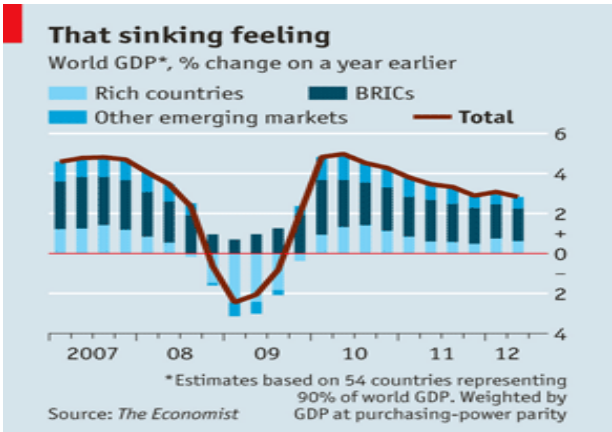

Figure 1 BRIC contribution to World GDP

Brazil has come a long way. The end of military rule and the beginning of democracy (1985) as well as the taming of 2,950% inflation (1990) has resulted in over a decade of relative stability for Brazil. Stability, however, does not mean growth. Between 1995 and 2009, Brazil's real growth averaged only 2.9%. As recently as 2011, their growth was only 2.7%. The success of individual high profile industries has created the image of Brazil as a vibrant country, largely because they are the largest exporter or producer of ethanol, electric power, iron ore, beef, sugar, coffee, and regional jets. The numerous commodities they produce have enabled them to grow on the backs of other nations, particularly other emerging economies, such as China, their largest trading partner.

Figure 2 Brazil's Competitiveness Ranking

INDUSTRY AND GOVERNMENT CONTROL. The future of Brazil's industries lies squarely in the hands of the government, who tightly controls many aspects of the business. The government is a majority partner in the following companies: Petrobras (oil), Eletrobras (electricity), Telebras (telecommunications), Vale (iron ore), Banco do Brasil, as well as many other companies. As might be expected in such circumstances, a protectionist attitude pervades the business climate of Brazil. According to the World Bank's 2010 "Ease of Doing Business" survey, Brazil ranked 129 out of 183 countries (Figure 2).

INFRASTRUCTURE SPENDING AND TRANSPORT. During the export boom of the last decade, Brazil has under invested in infrastructure. The result is crowded ports, a largely unpaved and totally inadequate road network, and antiquated railways. These inefficiencies cause producers to lose their comparative advantage because transport from the interior of the country to the coast is so arduous. Cargo transport is 40% more expensive in Brazil than in the U.S. The government's underinvestment in infrastructure at 1.1% of GDP seriously restricts Brazil's ability to grow.

MIDDLE CLASS ASCENDANCE. As unemployment has dropped and real income has risen, the middle class has started flexing their muscles, creating a need for credit. They have begun to buy cars and homes, and domestic consumption has risen to around 60 percent of GDP. Since hyper-inflation has been tamed, consumer credit has been able to grow. Recently, 30-year mortgages have been introduced causing mortgage lending to quadruple since 2005. Not surprisingly, in the last five years, property prices in big cities have doubled. (Figure 3)

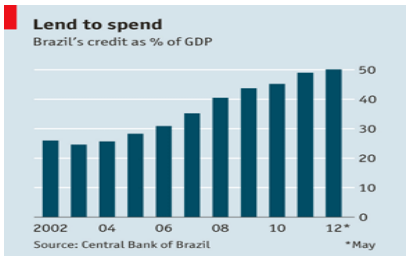

Figure 3 Brazil's Credit Growth

Millions of Brazilians are now living above the world poverty line (some estimate more than 50% of population), but some of this improvement has been created by government transfer programs. It seems political stability has been purchased with government transfer programs. Will this be sustainable?

ENERGY COSTS. Energy costs (electricity) are the 4th highest in the world because of 28 different consumer energy taxes with the result that taxes comprise half the cost of electricity. President Rousseff is lobbying to cut 2 of these taxes, which would decrease private consumer energy bills by 10 to 20% and commercial bills by 20-30%. This tax reduction would be very good for the economy.

TAXATION AND SOCIAL PROGRAMS. Employers pay social benefit taxes on payroll in the amount of 60-70% of salary, which discourages hiring. 32% of the payroll tax is spent on Brazil's national pension system, which is badly in need of repair. It is known as the most generous retirement system in the world. Currently, the demographics are 10 workers (ages 15-64) for every 1 retiree (over 65) and, as such, the pension system should be running a surplus but is not! (Figure 4)

Although Brazil is known throughout the world for their commodity and natural resource bounty, the policies adopted by the government will greatly affect the country's growth. The following things must happen for growth to resume and Brazil's economy to begin to thrive again.

Less governmental interference in businesses, more privatization.
Attract foreign investors.
Simplify and lower taxes
Continue to fight inflation.
Redraw the pension plan so that it does not run out of money.
Fix the infrastructure to reduce the cost of transporting goods.
Continue to focus on bringing more people up to the middle class.
Reduce dependence on commodity pricing.

As Brazil strives to be a dominant economic power on the world stage, progress on any or all of these fronts will serve to propel them to the next level of success.

- *Rachel Wakefield, CFA*