CURRENT HISTORY

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*"All chief executives want their presidencies defined by their own initiatives and policies, not by a predecessor's legacy."*

# Toodle-oo, Lula: Brazil Looks Forward with Dilma

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Speculation abounds, both in Brazil and abroad, about the directions that Brazil will take under President Dilma Rousseff. Such curiosity is natural considering that the country was governed for eight years (2003–2010) by the charismatic, if at times enigmatic, figure of President Luiz Inácio Lula da Silva. Lula oversaw Brazil's emergence as one of the BRICs (an acronym coined by Goldman Sachs in 2001 to refer to new players in the global economy—Brazil, Russia, India, and China). In politics, good luck is often as important as good policies, and Lula benefited from both.

His government continued important initiatives begun under President Fernando Henrique Cardoso (1995–2002). These included inflation targeting, fiscal discipline, and debt reduction. Lula also presided over a major reduction in poverty through a now famous conditional cash-transfer program, *Bolsa Família*. But Lula was lucky that world trade trends favored exporters of commodities and raw materials, categories in which Brazil is world class. China, a major buyer of what Brazil grows and mines, has replaced the United States as Brazil's major trade partner.

Other trends that marked Lula's eight years in the Planalto Palace were revealed with the financial crisis that began in 2008. As Lula has often observed, Brazil was the last major economy to be affected by the global economic crisis and the first to emerge from it—partly due to smart decisions at the central bank and the finance ministry.

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Meanwhile, Brazil has emerged as a major player in the Group of 20, a body that is replacing the Group of 7 as the forum most responsible for determining international financial policy. Lula was critical of US and European Union mismanagement of financial policy in the years preceding 2008 and commented publicly that the crisis was created by men with blond hair and blue eyes—none too subtle a way of emphasizing that this crisis, unlike some previous ones, had not erupted in the developing world.

Under Lula's government, Brazil became an important interlocutor in multilateral forums ranging from the Doha round of global trade liberalization talks to meetings regarding the environment and climate change. Today, Brazil takes a seat at any important multilateral table.

As Lula's second term in office drew to a close, the president to his credit refused to consider amending the Brazilian constitution to allow for a third consecutive term—a course taken by some of Lula's counterparts in the region in recent years. His impending departure, however, raised the "legacy" issue. Who would be the best person to preserve and extend Lula's record?

The answer was not obvious, as the traditional leadership of Lula's Workers' Party (PT) had at the end of his first term in office been decimated by a series of scandals. This protected Lula from some in the party who wanted him to move to the left and abandon his free market policies, but it created a void at the center of the political system. Slowly, the name of Dilma Rousseff emerged as a possible—if not yet probable—choice.

## COMPETENT, UNCHARISMATIC

Rousseff (known as Dilma in Brazil, where leaders are usually referred to by their first names) began her career in the southern state of Rio Grande do Sul, where she twice served as state secretary of energy. A latecomer to the PT, who joined the party only in 2000, she nonetheless served as minister of mines and energy under Lula. In 2005 she moved to the Planalto to become chief of staff when the incumbent in that position was forced to resign due to scandal; she was widely seen during Lula's second term as "running" the presidential palace.

Rousseff's reputation was that of a competent and tough administrator, but she was not considered a colorful or charismatic leader. In 2009 she experienced a brief bout with cancer. But in the absence of any stronger contenders in the PT, Lula anointed her as his choice to succeed him. The question was whether Lula's charisma and popularity would prove sufficiently transferable to Rousseff to allow her to win the presidential elections in the first round of voting.

The Social Democratic Party (PSDB), the leading opposition to the PT, nominated as its candidate Governor José Serra of São Paulo state. Serra, who belonged to a party mafia that had run the PSDB for decades, had sought the presidency once before, losing to Lula. A brilliant individual but a lackluster campaigner, he was never able in the 2010 race to distinguish himself from Rousseff and the PT. Although he deprived Rousseff of an outright victory in the first round of voting, she won in the second round with relative ease, gaining 56 percent of the valid vote. Her victory owed much to Lula's very strong public support.

The transition was fairly uneventful. Rousseff decided to keep many of Lula's major policy makers in their existing positions, or shift them to new ones. Finance Minister Guido Mantega remained in office. Alexandre Tombini, a senior official at Brazil's central bank, became the bank's president. Antonio Palocci, Lula's first finance minister, who had resigned as a result of a scandal, returned to government as chief of staff. Nelson Jobim, the defense minister and a key interlocutor with the armed forces and the United States, retained his post.

Rousseff deftly handled the demands of the Brazilian Democratic Movement Party (PMDB), the party of her vice presidential candidate, Michel Temer. Party coalition politics is important in Brazil, and the PMDB was granted influential cabinet positions. The election results for Congress favor the new chief executive with a "theoretical" majority supporting her; but, as always, legislation will require vote-by-vote negotiations to assure the support of the eclectic 10-party coalition that backed Rousseff during the campaign.

Rousseff took office on January 1, 2011, with a number of forces in her favor. Global commodity prices are predicted to remain high, driven by demand in Asia. Domestic unemployment continues to decline. Approximately 30 to 35 million people have over the past five to six years entered class "C" (the Brazilian middle class). This has resulted in consumer-driven economic growth.

Credit availability is increasing at a fast pace, allowing for new job creation as businesses feel confident enough to hire. Inflation, while higher than desired, can be dealt with by the autonomous central bank, with interest rate increases likely in the first quarter of 2011. And Brazil's foreign currency reserves are at a historic high—$287 billion. All of these positive trends are the result of good management and leadership over the past 15 years. Nonetheless, every new government needs to go to the drawing board.

## FIGHTING THE CURRENCY WAR

What are the major policy challenges that will confront Rousseff during her four-year term in the Planalto Palace? It is important to remember that she assumes power in a world that is moving, albeit slowly, beyond the 2008–2009 financial meltdown. Rousseff will need to assure capital markets that continuity in fiscal and monetary policy is guaranteed. Mantega's retention as finance minister and Tombini's appointment at the central bank should help accomplish this aim.

Speaking after the election, the finance minister signaled his intention to adjust fiscal policies (that is, cut spending) and also downplayed the idea of increasing the minimum wage. He also noted that public servants have received a series of wage adjustments over the past few years. On the monetary front, Tombini emphasized that he would enjoy full autonomy, as his predecessor Henrique Meirelles did for eight years under Lula, and that the bank would maintain its highly successful policy of inflation targeting.

Mantega, toward the end of 2010, stated that the global economy is in the midst of an "international currency war," as governments around the world compete to lower their exchange rates in order to boost competitiveness. Mantega's comment reflected what many finance officials are saying in private: A rising number of countries see a weaker currency as a means to lift their economies. A weaker currency makes a country's exports cheaper, potentially providing a source of growth for economies struggling to emerge from the global downturn. Brazil's concern in this environment is that its competitiveness will suffer.

The government since late 2009 has been implementing stringent capital controls to limit the appreciation of the *real*. This policy will continue under Rousseff, with measures applied incrementally. The government's track record on such issues has been very transparent. In October 2009, authorities enacted a 2 percent financial transaction tax on foreign fixed income and equity flows, and in October 2010 they raised the tax on fixed income inflows from 2 percent to 6 percent.

The Rousseff administration will probably consider taking measures such as placing greater restrictions on foreign exchange futures markets and eliminating a 15 percent income tax exemption granted to foreign investors in Brazil's government bonds. (However, in order to guarantee an adequate amount of foreign currency to fund the current account deficit, the government will probably behave more cautiously regarding restrictions on equity portfolio inflows and foreign direct investment.)

*The 2014 World Cup and the 2016 Summer Olympics will require a major upgrade of the country's physical infrastructure.*

The central bank and finance ministry might use other tools as well if the exchange rate approaches 1.60 to the US dollar. Rousseff's economic team appears convinced that greater restrictions on inflows are the only way to inhibit further appreciation of the *real*.

The *real*'s appreciation is related to a larger world trend: steadily increasing amounts of capital flowing into emerging markets in search of yield. This in turn is connected to a policy debate that involves the US economy's slow recovery from recession and a November 2010 decision by the US Federal Reserve to buy $600 billion in long-term US debt to support growth. That action was highly controversial, with many governments arguing that it will exacerbate the exchange rate problem.

Regardless, the weakness of the US economy and an ongoing crisis in the euro zone have made advanced emerging markets attractive to investors. This is especially true of countries, like Brazil, where interest rates are very high. This year will witness further debate as to what additional policies the Brazilian government should implement to protect the currency.

We may have seen a preview of further policy options when, at the end of 2010, the finance ministry unveiled a series of measures designed to attract foreign money to Brazil's corporate bond market. In part, these moves were designed to reduce the role of state banks, which have dominated lending in Brazil. Under the new measures, foreigners will no longer pay income tax on corporate bonds with maturities longer than four years; this will put corporate debt on the same tax footing as government debt.

Also, certain types of private equity financing will be taxed at a reduced tax of 2 percent, instead of the current 6 percent. This is an incentive meant to boost financing for infrastructure projects. These steps have not been fully elaborated but may offer a view of imaginative financing decisions that the Rousseff government will implement both to attract financing and to dampen speculative capital inflows.

## ACHILLES' HEEL

A key concern for the government will be Brazil's growing current account deficit, which according to the International Monetary Fund neared 2.6 percent of gross domestic product in 2010 and is likely to reach 3.3 percent by 2015. This, as stated in *The Financial Times* in late 2010, is Brazil's Achilles' heel.

The driving force behind the deficit's growth is insatiable demand for consumer goods by Brazil's new middle class, whose purchasing power is magnified by the strong *real*. The country's imports last September, for example, increased 43 percent year on year, the biggest jump among the world's largest economies.

Foreign capital is needed to finance the current account deficit, but the markets will watch carefully to see what the Rousseff administration does to balance the need for foreign inflows with measures taken to reduce the current account deficit in 2011. A major structural problem is that Brazil does not produce enough high-value products to satisfy consumer needs. A tangle of taxation, bureaucracy, and bad infrastructure inhibits innovation and productivity and is known as *custo brasil*—the Brazil cost, or the cost of doing business in the country.

Mantega will be influential in determining what is done, but Luciano Coutinho, who has been reappointed as president of the Brazilian Development Bank, will also be important. Coutinho is concerned that an overvalued currency poses a significant obstacle to reaching Brazil's industrial policy goals. The first quarter of 2011 will see intense discussions within the government about the need to reduce spending, lower interest rates, protect the currency, and control inflation. All of these issues will need to be considered in a global context. At least the government will benefit from a reasonable rate of GDP growth—probably in the range of 4 to 5 percent for 2011, after a growth rate in 2010 of between 7 and 8 percent.

All this amounts to a challenging environment for the Rousseff government. Markets will look for a sign that the Rousseff administration intends to address a number of pending policy issues after the exchange rate issue has stabilized. The first such challenge will be to reorganize Brazil's highly inefficient tax system; second is to continue restructuring social security; third is to make corporatist labor laws more flexible; fourth is to reduce the public debt burden in the context of a relatively high tax burden; and the last is to address a physical infrastructure deficit.

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These are all contentious policy issues that will require a high degree of consensus within the government and strong support in the Congress. Lula made some progress in his first term on social security reform but did not demonstrate that the other items were of high priority. While it is not imperative to address these issues immediately, they are important medium-term goals for Brazil's productivity and competitiveness.

## UNDER THE SEA

A different sort of policy challenge will be the implementation of new legislation to regulate a vast oil discovery off Brazil's southeast coast. This discovery was one of the "lucky" developments under the Lula government. If all goes according to plan, Brazil will become a major oil exporter in the next three to five years; it is basically self-sufficient already. Through a process that was to a large degree managed by Rousseff when she was chief of staff, the government proposed to Congress four items of legislation to regulate pre-salt oil (so-called because the oil lies beneath a layer of salt that must be broken through).

Congress in 2010 approved two of these proposals. The first created a new, state-owned enterprise called Petrosal, which is responsible for managing all contracts related to the expanded oil industry. The second gave Petrobras, Brazil's semipublic oil company, the concession to explore the new discoveries. The third proposal, not approved yet, would create a social fund that would receive revenues from the pre-salt oil and invest them in a set of social programs yet to be determined. The fourth proposal would determine the distribution of the royalties.

The social fund should be approved in early 2011. The royalties issue, on the other hand, is highly political and controversial. Before the pre-salt era, a large share of royalties produced by offshore oil went to the states in the southeast where the oil was discovered. As the dimensions of the oil find grew over the past few years, calls arose in Congress for a more equitable distribution of revenues across the federation. It is expected that some states will complain of revenue losses and look for compensation. How Rousseff deals with this thorny issue will be a good indication of her ability to manage the government coalition in Congress.

Distributing oil revenues, and handling other legislative matters, will in theory be easier because an estimated 74 percent of the Senate and 70 percent of the Chamber of Deputies support the government. The PT and the PMDB in the October 2010 elections increased their representation and will be the dominant players in the policy making process. But the smaller parties that endorsed Rousseff will expect—and receive—recognition of their support through legislation favoring municipal and state projects.

The pre-salt oil discovery has attracted considerable interest, but Brazil's energy mix is in fact multifaceted. The country is the world's second-largest producer of ethanol fuel, and the largest exporter. (Brazil and the United States in 2009 together accounted for 89 percent of ethanol fuel production worldwide.) The nation's 30-year-old ethanol fuel program is based on highly efficient agricultural technology for sugarcane cultivation.

And today, no light vehicle in Brazil runs on pure gasoline. It has been mandatory since 1976 that gasoline be blended with ethanol, and the Brazilian car industry has developed flexible-fuel vehicles that can run on gasoline or ethanol mixed in any proportion. In 2010, production of flex-fuel cars and light commercial vehicles reached 10 million vehicles.

The success of Brazil's ethanol program is attributable to the country's advanced agro-industrial technologies and its enormous amounts of land available for cultivation. A key component in the development of the ethanol industry was investment in agricultural research and development by both the public and private sectors. The work of EMBRAPA, a state-owned company in charge of applied agricultural research—together with research developed by state institutes and universities, especially in the state of São Paulo—has allowed Brazil to become a major innovator in biotechnology and agronomic procedures.

It is often noted that Brazil's sugarcane-based ethanol industry is more efficient that the US corn-based industry. Sugarcane ethanol production has an energy balance seven times greater than that of ethanol produced from corn. Yet Brazilian ethanol exports to the United States are limited by a US tariff to protect domestic producers, a highly controversial policy issue.

Brazil's flourishing ethanol industry reflects the sort of public-private cooperation that the Rousseff administration will probably expand. Indeed, it is well known that Rousseff and her advisers favor more public sector involvement in the economy. The "smart state" concept is one that appeals to the new president. Given her energy background, that sector of the economy will probably receive high priority, particularly in light of the increasing need for energy to support the expansion of the domestic economy and the rise of a consumer society.

## Along the river

A third, and more controversial, source of energy in Brazil is hydropower. The country is the third-largest hydroelectricity producer in the world, after China and Canada—hydropower accounts for more than 80 percent of Brazilian electricity production. With the need for power sources increasing, the government has decided to build a series of complex hydroelectric dams in the north of the country.

In 2010, authorities approved construction of the Belo Monte dam in the state of Para on the Xingu River, though construction has been delayed until the energy consortium that won the bid can demonstrate that the dam will not have negative socio-environmental consequences. The dam would be the second-largest in the world, behind the Three Gorges Dam in China. It is presumed that the electricity produced would provide power for the extraction and refining of large mineral deposits in Para, such as bauxite, used for producing aluminum.

The Belo Monte project has sparked a passionate debate about the dam's impact on indigenous peoples and the environmental implications for the Xingu River, which contains rich and diverse fish fauna. Environmental groups protest that the dam will flood approximately 150 square miles of the Amazon forest. There will be a loss of vegetation as well as changes in the quality of the region's water supply. Equally serious, the dam will produce high levels of carbon dioxide and methane during its construction and subsequent operation.

The energy challenge facing Rousseff is clear. Pre-salt, if developed responsibly, will catapult the country into the big leagues of global oil production and influence. Ethanol is a highly efficient product that will need to be further developed as demand increases, but with appropriate attention paid to the integrity of the agricultural frontier. Hydroelectric power is a crucial component of the national energy grid; further dams, modeled on Belo Monte, are under consideration. The Rousseff government will encounter increasing pressure from indigenous and environmental groups to reduce the planned construction program. However, with consumer and business demand growing each year, the choices are not easy ones, and the government will need to employ a highly diplomatic approach in evaluating and resolving competing concerns.

The energy debate will be an important part of the country's planning for two highly anticipated events, the 2014 World Cup soccer finals and the 2016 Summer Olympics. Both will require a major upgrade of the country's physical infrastructure—airports, roads, trains, hotels, and so on—all of which will require additional energy supplies. The Rousseff government will be under public pressure to get 2014 and 2016 "right" in order to enhance Brazil's international prestige. How the government deals with escalating energy demands associated with the World Cup and the Olympics, and with the continued expansion of a robust consumer society, will be watched closely both at home and abroad.

## THE GLOBAL PLAYER

As Brazil has consolidated its democracy and stabilized its domestic economy, it has also arrived on the world stage. The country's emergence as a global player—if not yet a power—began under President Cardoso and was expanded under Lula.

The question now is whether President Rousseff will have the time and interest to pursue a high international profile as the Lula government did. Of course, the president will appear at all the appropriate international meetings: the G-20, the United Nations, Ibero-American summits, and so forth. But she will have to decide whether the country's demanding domestic agenda allows her to invest as much time as Lula did in regional diplomacy and global affairs.

Lula strongly supported Brazil's involvement in both. He was a recognized leader in promoting South American integration through institutions such as the Union of South American Nations, the South American Defense Council, the Latin American and Caribbean Summit for Integration and Development, the Rio Group, Mercosur, and other initiatives.

At the international level, Lula was an enthusiastic participant in the BRIC policy process. A grouping known as the IBSA Dialogue Forum, made up of India, Brazil, and South Africa, has proved a significant mechanism of South-South diplomacy. (Lula played host in Brasilia to summit meetings of both the BRIC countries and IBSA in April 2010.) The Lula administration actively sought a seat on the UN Security Council—an effort that has failed to this point.

While relations with the United States were correct under Lula, they were not as warm as under the Cardoso administration. Indeed, a number of Lula's foreign policy positions or initiatives—his refusal to support the US stance during a 2009 coup d'état in Honduras; his 2010 trip to Iran (conducted with the prime minister of Turkey), which was intended to persuade Tehran to accept UN demands regarding its nuclear program; a vote in the Security Council against a US initiative to impose stricter sanctions on Iran; and others—saw Washington and Brasilia on opposite sides of an argument.

Rousseff, in an interview that appeared in *The Washington Post* in December 2010, stated that the relationship with the United States was very important to Brazil. She said that she would try to build closer ties with Washington, that she had great admiration for President Barack Obama, and that she thought the two countries could play a role together in the world. Brasilia's position with regard to the United States will be watched with interest by Brazil's business community, regional partners, and international players. A shift away from the Lula policies that irritated the United States would be duly noted. However, it is expected that tension between the somewhat ideological foreign policy leanings of the PT and the more traditional views of the foreign ministry will remain a constant during the Rousseff presidency.

A final consideration for the Rousseff administration will be the role of Lula. An extremely popular and charismatic presence in Brazilian national life for eight years, he will need to identify a postpresidential role in which he does not overshadow his successor.

As noted, Rousseff is not a charismatic leader, nor is she a party veteran. The agenda she faces is challenging—domestically, regionally, and globally. When strategic choices are made at the Planalto, the opinion of the former president will undoubtedly be taken into consideration. But all chief executives want their presidencies defined by their own initiatives and policies, not by a predecessor's legacy. The hope is that Lula understands this political reality and will gracefully exit stage left, satisfied with helping to keep the PT in power for another four years.

Some already speculate that pressure will be exerted on him to seek a third term of office in 2014, which the constitution would allow. Such speculation will continue until it becomes clear that the Lula era, no matter how successful it was, has reached a definitive conclusion and the Rousseff era has truly begun. ■