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Perspectives

Brazil: A Cautionary Note

The irrational exuberance over Brazil must be tempered by both macroeconomic and operational realities.

BY JERRY HAAR

"Curb Your Enthusiasm" is not just the title of a popular HBO television series but an astute advisory to those engaged in, or contemplating, trade, investment or commerce with Brazil. To be sure, Brazil continues to be the most attractive and "user-friendly" BRIC in which to do business. However, the irrational exuberance displayed by so many (those who have not lived or worked there) must be tempered by both macroeconomic and operational realities.

To begin with, Brazilian economic growth is heading downward. In the fourth quarter of 2011 Brazil's economy dodged a recessionary bullet. Consumer spending cushioned a continued decline in manufacturing; and despite slowdowns in China and India, the demand for commodities also served to curtail a further slide in the Brazilian economy. Clearly, Brazil is not growing near its full potential, despite rising commodity prices and inflows of foreign direct investment. An overvalued currency has been a boon to importers, Brazilian consumers, services, restaurants, and Brazilian shoppers traveling abroad. (Retailers in Miami, New York, and Los Angeles surely believe now that Deus é um brasileiro....or brasileira.) However, the strong real is contributing to what many claim is the de-industrialization of Brazil, as local manufacturers of auto parts, apparel, textiles, and electronics are experiencing a competitiveness meltdown, as cheaper imports—and not just from China—eat into their customer base. The government is attempting to cushion the blow through program such as "Brasil Maior," which offers a combination of tax cuts, financing, and trade-related measures to level the competitive playing field somewhat.

The good news is that consumers will continue to drive the economy. Firms like Redecard, Telefónica, Cielo, and AmBev have been strong performers. Additionally, there will be a fairly steady demand for commodities and natural resources. (China especially cannot afford to slow down its economy too much for social and political as well as economic reasons.) Unemployment remains low, wages are increasing and the government is committed to continued credit growth.

Much has been made of the coming oil bonanza along with the World Cup in 2014 and Olympics in 2016—all which will provide a constant flow of revenue and a stream of employment—especially for much-needed infrastructure projects—that will keep Brazil on a growth path. Here, too, however, one must sound a cautionary note. Lower interest rates and fiscal pumping could well end up exacerbating inflation; and will there be enough construction and related jobs after 2016 to allow workers preparing for the World Cup and Olympics to maintain their employment? And what of the public debt incurred to fund these massive sports-related projects?

As for oil reserves, Brazilian deposits below a layer of salt in the Atlantic Ocean hold at least 123 billion barrels of reserves, twice government estimates and equal to that of the North Sea. However, Petrobras financials have deteriorated, and there have been production setbacks and oil spills. Additionally, Brazil's refining capacity has hit its limit---the country now exports oil to Asia and imports it back as gasoline! For all these reasons, Banco Bradesco has lowered its rating on Petrobras.

Curbing one's enthusiasm for Brazil does not mean discarding the country as an attractive place for doing business. Despite its challenging business environment (the country ranks 126 out of 183 in the latest World Bank Doing Business report), the assets clearly outweigh the liabilities. The sheer size of the nation with its huge consumer class, abundant natural resources, prudent fiscal and monetary policies, a middle class that now accounts for more than half the population, and a broad array of domestic multinationals and supplier networks with a global reach are compelling reasons to be guardedly optimistic about Brazil. Competitive sectors, such as agriculture and agribusiness, avionics, biopharmaceuticals, and deep-water oil exploration, are driving innovation in the country.

Brazilians have long claimed that their nation is the country of the future. No longer. The future has arrived---but it is one that poses enormous challenges along with huge possibilities. Success can come only to those who proceed with caution.

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