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Economic Crisis in Brazil: Its Roots, Causes and Scenarios

A brazíliai válság gyökere, okai és várható kimenetele

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Abstract: Brazil's economic growth has been steadily decelerating from 2011 onwards. After 2014, it has obviously turned into recession, with the largest South American economy showing clear signs of crisis. After identifying the main features of the economic crisis, we[1] highlight the causal macro-economic factors, such as a diminishing trade balance, a rapid increase of household consumption, a low level of investment and the deterioration of fiscal discipline, and attempt to uncover the underlying reasons for these processes. Then we focus on the micro-economic factors and analyze the low competitiveness of the Brazilian economy, as well as the structural changes deriving mainly (but not exclusively) from changes in the directions of trade policy (from the early 2000s onwards). The main conclusion of the paper is that the ongoing, complex Brazilian crisis cannot be explained only by changes in international economic trends (e.g. the falling prices of primary commodity goods); instead, Brazilian economic policy decisions have played a pivotal role as well.

Összefoglalás: *2011 óta a brazil gazdaság növekedése fokozatosan lassult, majd 2015-ben csökkenésbe fordult, ami egyértelműen jelezte, hogy gazdasági válság van kibontakozóban Dél-Amerika legnagyobb országában. A válság főbb ismérveinek bemutatása után az írás az okokat kutatva elsőként a makroszintű tényezőket elemzi: a kereskedelmi mérleg romlását, a háztartási fogyasztás felfut(tat)ását, az alacsony beruházási szintet és a költségvetési fegyelem romlását, valamint az e folyamatok hátterére keres magyarázatot. Ezt követően a mikroszintű tényezők felé fordul, amikor is a brazil gazdaság alacsony versenyképességének és a külgazdasági irányváltás gazdaságtorzító hatásainak a vizsgálata kerül a középpontba. A cikk fő következtetése szerint napjaink brazil gazdasági válsága csak részben magyarázható a külső gazdasági feltételrendszer romlásával, annak kialakulásában (belső) gazdaságpolitikai döntések is jelentős szerepet játszottak. Végezetül a válságból való lehetséges kiutak felvázolása zárja az írást.*

Introduction

In this essay we aim to analyze the still ongoing economic crisis in Brazil, the influence of which extends far beyond the borders of the largest country in South America. First off, from 2000 onwards, Brazil, as a member of the so-called "BRIC" group of emerging countries (composed of Brazil, Russia, India and China) developed a new, state-controlled model of capitalism[2] that was soon to serve as an example for other developing and emerging countries – however, this model seems

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2 See Nölke, Brink, Claar, and May, 2015.

to be losing momentum recently. Secondly, Brazil's new model of development can also be seen as a positive case of Latin America's left-wing (re)orientation, a political development also dating back to the start of the new millennium. Therefore, its collapse parallels the similar processes of other countries in the region, though the analysis of the Brazilian case can lead us to important conclusions in itself.

In this study, the slowing down and the consecutive recession of the Brazilian economy since 2011 is examined in greater depth. We aim to identify the most important factors behind this crisis, and pinpoint both its internal and external components. The Brazilian crisis is a multi-dimensional process which has an economic, political, institutional as well as a social aspect. In practice, these various dimensions are often interlinked, and seem to strengthen each other. In this article we aim to primarily assess the economic causes, but in some cases it is inevitable to refer to the political and social factors as well.

The first signs of recession and crisis in the Brazilian economy had shown themselves as early on as 2011. Most analysts considered this slowing down of economic growth to be a natural correction after the exceptionally high economic performance witnessed in 2010, but the technical recession in 2014 (the economic recession in two consecutive quarters) made it clear that there were more complex reasons in the background.

At the start of the research the following hypothesis was set up: the recent economic crisis in Brazil can only partly be explained by the recession in external economic circumstances (and the development of global capital return cycles). Instead, the consequences of a number of (internal) economic policy decisions are also at play.

This study consists of four parts. First, the main components, political, economic and social processes and tendencies of the Brazilian crisis are analyzed. Secondly, the evolution of the Brazilian economic crisis is examined; the main macroeconomic processes and trends are reviewed, including the changes of GDP and the structure of the economy, FDI and other economic data. After this, we turn to factors on the micro scale and investigate the reasons and driving factors behind the back-sliding of the Brazilian economy, while also exploring the consequences of low competitiveness. Finally, we search for possible solutions to overcome the crisis and list some potential future scenarios in this regard.

Components of the Brazilian Crisis

The Brazilian crisis is a multi-dimensional process with interconnected *political, institutional, social and economic* dimensions equally present. According to our hypothesis the time of recession in these cycles (not independently from each other) happens to overlap, and that is the reason why a complex situation not seen for decades has developed in Brazil. To understand this, the analysis of political, economic and social processes must date back to the time of the millennium or at least to the 2003 election of Luiz Inácio Lula da Silva (from now on referred to as Lula) on behalf of the Workers' Party (*Partido dos Trabalhadores,* PT) as president. The first decade of the new millennium was characterized by the rise of Brazil: relatively strong economic growth, decreasing poverty and income inequalities, as well as a more prominent position in the global economy (or at least becoming a regional power with global interests).

Apart from the favorable external factors, a number of internal economic processes contributed to the relatively stable and reasonable course of economic growth. Among external factors the fast growth of the global economy, especially in Asian countries such as China, the resulting higher demand for raw materials and agricultural products and the favorable development of their prices, the complimentary international credit terms and the low American interest rates should be mentioned. Among the internal factors we highlight macroeconomic stability (low inflation and declining external vulnerability), the growth of agricultural production (and productivity) due to exports, and – last, but not least – the considerably increasing internal consumption driven mainly by active social policies.

Due to all these factors, a new Brazilian development model of Riordan Roett[3] was discussed not only in the daily and the international press,[4] but also in academic economic journals. In the meantime, however, some experts questioned the long-term viability of the model,[5] and after the 2014 recession most analysis[6] focused on the underlying reasons for the crisis.

According to mainstream expectations, Dilma Rousseff's rise to power in 2011 should have secured the continuity in politics and economic policy since she, as the newly elected president, was the representative of the same political party, the Workers' Party. A handpicked successor of Lula, she had already served in high government offices (for instance, she was Chief of Staff to Lula between 2005 and 2010). In spite of all these promising conditions, from 2011 onwards marked changes took place in both the political arena and in economic policy and decision-making (both contributed to worsening economic results) worsened by the changing of external conditions.

The changing external and internal factors mentioned above also resulted in a fundamentally different position and room for maneuver for the Rousseff government compared to the Lula period. Contrary to the common Brazilian political rhetoric, which explains the economic crisis with changes in the external environment, we are convinced that there are more complex reasons in the background of the recent Brazilian crisis that go beyond mainstream narratives based solely on global changes. First, we see an explicit change in economic policy since the rise of the Rousseff government in 2011. Conscious decisions, changes in economic policy

3 Roett, 2011.

4 E. g. *The Economist*, 2009.

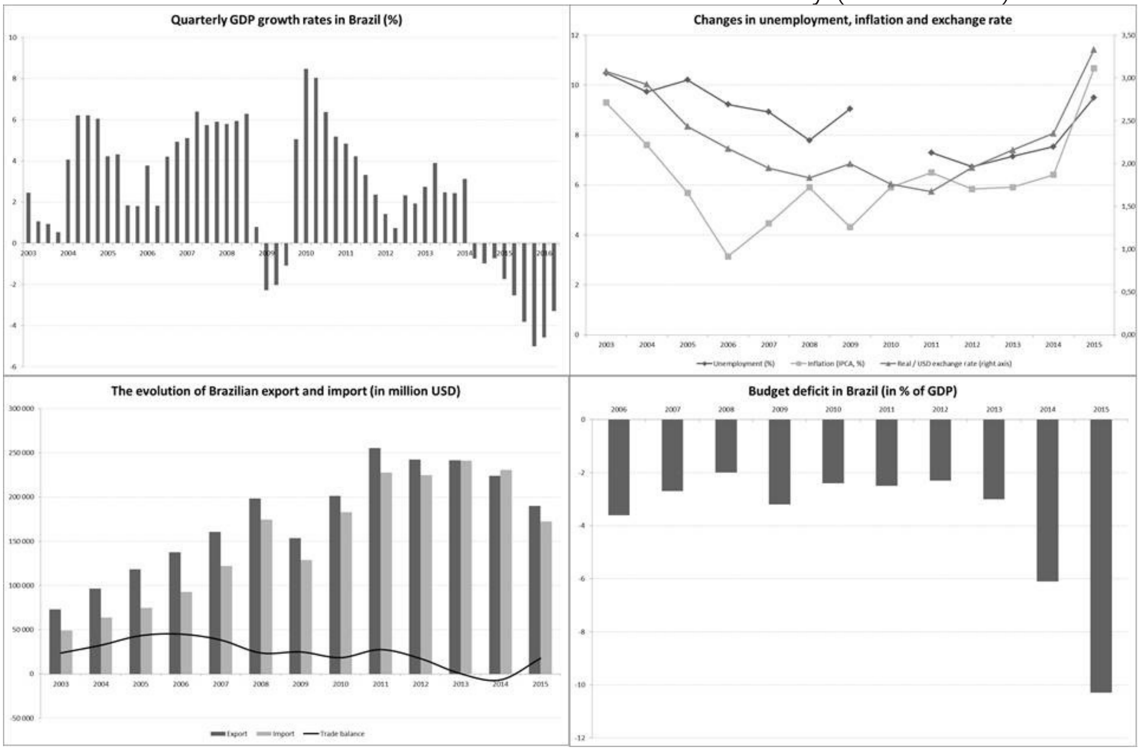
5 Izquierdo, Romero, and Talvi, 2008; Oreiro, Punzo, and Araújo, 2012; Soares, 2012.

6 Campello, 2015; Campello and Zucco, 2015; Bielschowsky, Coelho Squeff, and Vasconcelos, 2014.

priorities, cleavages in the social contract standing behind the "new" Brazilian development model and changes in the previous consensus- and cooperation-oriented governance methods characterized by a much more personal, almost authoritarian style, are all signs of a new era. On the other hand, disadvantageous economic changes coming to fore since 2011 can be dated back earlier, highlighting the weaknesses of Lula's new economic model that is often communicated as a success story. Among these weaknesses we can mention the rising dependency on the export of raw materials, the overheated increase in internal consumption (financed mainly by domestic loans and resulting in the rising indebtedness of the new lower middle classes) and the very low levels of infrastructural investment. Before providing evidence to this reasoning first we present the main symptoms and forms of the Brazilian economic crisis in terms of figures.

The recession since 2011 can be described as a deceleration-stagnation-recession story, well illustrated by Figure 1. Economic figures rose by only 1.6% between 2011 and 2014 (whereas this was 4.1% between 2003 and 2010) and fell by 3.7% in 2015,[7] with similar estimates for 2016.[8]

Figure 1
Main Economic Indicators of the Brazilian Economy (2003–2015)[9]



7 *IPEAData*, 2016.

8 *Economist Intelligence Unit*, 2016.

9 Own construction based on *IPEAData*, 2016 and *Banco Central do Brasil*, 2016.

Without being totally comprehensive we illustrate the economic crisis in Brazil with some economic figures (Figure 1). Inflation is gradually on the rise and in 2015 it reached 10%; the typically high interest rate rose even further (and hit the level of 14.25%); the balance of trade turned into a deficit in 2014; unemployment levels rose significantly, according to official statistics (registered unemployed people) to 9.5% in 2015 and above 10% in 2016 (while the real number is supposed to be higher); the balance of the budget is worsening, reaching 10.5% percent deficit in 2015; and last – but not least – gross public debt rose significantly (to 66% of the GDP in 2015 and is forecast to be over 70% in 2016). With this background it is not surprising that in the beginning of 2016 the country was downgraded to junk status by the three big international credit rating agencies.[10]

Social demonstrations, which have become commonplace since 2013, perfectly illustrate the worsening economic (and also social and political) climate. In 2013 demonstrations were triggered by the government decision to increase public transportation fees, later in 2014 they were related to the football world championship. This showed the extent to which the costs of showcase luxury projects hijacked the main discourse on the development agenda and the governmental expenditure structure in a country where heavy investment gaps characterize the social, physical, and logistical infrastructure, as well as the systems of healthcare and education. During 2015 the direct background of social dissatisfaction was the already huge corruption scandal related to Petrobras, the national oil company, while the economic recession and some other political issues (such as the impeachment procedure) also led to demonstrations.

Macroeconomic Background to the Crisis

In the first decade of the new millennium, the relatively high economic growth and the emerging new Brazilian developmental model built upon the favorable international context – primarily on the increase of the prices of raw materials and the growing demand for oil (in Asia, mainly in China). However, the market wavered after the 2008–2009 global financial crisis and – at last in 2011 – the world economy embarked upon a new direction as a result of the worsening terms of trade and the slowing down of the growth of the Chinese economy. The Brazilian economy could not offset these effects, which can be observed in the processes of the last 5 years (see Figure 1).

The Change of the Balance of Trade

Figure 1 shows that the balance of trade turned into deficit in 2014 as a result of the significant fall in exports. Although the trade gained surplus again in 2015, the real cause was the relatively greater decline in imports, and not the

10 Standard & Poor's downgraded the Brazilian sovereign debt in September 2015, Fitch in December 2015, and finally Moody's in February 2016.

sudden increase in exports. It was no good news for Brazil's economy that the country gained the highest foreign trade surplus since 1998 in February 2016.[11] However, the structure of the surplus, amounting to over 3 billion dollars, is quite worrisome. Imports decreased by 34% (to 10.305 million dollars) compared to the level in the previous year, while exports increased by 3.4% (to 13.348 million dollars). The significant decrease of the imports was the result of the inflation as a consequence of the substantial weakening of the Brazilian real and the relapse in consumption caused by the economic depression. However, the growth of the exports can be regarded very modest if we consider the 30% devaluation of the currency in the same period. This also shows that the country's economy and the export-oriented firms were not able to capitalize upon the opportunity provided by the weak Brazilian real.

Despite the economic opening, the ongoing liberalization since the 1990s, along with the rhetoric of the Lula period, Brazil can basically still be regarded as a closed economy, at least if we consider the 12–13% share of the export sector within the GDP. According to the rather optimistic IPEA estimate,[12] the export sector could contribute only modestly to the country's economic performance between 2003 and 2010 (see Table 1).[13]

R(A)ISING THE DOMESTIC CONSUMPTION

Apart from the factors detailed above, the earlier economic growth was particularly due to the boom in foreign direct investments and the rise of domestic – particularly internal – demand (accelerated mainly by government transfers and financed by debts).

Table 1
The Growth in the Weight of Households in the Use of GDP (Percentage of GDP)[14]

	2005	**2010**	**2015**
Household consumption	60.43	64.01	66.52
Government consumption	19.66	18.62	17.85
Investments	17.26	21.23	20.49
Exports	12.21	10.97	10.98
Imports	8.61	13.26	14.57
Net exports	3.60	-2.29	-3.60

11 *CNN Expansión*, 2016.

12 Dedecca, 2014.

13 More details in Amann and Barrientos, 2014; Canuto, Cavallari, and Reis, 2013.

14 Own construction based on *IBGE*, 2016.

Among the internal economic processes, the most striking is that the share of household consumption in the GDP increased sharply from the level of 60% in 2005 to 67% in 2015, while the share of investments reached its peak in 2011 with 23%, rising from 17% in 2003, then falling again to 18.5% in last quarter of 2015.[15] Domestic demand, especially the growth of household consumption improved the economy during the examined timeframe. However, it is worth noting that the consumption of the new Brazilian "middle class" was mainly financed by government transfers and credits.

The trademarks of the Lula era were the social and job-market policies aimed at increasing the living standards of certain social groups. The Bolsa Família program raised nearly 20 million people from poverty until 2010, and by 2015 nearly a quarter of the population (approx. 50 million people) had secured a minimal income above the poverty limit. (These cash transfers were conditional upon vaccination, regular medical checks and the education of the children in the supported families.) Although the share of the program in the GDP was small (around 0.4%),[16] the budget restrictions enacted in the coming years would touch these programs as well, in a manner that the real value of the transfers decreased by the freezing of their absolute value.

The increase of the minimum wage (from 487 reals in 2003 to 727 reals in 2010) contributed to a great extent to the rise of household disposable income, which increased the income of the informal sectors through the spill-over effect as well. The rise of the minimal wage continued after 2010 at a slower pace and reached 817 reals in 2014, but the average level of the minimum wage fell in value and under 800 reals in 2015.[17]

Last, but not least: the credit of the private sector compared to GDP was 28% in 2003 and that increased to 59% (sic) until 2014, the half of which was household credit. Its share of the GDP changed from 10% to 27.6% in the same period.[18] Although in international comparison the share of credit (including households' credit) is not extreme, this sharp increase caused a credit boom[19] and the weight of paying back loans also grew compared to the disposable income. Consequently, the share of non-performing loans increased.

Data from the Brazilian Central Bank (BCB) shows the share of household credit to have been 18% in 2005 compared to the disposable income, and reached 45% in 2013. This dynamic increase was interrupted slightly in 2009 and in 2012, and since then its growth rate has slowed down. In the backdrop lies the decrease of household credit for consumption goods, the share of which decreased by 2.3% since 2013.

15 *IBGE*, 2016.

16 Soares, Ferreira de Souza, Osório, and Silveira, 2010.

17 *IPEAData*, 2016.

18 *Banco Central do Brasil*, 2015.

19 *IMF*, 2013.

After the global financial crisis, the share of non-performing household credit reached 7% in 2010, while loans overdue by 15–90 days increased by 6% as well. Although the figures of the BCB do not reflect this, but the 2015 analysis of Seresa Experian[20] demonstrates a rapid increase in non-performing loans from the second half of 2014 and another 16.8% increase in July 2015 on a year-to-year basis.

FDI AND INTERNAL INVESTMENT

Another neglected factor of the Brazilian "growth path" based on consumption (financed mainly by credit) is the role of investment. The level of domestic savings and investment in Brazil is "historically" low. Gross Fix Capital Formation (GFCF) was 17% of the GDP in 2003, and reached 20% in 2010 with a falling trend since the second quarter of 2014. This could be only partially compensated by foreign direct investment, which represented only 10–15% of the GFCF, while the share of foreign capital in Brazil is around 30–32% of GDP.[21] (For the sake of comparison: the OECD average[22] is 36% and the EU average is 48%.) Figure 2 clearly shows that from the mid-2000s FDI inflow jumped significantly in Brazil,[23] and after the backlash during the global financial crisis in 2008–2009, the same increasing trend could be observed until 2014, when the trend turned into stagnation and into decrease in 2015.[24]

The data are convincing: the level of household real estate investment is at a historical low, as the long-term real estate financing for households is expensive due to the high national interest rates. Thus, the quality of urban housing is poor, but – as the saying goes – "at least it is expensive." (A state-subsidized housing program started in 2009, the so-called *"Minha Casa Minha Vida"* probably improved the situation, but budget cuts announced in Summer 2016 have also reached this social housing program.)[25]

20 *Reuters*, 2015.

21 *IPEAData*, 2016.

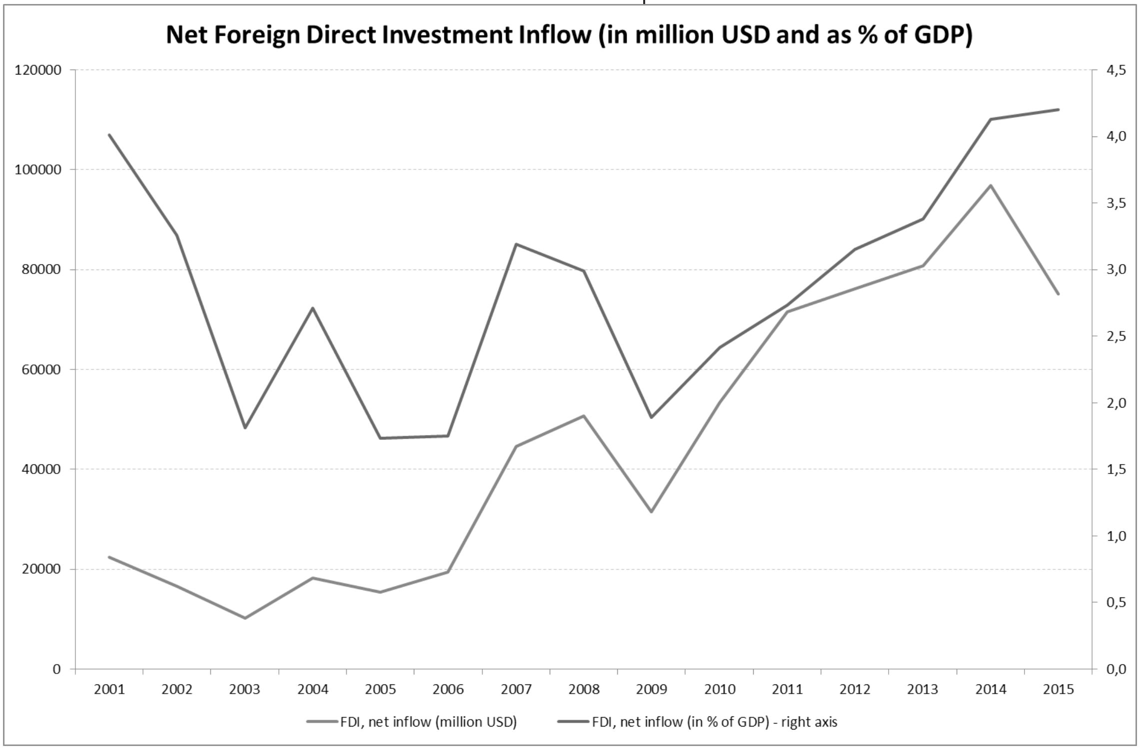
22 ***OECD***, 2016.

23 The positive economic trends were emphasized by the biggest credit rating agencies: in 2008 Brazil was rated among the elite club of countries suggested for investment.

24 *ECLAC*, 2015.

25 Bielschowsky, Coelho Squeff, and Vasconcelos, 2014.

Figure 2
Net Inflow of Capital[26]



Among the reasons for the crisis, the low level of infrastructure investment definitely takes a prominent place and because of this the country is in a significant competitive disadvantage for decades to come. While in the 1970s and 1980s the percentage of GDP spent on infrastructure construction was 5.2%, in the 2000s this ratio was about 2.25% (3.1% in 2010), and it barely reached 2.5% in 2013.[27] The shortcomings and failures of the realized investments (e.g. the Trans-Amazonian highway) are further worsening the situation caused by low investment levels. Furthermore, all this is happening within a country half the size of an entire continent (nearly as huge as the European Union itself), where the level (quality and quantity) of logistics infrastructure is traditionally very low. (According to the 2014 survey of the World Economic Forum, after the significant downturn, among 144 countries Brazil ranked 120th in this regard. In comparison, in 2006 it reached the 83rd position in the IMF[28] ranking.) Some of these cases became headline news in the international media, such as the blackouts experienced in 2014, the overcrowded ports or the day-long queues in times when the economic production was already slowing down.

26 Own construction based on *World Bank*, 2016 a.

27 *IMF*, 2015 b.

28 *IMF*, 2015 b.

A good example of the gravity of the situation is that according to Credit Suisse estimates there is a 1 trillion dollar investment gap in Brazil due to incomplete infrastructure, causing the country to perform far below its potential growth rate.[29] Morgan Stanley[30] estimates that with additional infrastructure investment amounting to 4% of the GDP, it would still take 20 years for the largest country in South America to reach the infrastructural development level of Chile. Compared to these numbers it is straightforward to see that the Brazilian government's infrastructure program (PAC) launched in 2007 cannot fill the gap. The PAC reached 0.3% of the GDP in the initial year and in the second, extension phase of the program in 2013 it was increased to 0.5 % of the GDP.[31]

In the international context and compared to other emerging countries, the consequences of the low investment rate are striking not only in the infrastructure deficiencies, but also in the fields of education and health systems. The low levels and quality of education and health investments fundamentally affect labor productivity and the long-term competitiveness of the economy, but this leads us to the micro-analysis of the causes of the crisis.

Regarding the traditionally low level of investments it is essential to mention the significance of the large-scale sports events in recent years. The preparations for the 2014 FIFA World Cup and the 2016 Summer Olympic Games burdened and distorted a slowing economy in a disproportionate way, where the infrastructure deficiencies (mainly logistics and transportation) constitute a serious development bottleneck.[32] Firstly, these investments (sports facilities and the connecting transport infrastructure) drew away significant resources from production and logistic investments, while also changing the development agenda, as these investments often did not reflect the social and economic needs of the country. On the other hand, the typically long-term profitability of the new facilities and their operation were not ensured. (According to FIFA the costs of the World Cup were 11.6 billion dollars.[33] By contrast, in the case of the Olympics, the Brazilian authorities budgeted for orders of a smaller magnitude, with initial estimates of 4 billion dollars – however, media reports suggested a twofold cost overrun.[34] However, this 0.1% GDP spending was one-fifth of the yearly infrastructure spending of Brazil.) In addition, the corruption scandals and low quality works significantly increased social resistance to these events.

The resistance against "prestigious," showcase sports events was clearly highlighted by the 2014 social demonstrations, where hundreds of thousands of people protested, demanding education and health investments instead of sports

29 Savaris, Vinagre, and Magalhacs, 2013.

30 Morgan Stanley, 2010.

31 *IMF*, 2015 a.

32 Nagy, 2016.

33 *Statista*, 2014.

34 *Rio Olympic Games*, 2016.

facilities. The required infrastructure for the Rio Olympics – which mostly consisted of temporarily expanding already existing sports facilities – was ready for the tournaments, and the total budget of the Games is assumed to be less than it was in the case of the World Cup. However, the required public transportation system and road infrastructure within the city (between sports facilities) were only partially completed on time (e.g. the new number 4 subway line of Rio was only be used with certain limitations) and this made the life of the fans and the residents of Rio more difficult during the Olympics. Even if we admit that the logistics for the athletes and other participants were well-organized and executed during the Games, this does not ensure the future utility of the new infrastructure for the city residents.

WORSENING FISCAL DISCIPLINE

The processes described so far were accompanied by a weakening of fiscal discipline in a "quasi-automatic" way: on the one hand, the revenues of the government were falling back significantly, while the majority of the spending is legally (or by powerful interest groups) protected so reducing them invokes strong (social and political) opposition.

In 2015, the then minister of economy ("Scissorhands" Joaquim Levy) reduced discretionary budget spending by 70 billion reals (the equivalent of 18 billion dollars), a record move, but the curtailing of additional expenditures would have required the support of the legislature which was not given, so the minister resigned in December 2015 after less than a year in office. A good indicator of political instability is that within two years the third person fills the position of finance minister in Brazil. In the 2016 draft budget a 9.5% increase of governmental spending was proposed, much of which was constitutionally prescribed as a "mandatory" increase (approximately 1,000 billion reals). This is the first proposal in 15 years that accounted for the primary deficit of the budget (0.5% of GDP); however, this did not conform with the fiscal responsibilities law introduced in the 2000s, which is why so many people have questioned its legal validity.

It is clearly visible in Figure 1 that the budget deficit soared dramatically since 2014. In fact, already in the 2013 election year Rousseff could keep it below the statutory 3% only with the help of "creative accounting." (This was later the legal basis for her impeachment.) In 2015 the budget deficit exceeded 10% and it is expected to be around 8% in 2016 (according to optimistic estimates).

Meanwhile, the gross debt also increased significantly: according to the data of the Brazilian Central Bank, from 55% in 2006 it rose to over 66% in 2015 and they estimated that in 2016 it will cross the symbolic 70% threshold, which is a critical level according to the most credit rating agencies in the case of the emerging countries. (Moreover, analysts envisage reaching the 90% level by 2018).[35] In addition, according to some estimates, with the existing implicit state guarantees for public companies, banks and pension funds, Brazil's government debt is already

35 *Economist Intelligence Unit*, 2016.

around 100% of GDP,[36] making Brazil one of the most indebted countries in Latin America.

Apart from the growth of central government debt as detailed above, the indebtedness of the federal states has also increased. It is clearly visible in Table 2 that the debt of the Brazilian federal states has doubled over the past five years in terms of their percentage of GDP.

Table 2
Indebtedness of the Brazilian States[37]

Year	2011	2012	2013	2014	2015
Cumulated debt of the federal states (billion real)*	436.357	467.312	502.448	539.132	600.029
Brazilian GDP (billion real)	2 615.235	2 413.136	2 392.082	2 346.076	1 799.612
Debt to GDP ratio of the federal states (in percentage)	16.7%	19.4%	21.0%	23.0%	33.3%

* The data for debt was available in December of each year, while the data for GDP was the final and official data for every year.

In light of these facts, it can be stated that the slowdown of Brazil's economic performance can also be explained by factors other than the change in the international conditions: instead, the exhaustion of the domestic demand model (focused mainly on consumption and financed by credits) and misleading economic policy decisions also played a key part.

Microeconomic Factors Behind the Brazilian Crisis

To better understand the roots of Brazil's economic turmoil, it is not enough to analyze the macroeconomic factors (see previous chapter); we need to take a closer look at the changing microeconomic conditions as well. The fact that the competitiveness of the Brazilian economy is low was covered by the relatively high GDP growth rates in the first decade of the millennium. But the price of foreign and trade policy changes, the rapid increase of exports serving the increasing Asian demand under Lula was high: the export structure changed drastically, which impacted the production structure of the economy as well.

Dependence of Primary Goods

The share of industrial production in 2010 was around 30%, meanwhile in 2015 it decreased to 23%. It shows a decade of deindustrialization, which is more recently worsened by the fall of the share of the service sector. From

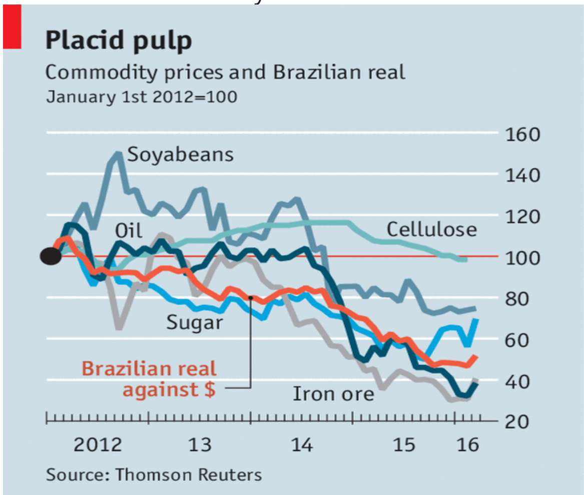
36 Moody's Investor Service, 2014.

37 Own calculations. Data source: *Banco Central do Brasil*, 2016; *OECD*, 2016; *IMF*, 2013.

2014 to 2015 the contribution of the industry to the GDP fell by 6% and the service sector by 3.6%,[38] and this automatically translates into worsening unemployment figures. Without going into deep historical analysis, we have to state that after half a century of import-substitution based industrialization (ISI), the industrial sector is for the most part not competitive in international terms, with some exceptions (e.g. the airplane or automobile industries), which reflects the duality of the Brazilian economy (a permanent characteristic). The market-oriented reforms of the 1990s could not undo the results of 50 years of state-interventionist, ISI-driven economic policy, where the competitiveness and efficiency of the private sector has always played a secondary role.

Daniela Campello[39] draws our attention to a remarkable interrelation: the US interest rates set by the Fed and the price-level of the raw materials or primary goods define the economic outlook for Brazil between 1980–2015, as calculated by the *Good Economic Times* (GET) composite index. In light of this correlation, the sharp downturn of the Brazilian economy in 2015–2016 is quite understandable in light of the low but rising real interest rates and the falling prices of primary goods (see Figure 3).

Figure 3
Prices of Some Primary Goods over Recent Years[40]



Rising export performance in the period between 2003 and 2014 was driven nearly exclusively by the commerce of primary goods. While in 2000 60% of Brazilian exports consisted of processed goods, and the share of the raw materials and agricultural goods was 25%, in 2010 this ratio became 50% and that of processed goods fell below 40%. The reason for this change lies in the restructuring of export markets: in 2000 the main export partner was the United States of America,

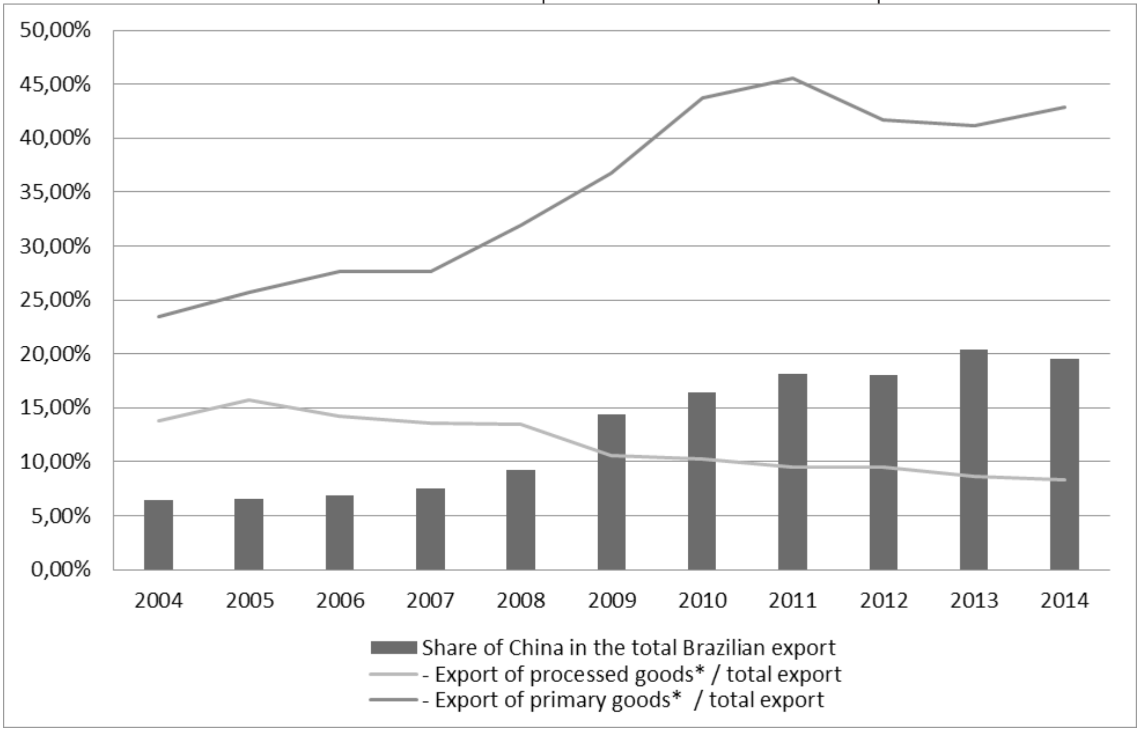
38 *Economist Intelligence Unit*, 2016.

39 Campello, 2015.

40 *The Economist*, 2016.

meanwhile in 2010 China was the number one trading partner. Figure 4 shows the results of Lula's economic policy (the South–South cooperation) which started with the legitimate goal of trade diversification but finally led to the dependency on China in ten years' time, and at the same time it also led to the re-primarization of the Brazilian export from processed goods to the primacy of commodities.

Figure 4
The Structure of Brazilian Exports and Its Chinese Exposure[41]



As mentioned earlier, the balance of trade in 2014 turned negative, and in 2015 the surplus was due to the sharp fall in imports. Overall, the fall of exports is not the biggest concern of the Brazilian economy, but the increasing share of imports (compared to the GDP) and the falling production capacities in the last decade are much more alarming.

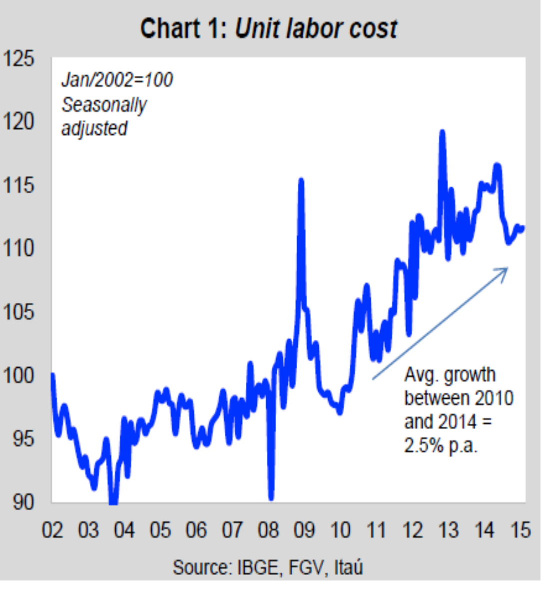
FACTOR PRODUCTIVITY

A general feature of the Brazilian economy is the extremely low *total factor productivity*, (TFP), which was stagnating in the first decade of the century (with the exception of the agricultural sector), while the real average wage

41 Own calculations based on *UN*, 2016. Note: Under the term "processed goods," our calculations include the 5 main product groups (iron and steel; vehicles; aircraft, spacecraft; parts for motor vehicles), while "primary goods" refers to the 6 main product groups (iron ores and concentrates, roasted iron pyrites; oil seed, fruits; petroleum oils; meat; solid cane or beet sugar; coffee) of the Brazilian exports.

was increasing. In the last decade the Brazilian unit labor cost rose (wages were rising much faster than productivity) and this shows the worsening of international competitiveness (at least regarding its factor of costs), which is illustrated by Figure 5. Julia Gottlieb explains[42] the continuous worsening of the trade balance with the same factors: in 2010 the surplus was 30 billion dollars, while in 2014 this turned into a 3.9 billion dollar deficit, while the Brazilian national currency, the real depreciated by 50% to the US dollar, which should have theoretically helped the international competitiveness of export firms.

Figure 5
Change of Unit Labor Cost in Brazil[43]



The increasing trend of the growing real minimum wage halted in 2015, while unemployment rapidly jumped (over the course of a single year, 1.5 million people lost their jobs), and the availability of social transfers was tightened. Due to these changes disposable household income fell, followed by the decline of retail sales and the increase of non-performing loans. The spill-over effects reached the entire economy and society, which led to a self-reinforcing spiral, a vicious circle. This economic downturn culminated in a political crisis and turmoil, which all lowered the "governability" of the country and the business performance for half a year.

At the end of 2015, Petrobras announced that it was forced to lower its investment until 2019 by 24.6% (the equivalent of 32 billion dollars). The Brazilian finance ministry issued a parallel report which showed that every dollar not invested by Petrobras meant a 2 dollar loss for the GDP[44] and argued that the GDP fall in 2016 will be mainly

42 Gottlieb, 2015.

43 Gottlieb, 2015. Note: Prices of 2002. January = 100%.

44 Fariello, Beck, and Corrêa, 2016.

due to the underperformance and lack of investment of Petrobras, which – besides the ever-growing corruption scandal encircling the national oil company – can be easily explained by the low oil prices not nearly covering the costs of the expensive offshore oil and gas projects. Petrobras announced the decrease of its production capacities until 2020 from 2.8 million barrels to 2.7.[45] The spill-over of Petrobras' decisions into the Brazilian economy reached not only the financial and construction sector, but also the SMEs attached to the company's services, resulting in a loss of jobs and regional tax revenues as well.

Beside the high labor cost and the low productivity, there are several factors that further undermine the competitiveness of the Brazilian economy. Among these we highlight the regressive and complicated tax system, the high rate of the informal sector and underemployment (partly caused by taxation problems), as well as the internationally low rate of research and development (R&D) expenditure (1% of GDP). This is somewhat higher than the regional average (0.7%), but still far from the American or the European levels, and even further from that of other developing countries (for example, that of China).[46]

COMPETITIVENESS AND "CUSTO BRASIL"

According to the Doing Business report, published by the World Bank, Brazil is ranked in the 116th place overall of 189 countries.[47] In one year it slipped 5 places, and lost its position in all the fields affecting the business environment (from starting up businesses to property registration, to access to credit and also in company liquidation). It managed to improve its position in only two fields: access to electricity and cross-border trade. These negative news all illustrate current trends in Brazil, and the picture is far from rosy even when compared to other BRICS countries: Russia (51st), South Africa (73rd), China (84th) are all ahead of Brazil in the Doing Business index, while only India (130th) lags behind. In the business environment, the most important regional competitors are in a much better position than Brazil: Mexico (38th), Chile (48th), Peru (50th) and Colombia (54th); only Argentina (121st), Ecuador (117th) and Venezuela (186th) perform worse (and this year Argentina's position is expected to show marked signs of improvement).

Altogether, Brazil needs comprehensive and deep reforms in its business environment including the fight against the "Brazil cost" (*Custo Brasil*), which means the structural, bureaucratic and financial burdens in the country. These extra costs are constantly lowering the willingness to invest in, or trade with the country, and contribute to the further widening of the informal sector, inciting the evasion of taxes and undermining the rule of law, while also worsening the competitiveness of domestic enterprises.

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45 *El País*, 2015.

46 *UNESCO Institute for Statistics*, 2016.

47 World Bank, 2016 b.

Finally, we could cite a number of institutional fields that are also in desperate need of reform (not to speak about the Brazilian political system), without which Brazil is highly unlikely to embark upon a path of the sustainable economic growth; however, these issues are outside the remit of our current research topic.

Conclusions and Scenarios

In this article we have focused on the economic dimension of the most recent Brazilian crisis. After presenting the main characteristics of the crisis, first we analyzed its macro-economic roots: the deterioration of the trade balance, the credit-led expansion of domestic consumption, low investment levels and the deterioration of fiscal discipline, and searched for explanations behind these processes. Then we turned towards a micro-economic perspective to examine the low competitiveness of the Brazilian economy, and the structural bias caused by the recent expansion of exports (mainly of commodities, primarily to China).

Overall we have found support for our initial hypothesis: the most recent economic crisis in Brazil can only partially be explained by the deterioration of external circumstances since the great financial crisis of 2008–2009, and has to also be attributed to the new export "diversification" and redirection since the mid-2000s, and the resulting economic structural changes as well as to mistaken economic policy decisions (during the PT era). As a result of the latter we can highlight the very low level of infrastructural investments (even further biased by expensive mega-sport events, such as the Football World Championship in 2014 or the Summer Olympic Games in 2016), the shortcomings of the health and education systems, the costly bureaucracy (red tape, also called *Custo Brasil*) and the weak and deteriorating business environment (measured also by the Doing Business indices).

REFORM AND STABILIZATION OF THE POLITICAL SYSTEM

Regarding the way out from the prolonged multi-dimensional crisis in Brazil we have to first admit that on the longer term the reform of the political system and the reconstruction of a new social contract are inevitable pre-conditions for getting the country on a sustainable developmental path. We are convinced that the Brazilian case provides a good illustration of the new developmental economics and also of the new institutional economics argumentation, namely that on the long term economic growth (and development) are determined by political *and* economic institutions. So we can easily apply the famous model of Daron Acemoğlu, Simon Johnson and James A. Robinson,[48] the so-called AJR model on the Brazilian case. In the AJR model economic institutions shaping economic performance are the result of the decisions of groups holding the reins of political power, while the

48 Acemoğlu, Johnson, and Robinson, 2005.

distribution of political power is determined by the distribution of resources and political institutions. This dynamic model stresses the central importance of political institutions: the (*de facto* and *de jure*) distribution of political power determines not only the economic performance of the given period but also the political institutions of the following period.

To draw up some possible scenarios out of the crisis we have to distinguish between reforms needed on the short, medium and longer terms, even though reforms of different dimensions (political, economic and social) and reforms applied in different time perspectives do interact with each other (back and forth), and this further underscores the complexity and far-reaching effects (and uncertainties) of the Brazilian crisis.

On the short run the restoration of political stability can be seen as a positive development, and is well signaled by improvements in investor confidence and the prompt (favorable) reactions of financial markets. Nonetheless, the lack of legitimacy (or at least its perception by large parts of the society) and widespread social distrust (and demonstrations) can act in the opposite direction, thus potentially provoking further political tumult.

On the medium term, however, the thorough reform of the political system, including the electoral system, the party and campaign financing rules, and party and coalitional disciplinary issues,[49] is inevitable, as is promoting transparency and accountability in the current rather cosy state-business relations. Regarding the longer term, deeper institutional and behavioral changes are needed. The formal and informal rules of the game (according to Douglass C. North) should be modified: behavioral norms such as following the rules and complying with the law should be strengthened. We are convinced that without important changes in the institutional and behavioral spheres Brazil cannot embark on an inclusive development path that is sustainable over the longer term, however the analysis of all these dimensions was not the aim of our research (and should perhaps be addressed in a separate paper).

CHANGE IN THE PERCEPTION OF CORRUPTION

Besides the inherent widespread nature of corruption in Brazilian every day (economic) life, its social acceptance and embeddedness is also incredibly high.[50] As long as violating the rules is not the exception but constitutes the mainstream behavioral pattern (even at the highest level of the political and economic elites), and as long as "non-payment" is a real option in business circles (let it be regarding tax evasion or credit repayment), it will be difficult to enact significant changes in economic and social terms. At the same time we have to draw attention to the fact that, despite appearances (such as the worsening rankings by Transparency International from 54 in 2003 to 69 in 2010 and to 76 in 2015),

49 Fleischer, 2011.

50 Martini, 2014.

significant institutional changes took place during the last 10 to 15 years, not least in the areas of the judiciary, police, investigation and prosecution. Even a few years ago it would have been unimaginable that members of the political and economic elite would be sentenced to prison for money laundering or corruption cases. Similar occurrences might also change the attitude of Brazilian society and decrease the social acceptance of corruption (as an integral and inherent part of everyday life). The role of the internet and the use of social and other new IT-based media has to also be highlighted (not just as a potential counterweight to the mainstream traditional media); as the availability of information increases within society, different interest groups and social classes might organize themselves more easily or in a more prominent manner. These changes are well signaled by the rising frequency of social demonstrations during the recent years even though these social forces are generally not organized into unified entities or efficient groupings; rather, they tend to be fragmented along individual ambitions or determined mainly by social class differences.[51]

RESTORING THE BASES OF ECONOMIC GROWTH

Coming back to the narrowly defined economic dimension of the Brazilian crisis, we argue that as a first step on the very short run a fiscal reform is needed to reverse the deterioration of the fiscal position of the last years, while special attention should be paid to decreasing the budget deficit and inflation levels, and at the same time to restore investor (and consumer) confidence.

We have to note that the government of Michel Temer (sworn in on 31 August 2016) has announced it will take steps in this direction, including a 20-year freeze on public spending in real terms and a reform of the pension system. (The required constitutional amendment has been already passed.) Other decisions, however, raise concerns, such as the planned lifting of the primary deficit to 2.5% for 2016,[52] or the approval of large salary increases for government workers.

The engine of economic recovery could potentially be the export sector, since in 2015 the trade balance turned positive once again; however as mentioned, the reason for this was the strong decline of imports, and not the surge of exports. The export-led strategy as a possible way out of the crisis is supported by at least two facts: the heavy deprecation of the real (which is supposed to increase the competitiveness of the Brazilian export), along with improving regional market potential (which could be further strengthened by Argentina's expected economic recovery or by the intensification of regional trade within Mercosur). At the same time the decline in production capacities (especially the permanent decline in manufacturing since the 2000s) indicates clearly that this is not an automatic way-out; rather, it requires substantial efforts both from the private and public sphere.

51 Saad-Filho, 2015.

52 While the acting president claims to have set a more "realistic target" for the 2016 budget with this bill, raising government workers' wages are rather worrisome in this regard.

Nevertheless, the high and increasing level of indebtedness may justify an even more negative scenario, although in Brazil gross public sector debt is less of a problem. (It was significantly restructured during the last decade, so that the sovereign debt is mainly denominated in domestic currency and long-term papers, while a considerable level of international reserves accumulation also reduces external vulnerability.) At the same time the indebtedness of the Brazilian states as well as the corporate and household sector is significant, and the ratio of non-performing loans is on the rise in each sector. We have argued that this has added to the exhaustion of the domestic-led developmental alternative, but regarding the future development track it also poses severe risks. Though we admit that the Brazilian banking system is well-capitalized, well-regulated and well-established even by international standards, so that the present situation cannot in any way be comparable to the situation 35 years ago (the debt crisis of the 1980s), still this could be considered a developmental risk today. A clear signal of this is that during 2015 and 2016, all three major credit rating agencies downgraded the Brazilian sovereign debt to junk status (non-investment grade).

Looking at shrinking domestic consumption and demand, rising unemployment and climbing inflation levels, accompanied by traditionally high interest rates (further increased to 14.25% in June 2015), not much room for maneuver remains for the central government to boost economic growth. For this deep structural reforms would be needed (the minimum reform package should include changes in the pension system, tax system, public administration, infrastructure, education and health care systems), but the implementation of these reforms will be difficult and might turn out to be politically costly in the present political and social climate (and ahead of the 2018 elections). The circle thus closes, without gaining legitimacy or reducing political instability in the short run (which requires changes in the political rhetoric as well as some compensatory measures to the above mentioned reforms to lessen their immediate social costs), so it is hardly conceivable to overcome the severe economic difficulties in Brazil. However, on the medium and longer term without thorough political reforms sustainable socio-economic development (or even crisis management) will hardly be imaginable. In this latter scenario the risk of wasting the opportunities raised by the crisis is significant and bears a long-term developmental cost for the country's future.

The most likely path of recovering from the current economic crisis is perhaps the export-led strategy, and the latest (August–September 2016) political developments have strengthened the plausibility of this scenario. Still, while there are some early announcements and decisions that might help to overcome the crisis, other decisions point in the opposite direction. The risk thus remains that short-term political interests override the need for economic reforms and real, deeply rooted reforms will be postponed because of their political costs. In this scenario Brazil will again "waste" the crisis as an opportunity for the transformation of its economic and political system, thus another "lost decade" might follow and Brazil would once again remain the "country of the future."[53]

53 Zweig, 1941.

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