BRAZIL

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Global governance
The world order must change in line with reality, says Celso Amorim, foreign minister
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Much still to do for the president-elect

Moving to the driving seat: Dilma Rousseff on her way to give interviews after winning the October 31 presidential election Corbis

John Paul Rathbone says one of Dilma Rousseff's biggest tasks is to turn the country into a developed nation

Continuity is the word in Brazil. So much so, that some Brazilians are understandably confused whether Luiz Inácio Lula da Silva, who was constitutionally barred from running for a third consecutive term in October's presidential election, really will be stepping down at the end of the year.

"The king is dead, long live the king," Mr Lula da Silva said at his first joint press conference with president-elect Dilma Rousseff. "Continuity lies in policies, not in the people," he added to emphasise the point.

Ms Rousseff won the October 31 run-off against the more centrist José Serra with a commanding 56 per cent of the vote.

But nobody doubts it was Mr Lula da Silva who transformed his former chief of staff from a little known bureaucrat with no experience as an elected politician into Brazil's first female leader. Some in the country's poorer north-eastern states even voted for her in the mistaken belief that while they could not elect Mr Lula da Silva at least they could vote for his wife.

Ms Rousseff, a 62 year old former leftwing guerrilla, faces some monumental tasks that Mr Lula da Silva left unfinished – not least turning the country into the developed nation that it envisions becoming. And then there is the challenge of how to stop her mentor's popularity overshadowing her.

During her campaign, Ms Rousseff pledged to stick to the mix of orthodox economic policies combined with large doses of social spending that helped lift more than 30m people into the ranks of the middle class over the past five years – and made Mr Lula da Silva the country's most popular president ever.

On the stump, her speeches were often wooden, and in TV debates she often came across as tetchy and bad-tempered.

But since winning, Ms Rousseff has shown signs of a good humoured poise and natural authority. A trained economist, with a fondness for state-led industrial policy, she has also moved quickly to assuage the worries of those that have the biggest doubts about her – São Paulo's business community.

Top of their concerns is the public purse. Despite strong tax receipts, the government will only balance its books this year thanks to some creative accounting – booking as revenue, for example, the sale of oil rights to state-controlled Petrobras in the company's $67bn October share issue.

To reassure markets, Ms Rousseff has promised to maintain the macroeconomic stability that has made the boom possible and rein in government spending, currently growing at 18 per cent a year.

However, she has also played to her Workers Party's (PT) supporters – labour unions and peasant movements – saying there is plenty of land to distribute and that she is studying ways to raise minimum wages by almost 20 per cent next year.

Her scanty public record means extra scrutiny is being paid to who will lead her cabinet.

Investors have clamoured for a senior post for Antonio Palocci, an important figure in her campaign and transition team, and a respected former finance minister. They also hope she will persuade Henrique Meirelles, the hawkish governor of the central bank, to stay on.

So far, other than displaying a strong belief in her own ability as a micro-manager, Ms Rousseff has given little away. "I'm the one responsible here," she told one television interviewer. "And I can assure that whoever is in these posts, I will be the one who guarantees the country's economic stability."

It was Mr Lula da Silva who introduced Ms Rousseff to Brazil, and it was he, too, who brought her out to the rest of the world at the G20 summit in South Korea last week. Nonetheless, Brazil's international profile may decline under Ms Rousseff as the country steps outside the circle of light of Mr Lula da Silva's charm.

"Without the drive of Lula's international popularity, it is reasonable to expect some deflation of [Brazil's] assertive rhetoric and its repercussions," says Brookings scholar Mauricio Cárdenas.

Nonetheless, before they left for Seoul, protégé and mentor showed some of the forcefulness Brazil is becoming known for, as its feels its way towards

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Much still to do for president elect

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superpower status, criticising the US and China (albeit, not very aggressively) for keeping their currencies artificially depressed in the so-called "currency wars".

"We will fight for Brazil's interests on the currency front. They'll have to face two of us this time." Mr Lula da Silva said. "The last time there was a series of competitive devaluations, it ended in the second world war," added Ms Rousseff.

The issue is particularly important, given that the trade-weighted real, has risen 33 per cent since the start of 2009.

This has helped keep inflation in check, and boosted consumption and imports. But it has also depressed manufactured exports – prompting fears the country might be "de-industrialising".

The finance ministry has introduced a 6 per cent tax on bond inflows to try to curb the real's rise. But few believe such measures will have lasting effect. Economists say that to curb capital inflows, the economic policy mix – loose fiscal policy combined with tight monetary policy – should be the other way around. After stripping out inflation, interest rates are the highest in the G20.

Brazil's low savings rate also makes the country dependent on international capital flows. Of the almost $100bn of capital inflows this year, only $13bn derived from bond portfolio buying, notes HSBC.

Government spending cuts would boost national savings, reduce interest rates and slow capital inflows. But, even though Ms Rousseff's coalition enjoys a majority in both the Lower House and the Senate – something Mr Lula da Silva never enjoyed during his two four-year terms – spending cuts may be politically difficult.

The president-elect has already ruled out big fiscal reforms – such as tackling the bloated public sector pension scheme. She has also refused to modify some of the world's most restrictive labour laws, as this would alienate one of her key constituencies, the unions.

Ms Rousseff proved her abilities while serving as Mr Lula da Silva's chief of staff – and there is no shortage of initiatives that need better management.

These include a drive to improve infrastructure under a huge government-led spending programme, readying the country for the 2014 football World Cup and 2016 Olympics, simplifying the Byzantine tax system, and improving its woeful state schools.

But Ms Rousseff's ability to manage domestic politics successfully so as to effect these changes remains to be seen. She has limited support among her own party, which she joined only 10 years ago.

There is also the task of managing the government's coalition partner, the PMDB, a collection of regional barons known for their fondness of pork-barrel politics.

Ms Rousseff has said she will "frequently knock" on Mr Lula da Silva's door for advice, and he has hinted he will play an active part in her government. That, in turn, raises another uncertainty: his future role.

Might he, for example, want to run for presidency again in 2014 – making her a caretaker over the next four years? When this was put to her, Ms Rousseff smiled and said: "I don't put the cart in front of the horse".

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Banks prosper from sharp rise in consumption

Consumer credit

Vincent Bevins and **Andrew Downie** say paying for goods in instalments is a widespread practice

There is cash in chaos. Or that is what Banco Santander thinks.

The Spanish banking group this year opened a branch in a Rio de Janeiro favela, or shanty town.

Attracted by a general rise in living standards and the realisation that more and more people are joining the formal economy, it has opened a small branch in the Complexo do Alemão, one of Rio's poorest and most violent communities.

"Many people here have never had a bank account before," says Guilherme Nycholas, the bank's manager. Known for drug-related violence, the Complexo do Alemão is an unlikely place to start. But Santander was clever enough to realise such ventures are better attempted with local partners.

The branch is identical to its 13,000 others around the world and is on land owned by AfroReggae, a well-known and highly-respected charity that aims to persuade kids away from gangs through music.

This is only one of the more visible signs of the extension of credit and the banking system to large new segments of the population. An economic boom and currency stability have led to an explosion in credit-fuelled consumption, though credit-to-GDP ratios are still low compared with equivalent countries, such as Chile.

High interest rates also mean that more lending is helping banks turn a tidy profit.

Since Luiz Inácio Lula da Silva took office as president in 2003, some 24m Brazilians have escaped absolute poverty and 31m have progressed to the middle class, according to government figures. But until recently, unpredictable and sometimes very high levels of inflation meant it was often impossible and ill-advised for the lower-middle classes to access credit.

That has changed. Over the past five years, the amount of credit extended to individuals has doubled as a share of GDP.

The residents of the infamous Complexo do Alemão favela do not need to look far to find credit. It is extremely common when buying household appliances, computers, or other relatively expensive items to pay in instalments: a refrigerator, for example, could be paid for in 18 monthly parcels of R$100 ($60).

A bank will be a counterparty to the transaction, and interest rates – some of the highest in the world – will be built into the price, whether or not this is clear to the consumer. Often, to conceal this, the "up front" price is identical to the value of the total instalment plan.

Direct consumer instalment plans have been one of three main components of the recent expansion of consumer credit. The other two have been lines extended by banks based on payroll guarantees and the proliferation of credit cards.

> 'One type of credit that is growing rapidly, but from a small base, is home mortgages'

Analysed, the mark-ups can appear brutal. People often end up paying more in interest than they do for the products. It is unsurprising, then, that Brazilian banks are some of the most profitable in the world. But many consumers are used to the high rates and are eager to get access to products that were previously out of their reach.

"Until recently, I could never have bought a car," says Mariele Petriconi, a housewife. "But now I have. I can trust that the prices on my two-year payment plan won't change, and that we can make them."

"The market for individual credit is growing rapidly," says Walter Malieni Júnior, credit director at Banco do Brasil. "We have 14m new jobs this year, and people are more confident in their wages and in their ability to take out consumer credit. As a result, loan terms are getting longer and rates are coming down. We expect this to continue into next year."

State-owned Banco do Brasil was nudged by the government last year into expanding credit for consumers in what some saw as a kind of post-crisis economic stimulus measure. The strategy paid off, and the bank reported the largest profits for any bank in Brazilian history.

Other banks are also getting in on the action.

"All the banks in Brazil have in their strategy to provide credit to the affluent new consumer base," says Marcelo Gil de Souza, global head of Accenture's Corporate Strategy and Growth Strategy Groups, based in São Paulo.

He adds: "One type of credit that is growing rapidly, but still from a very small base, is home mortgages. In the next years, that's where we will see the best movement in Brazil."

Mr Malieni agrees: "Real estate credit corresponds to just 3 per cent of GDP in Brazil. The total credit-to-GDP ratio is about 45 per cent." In nearby Chile, which is more developed, the figure is 80 per cent. If that gap is to close – it will probably be because of growth in the mortgage market.

Edible wealth: demand for commodities such as soya, from China in particular has delivered economic growth and rising incomes Corbis

Stability is not the same as durable growth

Economics

With bank lending growing at 20 per cent a year, a consumption boom is cause for concern. **John Paul Rathbone** reports

The economist, a regular columnist at a leading newspaper, looks out of the window at São Paulo's sparkling nightscape – but expresses only scorn.

The view from his 18th floor apartment encompasses the business district, the skyscrapers on Paulista Avenue, the roads thick with commuter traffic, plush shop fronts on the street below, and city lights that stretch as far as the horizon, hinting at the surrounding vastness of the country.

"All this," the economist says, pointing at the urban expanse, just a fraction of São Paulo state, which has an annual economic output twice that of Greece, "it's just home to Brazil's top 1 per cent, no more. The millions, the other 99 per cent, live beyond. The idea that Brazil has somehow made it? Nonsense."

It is only an anecdote. Nonetheless, it captures the bemusement some feel about how the country has recently become an international investor "darling". For the first time in living memory, it seems, foreigners are more bullish about Brazil than are Brazilians.

This is due to the great strides the country has made over the past 16 years under outgoing president Luiz Inácio Lula da Silva and his predecessor, Fernando Henrique Cardoso.

The country built a reputation for macroeconomic stability. Combined with the Asian-driven commodity boom, this delivered economic growth and rising incomes.

Reforms enacted in past crises also immunised the financial sector: there were no big bank failures during the global financial crisis.

Meanwhile, record levels of job creation created a feelgood factor.

But stability and feeling good are not enough – as Mr Cardoso has put it, they risk "anaesthetising" the country.

For one, stability is not the same as durable growth – especially when much of it is based on a consumption boom, in which bank lending is growing at a 20 per cent annual clip.

Nor should continuing stability be taken for granted. As Guido Mantega, the outgoing finance minister has said, the country faces a global "currency war". Indeed, it is already suffering early wounds.

Capital inflows, funded at near zero per cent internationally and drawn to Brazil by interest rates some 10 percentage points higher, have pushed up the trade-weighted exchange rate by over 35 per cent since January 2009.

In addition, nominal wages have soared by more than half between 2003 and 2009, according to the InterAmerican Development Bank. This has increased local costs further.

A meal in São Paulo or Rio de Janeiro, for example, now costs the same as comparable restaurants in London or New York.

Rising local costs have also hurt export competitiveness. Exports have risen by 40 per cent over the past five years, for example, but imports have almost doubled.

One result of this consumption boom is a steadily widening current account deficit, forecast to reach about $60bn this year, or 3 per cent of gross domestic product.

> 'If [Brazil] wants to keep its high cost model . . . it can't think about having a competitive manufacturing industry'

Only about half of that is covered by direct investment. Much of the rest is funded by the "hot money" that Brazil, ironically, now seeks to discourage via a 6 per cent tax on bond portfolio inflows.

The paradox points to a macroeconomic weak spot.

On the one hand, the country needs foreign savings. In 2008, according to the World Bank, Brazil saved a mere 17 per cent of GDP, against 38 per cent in India, and 54 per cent in China.

At the same time, it needs to boost investment – both to maintain growth and to build the new roads and better ports that will help companies become more competitive and so vault the strengthening exchange rate.

Yet, historically, Brazil has invested only about 15 per cent of GDP a year.

To reach the 25 per cent level of most emerging economies would require another 10 percentage points of GDP – some $200bn a year, notes Neil Shearing, an analyst at Capital Economics, the consultancy.

As this funding would come from abroad, however, that implies even more capital inflows.

The country is not in any danger, yet. But "Brazil has to take care not become complacent," says Armínio Fraga, a former central bank governor.

The surest solution would be to cut government spending, currently growing at 18 per cent a year.

This would free more cash for national savings, lower local interest rates and curb capital inflows. It would also cool an economy that is growing at 7 per cent – almost twice its 4 per cent sustainable rate.

Slowing government spending "would pay huge dividends," adds Mr Fraga.

Put more starkly, Brazil faces a choice about the kind of economy it wants to be, says Charles Tang of the Brazil-China chamber of trade and industry.

"It has to decide if it wants to keep its high cost model, in which case it can't even think about having an internationally competitive manufacturing industry."

It is perhaps the biggest decision that Ms Rousseff, a trained economist, will have to make.

A one-stop shop for food and industrial commodities

China and Brazil

Balancing relations with the east and the west will be a big challenge, notes **Jonathan Wheatley**

When Charles Tang set up the Brazil-China chamber of trade and industry in 1986, he remembers, "nobody was interested".

"Brazil was a closed economy and China was very poor." Things have changed. "Now," he says, "everybody wants to know."

Since the turn of the decade, exports to China have increased 18-fold. The Asian giant now buys more than 12 per cent of Brazil's exports and in 2009 overtook the US to become its biggest single market.

Chinese investment in Brazil is growing even more quickly.

According to Mr Tang, it totalled just $396m to the end of last year.

So far this year, he says, it is more than $27bn, including Sinopec's $7bn purchase of 40 per cent of Spanish-owned Repsol Brasil.

The deal is emblematic of what lies behind the surge in China's interest. As Beijing scours the world for sources of the industrial and food commodities essential to feed its rapid growth, Brazil offers something of a one-stop shop.

It is the world's biggest exporter of iron ore and of a host of agricultural products, including coffee, sugar and – of special interest to China – the "soya complex" of beans, oil and meal.

It is also set to become a big exporter of petroleum. By some estimates, recently-discovered deepwater oilfields put its reserves on a par with Kuwait and Russia.

But in spite of the recent rise in bilateral trade and investment, China is still a long way from fulfilling its potential as a driver of Brazilian growth.

As Sebastian Briozzo and Joydeep Mukherji of Standard & Poor's, a credit-rating agency, point out in a paper published this month*, Brazil remains a relatively closed economy, with exports equal to only a little more than 10 per cent of gross domestic product.

Even the very fast recent growth of exports to China has had little impact on GDP growth – in fact, the authors point out, quite the opposite:

"In China . . . net exports still contribute significantly to GDP growth. Conversely, in Brazil, net exports only made a positive contribution to GDP until 2004. After that, investment growth (and its corresponding impact on imports) diminished the importance of the external sector. Net exports have actually had a negative contribution to GDP growth ever since."

Nevertheless, they say, trade with China has been extremely important for some sectors, including iron ore and soya producers.

But this too, has its downside. Between 2002 and 2009, manufactured goods fell from 55 per cent to 44 per cent of Brazil's total exports, while primary and semi-manufactured goods grew from 43 to 54 per cent.

Many commentators fear that rising commodity prices and the steady strengthening of the real are eroding the competitiveness of Brazilian industry and its manufacturing base risks being replaced by low value-added commodity production.

Mr Tang at the China-Brazil chamber says Brazil faces a choice.

"The country has to decide what it wants to be, which is precisely the question that did not emerge during the election campaign," he says.

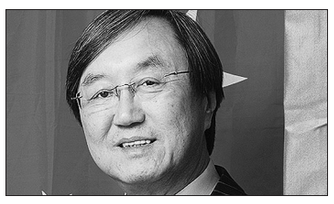
"Either it can be a high-cost, non-competitive country, in which case it can still be successful as a commodity exporter.

"Or it can lower the *custo Brasil* [the term for the extra it costs to do business in the country – the structural issues that erode competitiveness] to stimulate industrial production based on lower costs.

"And this has nothing to do with the Chinese."

Yet rather than considering far-reaching reforms to cut public spending and allow interest rates to fall, or addressing other complex fiscal issues, such as public sector pensions, the incoming administration seems likely to be content with trimming public spending.

This will leave it with little option in tackling the strengthening real than to turn to currency controls. In the global "currency war" between the big economies, Brazil has tended to align itself with China in criticising the US's expansionist monetary policies, and has avoided frequent public criticism of Beijing.



> 'Brazil has to decide what it wants to be: a high-cost country or it can lower the custo Brasil'
>
> **Charles Tang, Chairman, Brazil-China Chamber of Commerce & Industry**

"This has more to do with politics than foreign exchange," says Rubens Barbosa, a former Brazilian ambassador to London and Washington. "Brazil is moving closer to China than to the US and Europe."

Investing political capital in China at the expense of traditional partners has its risks. For one, Brazil is likely to run a growing trade deficit with China.

But as the Standard & Poor's paper notes: "The economic benefits of Brazil's and China's trade relationship remain high. Brazilian exports do not compete with Chinese exports in many markets . . . Increasing exports to China could continue to provide additional resources to Brazil, helping ease both external and fiscal constraints."

How Brazil balances its relationship with China, the US and Europe will be one of the biggest challenges for the incoming government.

**How Important is Trade With China to Brazil's Economy?*

Companies must expand to prosper

Globalisation

Jonathan Wheatley says growing abroad has become an essential part of corporate strategy

Vale, the world's biggest producer of iron ore, is also the world's second-biggest mining company. Its target is to be the biggest.

AB InBev, the world's biggest brewer, was created and is run by Brazilians. JBS-Friboi, which started life as a tiny slaughterhouse, has grown to become the world's biggest processor of animal protein, with operations on all five continents.

For companies with global ambitions, even the size and dynamism of Brazil's fast-growing consumer market are not enough. Yet market domination on a global scale is far from the only reason for expansion abroad.

After hovering around zero until the early years of this decade, overseas investment by Brazilian companies jumped to nearly $30bn in 2006 and was about $20bn in 2008, before the global financial crisis forced a severe retrenchment – so severe that, overall, national companies brought back about $10bn from overseas operations.

But in spite of the slower growth now expected in many companies' foreign markets, outward investment is continuing and several Brazilian transnational companies expanded their foreign operations last year. For many, growing outside their home country has become an essential part of their business strategy.

Sabó, a Brazilian auto parts maker, was quoted as saying in a recent report: "Going international is a matter of survival and competitiveness, not only in the automotive industry, but also in the globalised world."

The report, on Brazilian transnational companies was prepared by Sherban Leonardo Cretiou and colleagues at the Fundação Dom Cabral, a business school.

Mr Cretiou says the advance of globalisation means that many Brazilian companies that are big in their home market have found themselves competing with foreign companies that, on a global scale, are much bigger.

"If you want to avoid internationalisation from the outside, expanding overseas can be your only defence against being acquired by foreign competitors," he says. "That gives you the muscle to continue to compete."

Globalisation has also exposed competitive disadvantages in Brazil, including its complicated and onerous tax system, costly labour laws and inadequate infrastructure – all exacerbated in recent years by the steady strengthening of its currency, the real. This has forced changes in company business models.

Marco Polo, for example, a busmaker with a long history of foreign operations, has traditionally sent parts abroad for assembly. Increasingly, it is doing more local purchasing and manufacturing at its foreign operations because exporting from Brazil has become less competitive.

Other companies have gone abroad in search of new technology.

For Gerdau, a steelmaker with about half its sales and assets outside the country, learning about new processes and diversifying product lines was one of the main drivers behind its acquisitions in the US and Canada.

Several companies have expanded overseas to follow their customers, be they other Brazilian companies or foreign multinationals.

Service companies such as Totvs, which supplies business software, have no choice but to establish foreign operations if they want to service customers abroad.

While many companies take their first steps abroad by opening a sales office, true expansion for most means taking the plunge into mergers and acquisitions.

This can be far from easy – as Vale found when it bought Inco of Canada and a clash of business and national cultures resulted in strained relations between managers and a lengthy strike by workers.

Sérgio Citeroni, a partner at Ernst & Young Terco in São Paulo, says such clashes constitute one of the biggest threats to the success of foreign expansion.

"Culture shocks, power struggles, questions of governance, all these provoke a loss of focus and stability, and in a very competitive environment you can't afford the luxury of wasting time over internal disputes," he says.

Going international, he adds, often means making commitments to foreign regulators that Brazilian companies are not used to. "This can be a big obstacle."

But Brazilian regulations also play a part in overseas expansion.

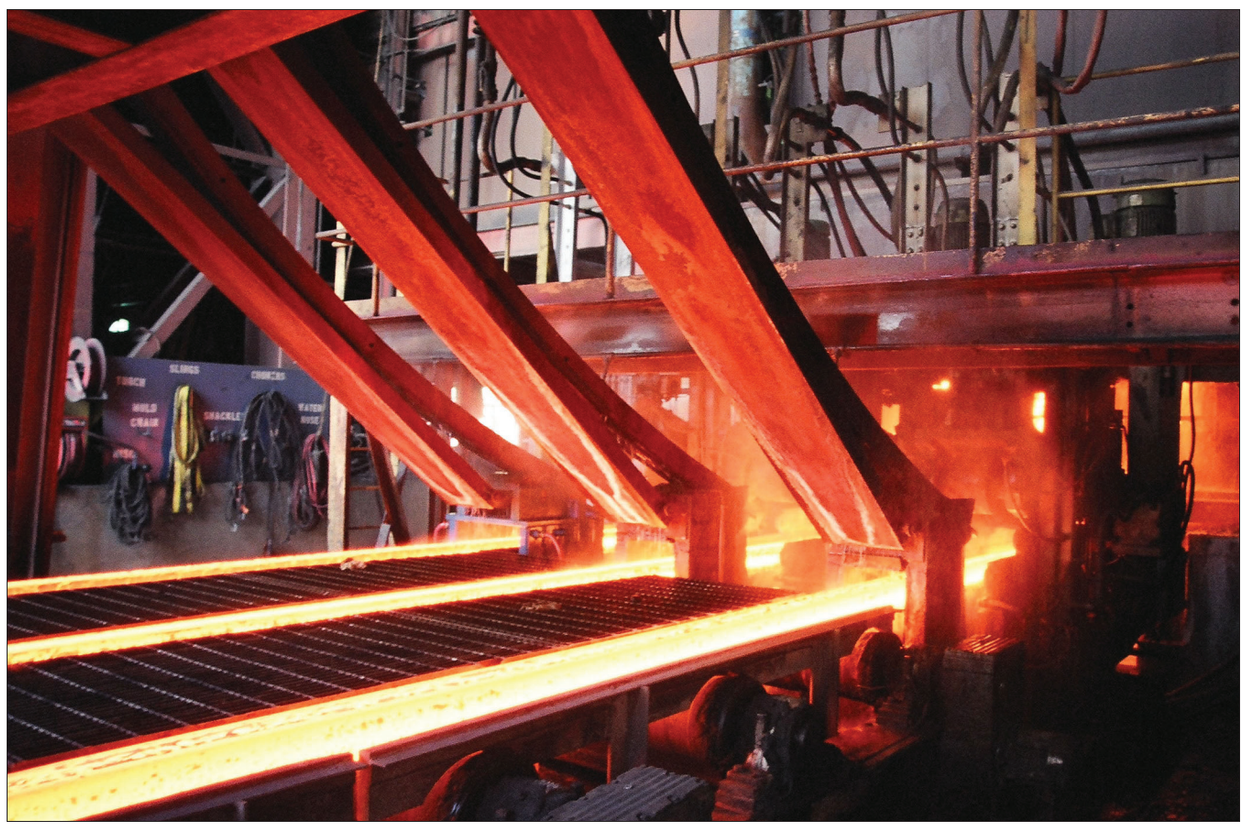
Antitrust bodies have become much less tolerant of monopolies and oligarchies in recent years, meaning that many large companies have run out of room to expand at home and must pursue growth overseas instead.

Some companies have been helped in gaining scale and therefore competitiveness through natural advantages, such as the country's mineral and other natural resources, including its excellent climate and abundant farmland. Vale, JBS and Gerdau all come to mind.

But Mr Cretiou says few, if any, would have succeeded abroad if they did not also have good management capable of taking decisions quickly. He says Odebrecht, a construction company, offers a good example of a strategy that sets rigid parameters but also allows local managers great freedom in applying them.

In spite of last year's retrenchment, he says, Brazilian companies are ready to resume their overseas advance next year.

"We have seen some foreign acquisitions this year and my guess is that we will see a lot more in next year's report," he says.



Gerdau, a steelmaker, has about half its sales and assets outside the country Bloomberg

Top 10: Brazilian companies' international reach

	Company	Primary industry	% abroad Sales	Employees	Assets
1	JBS-Friboi	Food	84	64	37
2	Gerdau	Steel and metal	48	46	54
3	Ibope	Research	32	54	51
4	Metalfrio	Metal-mech	37	54	41
5	Odebrecht	Construction	46	49	20
6	Marfrig	Food	52	35	23
7	Vale	Mining	33	24	46
8	Sabó	Autoparts	34	34	19
9	Tigre	Building materials	20	23	43
10	Suzano Papel e Celulose	Pulp and paper	70	4	9

Source: Fundação Dom Cabral

Foreign policy Big ambitions

Foreign policy has acquired a new importance in Brazilian political life. This is not just because of outgoing president Luiz Inácio Lula da Silva's occasionally controversial foreign policy initiatives, such as when he tried to broker a nuclear agreement with Iran this year, or embraced president Raúl Castro on the same day a Cuban dissident died on hunger strike, **writes John Paul Rathbone**.

For some, such events marked a worrying shift in Brazil's traditional approach to foreign affairs, which had previously been marked by the skilled attention of its diplomatic corps to narrower issues, such as trade.

For others, including Mario Vargas Llosa, a Peruvian novelist, it was also morally abhorrent. "Lula is a democrat, and then he goes and hugs a repellent dictator like Mr Castro . . . It bothered me, it saddened me, I felt indignant," commented Mr Vargas Llosa, shortly after receiving the Nobel Prize for Literature this year.

Be that as it may, Brazil's political stability, fast-growing economy, Bric and G20 status, and sheer size (the world's fifth biggest nation and already eighth biggest economy) ensure it will play an increasingly important role in world affairs – whoever is president.

For example, in a September Pew Research poll, 24 per cent of Brazilians believed their country was already a superpower and 53 per cent that it would soon become one.

As Marco Aurélio Garcia, the éminence grise of Brazilian foreign policy and Mr Lula da Silva's point man on Latin America, puts it: "Foreign policy shouldn't be understood as way of projecting Brazil's presence on the world but rather as a substantial part of Brazil's national project."

By that Mr Garcia, who played a big role in managing president-elect Dilma Rousseff's electoral campaign, means Brazil no longer thinks of itself as apart from the world – or even the region.

Instead, commensurate with growing confidence at home, it believes in multilateralism, the rise of the south, regional integration, and furthering the country's financial and corporate reach.

All this suggests that foreign policy will be no less ambitious under Ms Rousseff, who formally becomes president on January 1 – although it may be less aggressive.

"Without the drive of Lula's international popularity, it is reasonable to expect some deflation of the assertive rhetoric and its repercussions," suggests Brookings scholar Mauricio Cárdenas. Instead, Ms Rousseff's main challenge, after finding her feet at home, will be to find a balance between "a less flamboyant and ideologically driven foreign policy, without seeming to be less ambitious".

Marco Aurélio Garcia: for multilateralism and regional integration

Caution and tough regulation are all-weather assets

Capital markets

The São Paulo exchange is now the second largest in the world by asset value, says **Vincent Bevins**

When Guido Mantega, the finance minister, coined the phrase "currency war" and attempted to stem the tide of capital flowing into Brazil, he was responding to some unexpected consequences of his country's successes.

Not that long ago, it was a much less popular destination for capital.

But Brazil has conquered runaway inflation, is growing quickly, and has some of the most sophisticated and well-regulated capital markets in the developing world, especially for equity.

The BM&FBovespa, the country's multi-asset exchange based in São Paulo, is now the second-largest in the world based on asset value, and is increasingly becoming a regional hub.

Luiz Muniz, head of investment banking for Brazil and Latin America at Rothschild, says: "Capital markets are quite developed. For example, the listing segmentation created by the BM&FBovespa on the basis of levels of corporate governance standards is remarkable."

The segmentation, referred to as the *novo mercado*, groups companies on the Bovespa by the level of corporate governance they have adopted.

Companies can choose to agree to rigorous corporate governance rules, or to sign up to less stringent regulations and list on 'level 1' or 'level 2'. Or they can simply stick to the basic requirements of Brazilian law.

These structures, introduced in 2001, cleverly deployed market forces to bring companies in line with internationally recognised standards, and the dearth of listings and IPOs at the start of the decade turned into a steady stream, that continued even through the crisis of 2008-2009.

As interest rates nosedived in the developed world, Brazil became more attractive. Since March 2009, the Ibovespa, the main stock index, has risen by more than 170 per cent in dollar terms.

According to the exchange, the majority of its market capitalisation, trading volume, and share issuance now involves companies adhering to the highest level of corporate governance standards. One notable exception is Petrobras, and its recent record-breaking $70bn share issue. The national oil company makes no claims about *novo mercado* standards of behaviour.

"The rules and options are clear with segmentation. Issuers know what they should provide in terms of disclosure, economic and governance rights, and investors know what to expect when they're buying *novo mercado*, level 1, 2, or traditional-segment stocks," Mr Muniz says. "Issuers and investors should not be forced in either direction. Our listing segmentation lets the markets price each category and decide what segment will prevail."

The BM&FBovespa's growth has recently been aided by enthusiastic adoption of the newest trading technologies. There are now facilities for co-location, an important tool for the high-frequency trading it promotes and for which offers discounts.

"High-frequency trading now accounts for about 5 per cent of volume," says Cicero Vieira, chief operating officer. "I think that if we reach 15 per cent in one or two years, that would be good for the market."

> The exchange acts as a counterparty in all trades and requires details on each one

The discounts also make it easier to track high-frequency traders, one of a few precautionary measures to alleviate concerns that arose about the practice after the May 6 "flash crash" in the US.

Caution and strict rules have become some of the hallmarks of equity markets in a country that learnt hard lessons from a history of financial crises and instability. This was an asset during 2008-2009, and Brazilian markets remained stable.

Among other rules, the exchange itself acts as a counterparty in all trades and requires detailed information on each one.

For the corporate debt market, the combination of high interest rates and fast growth delivers a mixed bag. Large companies issue debt abroad, where high yields – often more than 5 and 6 per cent for 10- and 30-year bonds – and a relatively low risk profile generate lots of interest.

Locally, though, markets are underdeveloped, and small and medium-sized companies struggle. Though most analysts think that interest rates will come down in the long term, at the moment they give rise to low leverage levels and short maturities for bonds.

"The local corporate market is a bit more short-dated [than abroad], and usually goes up to six years maximum," says Alexandre Aoude, global head of fixed income at Itaú BBA, the wholesale and investment banking unit of Itaú-Unibanco. But there is every reason to believe that history is on the side of Brazil`s debt markets, he says.

"The current environment is so positive in terms of growth, and with new companies coming in the next year, that the market might start shifting to low investment grade companies in the local market. We might start seeing more high yields locally. We're going to follow the path of developed markets."

But the BM&FBovespa is not waiting for anything. Officials are embarking on a three-pronged strategy to grow quickly.

The first is technological updating.

The second is internationalisation. Through the launch of BDRs (Brazilian Depository Receipts, Brazil's answer to ADRs in the US) and a project with Chi-X, the trading platform, investors worldwide will be increasingly able to buy Brazilian stocks in their own currencies.

The idea is go to after individual investors in the US, Europe and Japan who might have heard about opportunities in Brazil.

The third goal is to entice Brazilians to invest.

Dominance of Petrobras may slow development

Oil

Jonathan Wheatley on the effects of the involvement of an enormous state company in the sector

When Petrobras, Brazil's national oil company, raised $70bn in equity in September, it was not only the biggest share issue ever undertaken. It was also an affirmation of the enormous investor interest in Brazil and of its huge potential as an oil producing nation.

Yet the issue also raised concerns about corporate governance at Petrobras and about the role of the state in Brazil's fast growing oil and gas industry.

The industry is undergoing transformational change. Petrobras has overseen the development of the national oil and gas sector for more than half a century, enjoying a monopoly on production and exploration until private sector competition was permitted in the late 1990s.

Petrobras continues to dominate the industry, partly through its privileged position and partly because of world-class expertise in deepwater exploration, acquired as the company pushed further away from the coast into more challenging environments.

It is setting out to test that expertise in the "pre-salt" fields, discovered in 2007 and so called because they are under several kilometres of seawater, rock and a hard-to-penetrate layer of salt.

At the same time it has embarked on an ambitious $224bn investment programme for 2010 to 2014. As well as exploration and production in and outside the pre-salt region, this includes refining, energy generation, biofuels and other activities.

Many analysts think Petrobras will be overstretched, especially because regulations currently before Brazil's congress would make it the sole lead operator in all future consortia working in the pre-salt fields.

"The government is embarking on a route that will clearly lead to a slower pace of development," says Christopher Garman of the Eurasia Group, a consultancy.

"It is limiting development to the operational and financial constraints of a single company. There's a big question as to whether they will be able to attract serious junior partners."

Petrobras says it has all the expertise needed to develop the pre-salt fields alone – and that other companies only want to take part in order to gain access to its proprietary technology.

It also says it is preparing to train 250,000 workers, even giving them basic schooling if necessary.

Petrobras will also be obliged to take a minimum 30 per cent stake in any consortia operating in the pre-salt fields and may have to fund up to 100 per cent at the government's discretion.

And operations will be overseen by a new, 100 per cent state-owned company with a veto over all decisions, including procurement and rates of production.

Some analysts believe Petrobras will quickly run out of funds and be forced to return to capital markets for more equity within two or three years.

Luiz Inácio Lula da Silva, the outgoing president, shows hands dirty with the first "pre-salt" oil extracted AFP

The share issue itself raised other questions. As part of the process, the government sold Petrobras the rights to 5bn barrels of pre-salt oil, for which the government received $42.5bn worth of new shares in the company.

Since the government controls Petrobras – it has a majority of voting stock but a minority of total capital – many investors were concerned about what they said was a conflict of interest, as the government was the biggest party on both sides of the transaction.

Investors also complained about a lack of transparency in the way the price Petrobras paid for the 5bn barrels was arrived at and that the price itself, of $8.51 per barrel, was too high, as it would result in a rate of return similar to Petrobras's cost of funding.

"The net present value of the investment is zero," says one fund manager.

He adds: "Petrobras says that it will make savings through synergies, by using existing platforms already operating nearby, but it still seems to be a lot of effort for little return."

More broadly, investors are concerned that the government used the share issue as a way of gaining greater control. Before the issue, it owned about 40 per cent of the company's total capital. It now owns about 48 per cent.

Taken together with the regulatory changes now before congress, this is seen as a further dilution of the interest of minority shareholders, who still provide the bulk of Petrobras's capital.

The extent of government influence can be seen in the way President Luiz Inácio Lula da Silva has ordered Petrobras to build refineries that analysts say make no commercial sense, arguing it would be cheaper to export crude oil and import refined products.

The government's response is that it is no secret that Petrobras is a public sector company and that if investors do not want to participate, they are under no obligation to do so. Investors reply that they would at least like to know the degree of government influence before taking that decision.

Nevertheless, investors also agree that, compared with many other national oil companies, corporate governance at Petrobras is of a high standard.

And there are no other oil companies in the world, in the private or public sector, with such a huge development project before them.

Governance must reflect global reality

Guest Column
Celso Amorim

A profound adjustment is needed in world governance.

We seem to be stuck with structures similar to those of vast empires of the past, where decisions are taken behind closed doors by a handful of actors, regardless of what wider society has become.

An article published this year by the Financial Times showed that the Bric countries will account for more than 60 per cent of the world's growth from 2008 to 2014.

Emerging and developing economies will create a significantly larger share of global growth. Brazil itself is poised to become the fifth-largest economy by the end of the decade.

A new group of countries has surely earned growing influence on core issues on the international agenda, from climate change to trade, from finance to peace and security.

They bring fresh perspectives and contribute to a new, fairer international balance.

Yet their ability to express legitimate interests, is constrained by global governance structures that are no longer representative.

In a domestic context, such a situation might lead to revolution; in a world with obsolete institutions, it is leading to collateral alliances.

Greater co-ordination in the WTO, the IMF, the UN, as well as new coalitions, such as the Bric, have allowed developing countries to raise their profile.

The Bric grouping has evolved to an effective forum for discussion and co-ordination of international issues, especially those related to the economy.

Two summits have already been held, the first in Ekaterinburg, the second in Brasília. The third is scheduled for 2011 in China, but before that the leaders will meet in Seoul at the margins of the G20.

Although there are differences between members, there is a shared view of the need to improve global governance.

Regional and inter-regional co-ordination among emerging and developing countries is expanding rapidly in Africa, Asia and Latin America and the Caribbean.

Trade and investment patterns have changed to reflect this. So much so, that the definition of peripheral countries has to be continuously reassessed.

Overall these trends represent a welcome evolution, generating more balance. It was the perception of such a scenario several years ago, that prompted Brazilian diplomacy to adjust its course.

The more developing countries discuss and co-operate, the more their voices will be heard.

The memory of a side meeting during the WTO Ministerial in Hong Kong, in 2005, is still vivid for me. We had decided to summon a gathering of developing nations to discuss – and protest against – the subsidies paid by rich countries to their agriculture, to the detriment of poor farmers around the world, in particular cotton growers in Africa.

Quite unexpectedly, more than 100 delegations showed up, eager to tackle one of the most harmful forms of agricultural subsidies.

The "G110", as this group called itself, issued a strong statement urging that export subsidies be eliminated by 2010.

In the event, the Hong Kong Declaration established 2013 as a deadline. As things stand now, we are far from sure this promise will be kept.

But that near-spontaneous movement had a bigger impact on the result of the conference than any behind-the-scenes negotiation.

Another example of "collateral action" was the recent Brazilian-Turkish brokered Tehran Declaration, which made clear that new perspectives and approaches are necessary to solve seemingly intractable problems.

This initiative, essentially the proposal originally made by some permanent members of the Security Council (and ultimately rejected), was brought to fruition by two emerging powers.

The recent financial crisis also made it clear that the world can no longer be run by a club of just a few.

The economic meltdown – from which, not by accident, some emerging economies were essentially spared – represented a "revolution" of some sort, replacing the inoperative G8 with the brisk G20.

The IMF has just increased the voting power of developing nations, thus increasing its legitimacy as well. But change in decision-making structures needs to go beyond the economic sphere.

Barack Obama just announced US support for India's candidacy for a permanent seat in the Security Council.

From finance to peace and security, no sustainable solution to any significant problem can be found if relevant players are not involved.

The idea is simple: representativeness brings legitimacy and thus greater efficacy.

Let us not wait for widespread crises to bring the core institutions of world governance in line with the real world. Let us practice democracy not only domestically but also in the global sphere.

Celso Amorim is Brazil's foreign minister

Slow-floating consumer goods arrive

Retailing

Dom Phillips and **John Paul Rathbone** on novel ways to reach lower income customers

The gaudy blue-painted boat on the muddy River Pará in the Brazilian Amazon looked like something out of *Fitzcaraldo*, the Werner Herzog film about a rubber baron, who at the start of the 20th century drags a steamship over a hill to access a rich rubber-producing territory.

In fact it was an air-conditioned Nestlé "floating supermarket", steaming gently downstream, its immaculate shelves and fridges neatly stacked with 300 of the Swiss company's products.

When the "Terra Grande", docked at the town of Barcarena, a crowd of curious locals flocked on board. Raimunda Pachego says: "It's good to come here to the town, but they need to go to the remote communities. The cost of goods there is a lot more."

In fact, that is just what the boat will do. Nestlé says it will serve 18 remote communities from its home port of Belém, in north-eastern Brazil.

More than 30m Brazilians have risen from poverty over the past decade and the Terra Grande is part of a general push by fast-moving consumer goods companies to expand their reach to less well-heeled but upwardly-mobile consumers – both in and far beyond the main cities.

At a cost of R$1m ($590,000), however, it is an expensive investment – and not one that will necessarily generate much return.

"I don't want to say whether we will make a profit," says Alexandre Costa, Nestlé director for regionalisation. "But it will give us customer feedback."

Over the past decade, many consumer goods companies have thrived by serving the rising "middle classes" – families earning between R$1,115 and R$4,807 ($660-$2,800) a month and who last year became the majority for the first time.

To penetrate this market more deeply, some companies have started offering free samples in upmarket areas of big cities, as a way to test consumer tastes, create ties with them and "pre-launch" or redesign their products.

Companies such as Unilver, Brazil Foods, and AmBev, a brewer, have all joined in with this "try-vertising".

Because of rising prosperity, however, many are also turning their attention to lower-income groups.

Over the past six years, the annual growth in income of the bottom 30 per cent of the population has exceeded 9 per cent, while the top 30 per cent has grown at half that rate.

Cláudio Felisoni, president of the Fundação Instituto de Administração, a business school, believes the increasing availability of credit to low-income groups is a key factor.

Official data show the household debt-to-income ratio rose to 35 per cent last year, from 18 per cent at the beginning of 2005.

Prof Felisoni's research in São Paulo found 70 per cent of low earners own mobile telephones and 55 per cent have credit cards.

> 'I don't want to say whether we will make a profit . . . But it will give us customer feedback'

Three big retailers, Pão de Açúcar, Carrefour and Walmart, are boosting their investment in businesses and strategies aimed at the lower-middle classes.

McDonald's is also investing. It announced this year it was focusing on "Minas Gerais and the states of the north and north-east." The north and north-east are the poorest of the country's five regions.

In the Amazon, Bradesco, a big bank, last December launched a floating outlet on the River Solomões, that sails between Tabatinga and Manaus.

However, the Terra Grande is Brazil's first floating shop.

Nestlé says the country's C, D and E social classes – the "bottom of the pyramid", or BOP – comprise 157m people who account for 72 per cent of food consumption.

"BOP is the market, not simply a segment," says Mr Costa. In 2006 Nestlé launched its *Porta-a-Porta* door-to-door project, using housewives as freelance sales reps. Today, 7,500 *revendedores* – resellers – earn R$750 a month from it, and are forecast to visit 3.2m homes this year.

Nestlé has been in Brazil for almost 90 years. As the economy continues to grow quickly – the current growth rate is 7 per cent year-on-year – the company is hoping rising incomes among the poor will bring its higher priced goods within their reach.

If the economy keeps on performing, this seems a safe bet. While 32m have moved up from the lower D and E classes over the past seven years, another 36m could follow in the next four, forecasts the Getúlio Vargas Foundation, a think tank.

The Terra Grande only sells Nestlé products, and the absence of staples such as rice, beans and chicken, not to mention the dearth of fresh fruit or vegetables, would make it hard to cook a full meal after shopping there.

Nevertheless, at Barcarena, as it prepares to leave, local encyclopedia salesman Luzeilton Costa enthuses. "The idea is really cool," he says. "Today, you have to innovate and go after the customer."

Stricter rules lure back western companies

Pharmaceuticals

A tighter patent regime and requirements for generic drugs make the market more attractive, writes **Andrew Jack**

Three decades after they quit Brazil, western pharmaceutical companies are rushing back to expand and make acquisitions, just as domestic groups begin to consolidate and spread abroad.

In the 1980s, many multinationals left, driven out by high inflation, tough price controls, and weak intellectual property rules.

They signed distribution deals with local companies, but also saw market share taken by "*similares*" – drugs containing ingredients similar to original products but often without rigorous testing to demonstrate they are identical in composition and effect.

Now the environment has changed. Since the mid 1990s, patent rules and regulatory requirements for generic drugs have become stricter.

A tougher attitude by Anvisa, the national drug regulator, has imposed "bioequivalence" measures; while new auditing requirements are reducing the discretionary ability of pharmacies to sell prescription drugs or substitutes over the counter.

Such measures are likely further to reduce the scope for *similares* by 2013, as a clearer distinction between patented and generic products – already familiar in the west – emerges.

The changes are luring western companies back, just as growth in their established more developed markets is slowing and they see the need to expand geographically to maintain momentum.

While sales are coming largely without any reimbursement from state or private health insurance, the rapid growth in the middle class – and the increasing number of pharmacies to meet demand – is stoking expansion that has turned the country into the eighth largest drug market in the world by sales.

With the authorities keen to encourage domestic production, Novo Nordisk was an early mover with its purchase in 2001 of Biobrás, a large insulin production plant outside São Paulo.

A more eye-catching recent buying spree began last year when Sanofi-Aventis of France acquired Medley, boosting its portfolio of over-the-counter and branded products to complement its own innovative and "mature" offerings.

Last month, Pfizer of the US bought 40 per cent of Teuto, another generics business; and other US, European and Japanese companies are studying the market closely.

Some have so far held back from acquisitions, but are investing internally: AstraZeneca, for example, is gearing up for the launch of a series of products combining its own drugs with others that are already off-patent.

> The increasing number of pharmacies to meet middle class demand is stoking expansion

Meanwhile, national groups have not been dormant. Aché, a family owned group and one of Brazil's largest branded generics producers, has made smaller domestic acquisitions, and was considering buying Medley.

It has also begun forging alliances across Latin America, while its rival Eurofarma earlier this year bought Laboratorios Gautier in Uruguay, as the groups seek economies of scale in manufacturing and sales across the region.

Even Farmaguinhos, the state-owned drug company, has been co-operating with Mozambique.

Domestic research and development still remains in its infancy, although government research units such as the Butantan Institute in São Paulo and Oswaldo Cruz in Rio de Janeiro are involved in international scientific collaborations and technology transfer.

The question is whether their commercial peers will be able to take up the slack before they are acquired by western groups keen to return to Brazil.

Farmaguinhos, the state-owned drug company, has been co-operating with Mozambique

Best-selling drugs List gives picture of nation's health worries

By its medicines, you shall know the country.

Brazil's list of top-selling drugs reveals much about national preferences and the state of the healthcare sector alike.

Two "lifestyle" drugs – Viagra and Cialis for erectile dysfunction – are among the leading 10 products sold, outstripping their popularity in many other countries, according to data from IMS, the healthcare consultancy.

The more familiar high-ranking presence of Lipitor and Crestor to lower cholesterol and Co-Diovan to reduce blood pressure highlight how far infectious diseases have been displaced as a heavy healthcare burden. Their place has been taken by chronic "lifestyle" conditions – only too familiar in western countries – that affect the wealthier but ageing population.

Other patented drugs that would typically be among the top-sellers in many countries are absent.

That reflects restricted access in Brazil to more costly innovative therapies, because few drugs are reimbursed by the state or even private insurers. Most are bought "out-of-pocket" by patients.

The best-selling product on the IMS list is Dorflex, an over-the-counter muscle relaxant and painkiller; Neosaldina, a similar product, and paracetamol, are also among the top 10.

The first two both contain metamizole, which is not used in other countries, including the US, where it was banned long ago because of a rare side effect called agranulocytosis – where the body does not make enough white blood cells.

Sanofi-Aventis, which makes Dorflex, stresses that Latin American regulators have reviewed the drug and considered the benefits outweigh the risks.

Not that the IMS numbers are perfect. Like those in other emerging markets, the data cannot always pick up the nuances of a fragmented system that includes substantial over-the-counter sales of drugs which are officially available on prescription only.

Andrew Jack

Wealth is still unevenly distributed

Race

Afro-Brazilians generally earn half as much as whites, says **Amy Stillman**

Edilson Sergio Goulari is not the first student to worry about his career prospects when he leaves university. But in Brazil's booming economy, it is not a lack of jobs that concerns him. Surprisingly for a country that casts itself as a "melting pot", it is the colour of his skin.

"I try not to think about it," says the black 26-year old, referring to the paucity of Afro-Brazilian stock market analysts – his chosen career. "I try to have the mindset that when I look for a job I will be judged by my professional skills, not my skin colour."

Like the US, Brazil has significant minority black, indigenous and immigrant populations. Unlike the US, Brazilians rarely classify themselves by their race. In a 2009 survey, 44 per cent of the population simply described themselves as mixed.

Even so, Mr Goulari has already been judged on his race – attaining a place at Rio's State University (UERJ) through a quota system that reserves 20 per cent of places for black students.

Many Brazilians take pride in their multiracial society and some argue racism is absent. But the experience of blacks trying to progress professionally tells a different story – something also reflected in social indicators.

UERJ, for example, began its affirmative action policy in 2003. Since then, more than 1,000 academic institutions have followed suit. But the policy has sparked a furore, with some universities facing court proceedings, the most notable being a Supreme Court case against the Federal University of Brasília.

Critics argue that positive discrimination flouts the country's racially-blind constitution. Since slavery was banned in 1888, laws have been racially neutral. Furthermore, because few people define themselves as black or white, positive discrimination can create difficult shades of grey.

"In Brazil you see people of all colours together at football games, music events, and on the streets," says Simon Schwartzman a researcher at the Institute of Work and Society Studies in Rio. "Race-based affirmative action imposes racial classification and divisions where they didn't exist before."

The country is certainly racially diverse, with 25m people of Italian descent, 10m German, and more than 10m Lebanese. There are also more Japanese in São Paulo than any other city outside Japan and, because of the history of slavery, more people of African descent than any country besides Nigeria.

But this diverse mix belies a more black-and-white economic reality: Afro-Brazilians generally earn half as much as whites. They have on average three years less schooling, and account for two-thirds of those living below the poverty line.

Allyne Andrade, a young black lawyer, says: "Brazil is mixed, yes, but to be a black person in a high position is very difficult. People are surprised if you are very smart; they treat you like an alien."

Brazil's first and only Afro-Brazilian senator, Paulo Paim, believes affirmative action is the best way to redress a history of social wrongs that began with slavery and was then masked by what some call "the myth of racial democracy".

"To become a truly equal society, it is necessary to treat unequals unequally," he says. Such was the thinking behind the Racial Equality Statute created by Mr Paim, passed by Congress in June and which may affect the proceedings against the University of Brasília.

Wilson Prudente, a public prosecutor, says: "The statute endorses the need for policies that address social inequalities for blacks at the highest level, making it more difficult for the Supreme Court to rule that the quotas are unconstitutional."

However, some universities now question whether racial quotas mask a deeper problem in the education system: the notoriously poor quality of state schools. These have a higher number of black students, as their families typically cannot afford private education.

> 'Brazil is mixed, yes, but to be a black person in a high position is very difficult'

"The teaching in state schools is so bad that students do not even attempt the university entrance examination," says professor Ericksson Rocha e Almendra, director of the Polytechnic School of Rio's Federal University. UFRJ recently opted for social quotas rather than racial quotas – reserving 20 per cent of its places for public school students.

The country has few models to follow. Mr Paim's statute was inspired by the South African Freedom Charter. However, South Africa's policy of affirmative action has had mixed results, with complaints that jobs were being filled by poorly trained candidates.

The US is also held up as an example. However, Brazil never had Jim Crow segregation laws. It also has a much larger black population. And then there are the practicalities: in a mixed society, who counts as black?

"We must find a model that meets Brazil's reality," says Pablo Gentilli, a rights activist.

It will be a tricky task, but then Latin America's biggest and most racially mixed country is accustomed to inventing its own way.

Politics and finance hold up projects

Infrastructure

Vincent Bevins says the BNDES development bank has been an important lifeline

One thing politicians, economists and business leaders all seem to agree on in Brazil is that the country is in urgent need of infrastructure expansion.

Ships can be backed up at ports for weeks. Only a small proportion of roads are paved, imposing heavy costs on the industries that must use them to move goods for export. For the fast-growing soya export industry, it often costs more to get the product to the coast than to complete the journey overseas.

The roads in the densely populated south-eastern corridor choke up rather quickly, especially in busy periods. Business or holiday travellers can de delayed for hours, and some super-rich commuters in São Paulo famously avoid the problem by relying on private helicopters.

The state of airport infrastructure is also troubling, especially as Brazil waits to welcome the world on two big occasions: the football World Cup in 2014 and the Olympic Games in Rio de Janeiro in 2016.

In many poor neighbourhoods, lack of electricity, housing, or water treatment keeps millions excluded from the public welfare benefits of growth.

There is broad agreement about the need to improve infrastructure but a huge amount to be done. "Studies indicate that countries growing like ours need to invest between 4 and 5 per cent of GDP [on infrastructure] for decades, says João Teixeira, executive vice-president at Santander Brazil. "We've been doing just 1-2 per cent. If you travel around Brazil, this discrepancy becomes obvious."

Addressing this has been moved to the political foreground by the administration of outgoing President Luiz Inácio Lula da Silva and president-elect Dilma Rousseff.

In 2007, the government announced its Pac (Accelerated Growth Programme), that promised spending of R$504bn ($302bn) on housing, electricity generation, highways and a host of other infrastructure essentials. The total was later revised upwards to R$638bn. Then, Mr Lula da Silva and Ms Rousseff unrolled Pac II: R$959bn for 2011 to 2014, Ms Rousseff 's term in office.

Mr Lula da Silva dubbed Ms Rousseff "the mother of the Pac" and her involvement featured often in her presidential campaign.

But despite the programme's achievements – delivering jobs, housing and better lives for many people living in the favelas, or shanty towns – many of the planned projects remain incomplete.

Generally, the Pac efforts have come up short for two main reasons.

The first is politics. Some of the plans require privatisations, redistribution of authority or co-operation with agencies and local governments – all tricky, especially in an election year.

"Privatisation is a very dirty word in an election year", says David Fleischer, professor of political science at the University of Brasília. "In 2006, Lula used the claim that [his opponent Geraldo] Alckmin would privatise everything to help him win," he says. "And this year, we saw similar accusations between Dilma and [rival candidate José] Serra."

> It is unlikely there is enough capital in the country to fund its long-term needs

Many analysts believe Ms Rousseff is willing to press forward with privatisations, especially for roads. But she may face opposition from the left wing of her Worker's Party. On other issues, confronting government agencies, bureaucrats and incumbents will be a test of her political acumen.

The second big problem is finance.

Because the country has some of the highest real interest rates in the world so as to avoid inflation, private banks cannot afford to finance big long-term infrastructure projects.

As a result, developments rely heavily on the BNDES, the national development bank, to extend credit at lower rates.

BNDES is sometimes criticised for distorting credit markets with subsidised rates or being subject to political influence, but it has been a lifeline for big long-term projects.

Wagner Bittencourt de Oliveira, director of infrastructure and project organisation at the bank, denies that rates are subsidised or distorting and says the bank is eager to facilitate private sector participation.

"Over the past few years, the private sector has increased participation – but in small terms and at higher spreads", he says. "A small amount of involvement from BNDES will bring in a lot of private investment."

Most bankers and analysts believe that interest rates will come down in the long term, as the country moves away from its hyper-inflationary past, and this will bring increased private sector participation.

It is unlikely there is enough capital available in the country to fund its long-term needs. Foreign investment will also be necessary. Private-public partnerships, when cleverly executed, have been useful for bringing private money into projects.

Eike Batista, an entrepreneur and Brazil's richest man, has used the country's equity markets to fund private infrastructure projects for his empire of companies.

But the heaviest weight will fall on the government to make projects happen – that is, for the "mother of the Pac" to live up to her nickname.

The problem of violence no longer seems intractable

Crime

Louis Amis finds that new approaches to policing are making a difference

When Sergio Cabral took office as governor of Rio de Janeiro state in January 2007, one of his priorities was security at the Pan American Games that summer.

Bowing to then-accepted wisdom, Mr Cabral launched a "mega-operation": 1,350 military police were sent into the Complexo do Alemão, one of Rio's largest and most violent favelas (shanty towns) and the hub of the city's most powerful drug gang, the Comando Vermelho, or Red Command.

The goal was to repress this small number of heavily armed drug-traffickers, who ruled over the slum's 160,000 inhabitants. But the result was typical. Some 44 people were killed, at least 11 of whom had no connection to the drug trade, and when the police withdrew the gang resumed their usual business.

Mr Cabral has changed some of his ideas since that ill-fated operation. After all, Rio is the public face of Brazil. And with the football World Cup in 2014 and the Olympic Games in 2016, the pressure is rising again to improve public security.

In supposedly drug-torn Mexico, for example, the homicide rate is about 14 per 100,000 inhabitants. In Brazil, it is 25, in Rio 35 and in the north-east area of Recife, almost 100.

One turning point came for Mr Cabral after he made a trip to Colombia in 2007, to observe the gains in public security made in Medellín and Bogotá through a combination of tough policing and large-scale public spending.

On his return, Mr Cabral obtained a $1.7bn federal commitment to "urbanise" a number of Rio's most deprived favelas, including the Complexo do Alemão.

A project, called police pacification units, or UPPs, was also begun, under the direction of José Mariano Beltrame, public security secretary.

Aggressive, temporary incursions have been replaced in 13 favelas by a permanent military police presence, staffed by recruits who receive R$500 ($300) bonuses a month. By 2014, 12,500 officers will be deployed in 40 UPPs.

The results so far have been overwhelmingly positive. Rio's favelas have become relatively peaceful and monthly crime statistics have fallen significantly. Most importantly, favela residents are being won over.

"This would have never been possible before," says Álvaro Maciel Júnior of an outdoor evening movie club, linked to a local youth centre that he co-ordinates in Babilônia, a Rio favela pacified in July.

Sergio Cabral, Rio governor, was inspired by security ideas from a trip to Colombia

Free IT and foreign language classes are also available at the youth centre. In gang-controlled favelas, by contrast, groups of aloof teenagers preside over public spaces, machine-guns slung over their shoulders.

"I don't think anyone particularly likes being in the presence of the police. But people here can see the positive effects, and want the UPP to stay," Mr Júnior adds.

"People no longer accept violence. We still have drug-dealers, but now they would be ostracised if they brought out a weapon."

Of course there is great scepticism. In addition to drug gangs, militias made up of ex- and off-duty police and firefighters have sprung up.

A UN study this May was the latest to show how extra-judicial killings, torture and extortion are widespread among police forces and in the overcrowded prison system.

As well as being badly-trained, underpaid, and often outgunned, the police are also often corrupt.

Indeed, the new militias are thought to control 40 per cent of Rio's favelas, with various rackets and their own brutal justice. Some say the recent reduction in crime owes as much to their rise as it does to the very small number of UPPs.

Another cause for concern is that the most dangerous favelas, such as Complexo do Alemão, have not been properly dealt with.

"There may be problems if they [the traffickers] come to the conclusion that they are too strong for the military police there," says Alba Zaluar, co-ordinator of the Centre for Research on Violence at Rio de Janeiro State University.

The most common suspicion is that the UPPs are only intended for favelas near tourist areas, and that they will disappear after the Olympics. It is true that the project has guaranteed finance only until 2016. But Mr Beltrame is bullish. "Residents and society in general will not want to return to the old ways," he says. "The achievement is already irreversible."

For decades, the problem of violence in Brazil seemed intractable. But the UPPs are not Brazil's only security initiative to enjoy success.

In Pernambuco state in the north-east a comprehensive scheme called Pacto Pela Vida, or covenant for peace, which includes police and prison reform as well as social programmes, has greatly reduced murder rates. Similar projects are appearing elsewhere.

Such projects offer more than glimmers of hope – they appear to be gaining momentum.

Evidence of new self-confidence is everywhere

High society: São Paulo, the commercial and financial capital Getty

State of the nation

Richard Lapper says the country is much more than a simple commodity story

Visit São Paulo or Rio de Janeiro these days and signs of new-found prosperity and confidence are everywhere. Popular upmarket restaurants are now so costly they make the trendy eateries of London or New York look good value.

In the *bairros nobres* – the desirable property developments loved by Brazilian buyers – prices are surging upwards.

Poorer people too are walking with more of a spring in their step.

Falling unemployment and rising wages mean the middle class – just like their British or US equivalents of a century ago – has a something of a "servant problem". A good *empregada* (maid) or a reliable builder is much more expensive than a couple of years ago.

At first glance there seems to be something of a bubble about all this. Certainly, the real – which has appreciated this year against the US dollar by a staggering 40 per cent – looks overvalued, especially considering the recent deterioration of Brazil's external accounts and the scale of portfolio inflows attracted by the high interest rates.

And yet there is every reason to think that Brazil's emergence can be sustained. Its comparative advantage as a producer of minerals, food and other agricultural products is formidable.

Rising commodity prices mean the terms of trade are still running in its favour. The strength of the resource base will become even more pronounced when the so-called pre-salt oilfields off the coast come on stream.

But Brazil is much more than a commodity story or a derivative play on China, whose deficits of soy and iron ore are perfectly complemented by Brazil's surpluses.

China's expansion at the beginning of the 2000s may have served to trigger forward momentum, but Brazil's rise now is being sustained by big shifts in the domestic economy and in particular by the rise of new urban middle and working class consumers: groups that Brazilians habitually label the Cs and the Ds.

Former President Fernando Henrique Cardoso can take some of the credit for this. He championed policies that put an end to decades of chronic – and occasionally hyper- – inflation.

But if Mr Cardoso made a market possible, it is President Luiz Inácio Lula da Silva who has helped inject demand into it. His government has done that by introducing a minimum wage policy and radically extending the reach of *bolsa familia*, the conditional social grant that now benefits more than 12m families.

> Over the past five years, the capital market boom has prompted companies to formalise

There has also been a big increase in the number of formal jobs, with the annual rate of new positions doubling over the past six years.

In the first eight months of this year, 1.93m jobs were created – a record-breaking increase. Again, Mr Lula da Silva has contributed directly by adding to the public sector payroll.

However, analysts suggest a more profound and sustainable process has also been at work. This has changed employment practices in the private sector.

In some senses this is surprising. The business environment is highly regulated. It can be expensive for start-ups to register, complicated and time-consuming to pay tax and onerously costly to employ workers.

In its most recent annual ease of doing business survey, the International Finance Corporation classifies conditions in Brazil as among the world's most difficult.

Yet, over the past five years, the country's capital market boom has prompted Brazilian companies to formalise. With excitement about growth prospects increasing, many have found investors more than willing to value their businesses at a multiple of their paper value.

The potential money available from a successful initial public offering or an issue of debentures or corporate bonds far outstrips the savings from tax avoidance.

Formalisation has therefore become attractive and hundreds of companies have opened their books to scrutiny from investors, even if that means coming clean with the tax authorities.

The effect of these trends, documented by Marcelo Neri, a professor at the Getúlio Vargas Business School, has increased the size of the C income quintile – households whose incomes range from R$1,126 to R$4,854 ($660-$2,900) a month – by 29.1m since 2003.

Seven years ago As, Bs and Cs accounted for 37.9 per cent of the population.

By last year, 61.1 per cent – a sizeable majority of the population – were members of those better-off income groups, a shift that has boosted demand for products from cell phones to health insurance. Mr Neri estimates that more than 20m people have escaped poverty over the past seven years.

Add to this the prospect of higher infrastructure spending – current outlays amount to only 2 per cent of GDP – linked to the 2014 football World Cup and the 2016 Olympic Games and Brazil's rise definitely seems to have staying power.

Richard Lapper is editor of Brazil Confidential, a new FT electronic newsletter and premium research service to be launched early in 2011

Forest code must be fixed

Guest Column
DAVID CLEARY

The incoming government in 2011 will be very aware of the 20 per cent of the vote that Marina Silva of the Green Party won in the first round of the presidential election.

No government can ignore Ms Silva's better educated and more affluent voters without paying a high political price. Politicians of left and right usually emphasise development over conservation; much hangs on whether a more nuanced view can prevail.

Outsiders obsess about the Amazon, but environmental issues go well beyond the rainforest. The rise of agriculture has occurred largely in the Cerrado, a biodiverse savannah in the centre of the country that is now the world's largest and most dynamic agricultural frontier.

Newly discovered oil deposits lie off one of the most spectacular coastlines in the world, and the BP disaster in the Gulf of Mexico was a sobering reminder of what can go wrong.

Even in the Amazon, where deforestation reached record lows in the past two burning seasons, a deforestation spike looks likely in 2011 reflecting Brazil's rapid recovery from recession.

On paper, environmental advances were one of Mr Lula da Silva's many achievements. The country produced its first detailed climate action plan in 2008, with targets for reducing deforestation, its main source of carbon emissions, in the Cerrado as well as the Amazon.

Biofuels, expanding almost entirely on pasture and cropland rather than native habitat, along with an energy matrix where hydroelectricity figures prominently, mean Brazil has a much lower transport and industrial carbon footprint than comparable economies.

Protected land systems, especially in the Amazon, were expanding, while illegal logging declined. Sophisticated compensation schemes channelled oil and other royalties towards good environmental causes.

Yet Ms Silva won the environmental vote. Why?

It was largely because of a controversy over reforming Brazil's Forest Code, which lays out the environmental obligations of farmers and ranchers.

It is rigorous by international standards, forcing rural properties to keep set percentages of land as native habitat.

More often ignored than observed, it nevertheless provided a compliance framework and recent advances in satellite monitoring and concern about deforestation were giving it traction.

Heavy government investment in CAR – the Rural Environmental Registry – is extending satellite monitoring of deforestation on individual farms and ranches to more than 100 municipalities in the Amazon and Cerrado over the next two years, a big step in increasing governance on the steadily less chaotic frontiers.

The reaction from some sections of the farm lobby to more effective regulation was to attempt to gut the code. Proposed reforms effectively abolished most environmental requirements and gave deforesters amnesty.

The issue caused a political firestorm in the run-up to the election, until it was deferred.

If approved in its present form the code will ride roughshod over carbon emission targets and be exploited by agricultural competitors. A workable compromise is the most serious environmental challenge for the next administration.

In the longer term, Brazil must move from theory to practice. Its many excellent research institutes have long argued that agricultural expansion should proceed by converting millions of hectares of under-exploited pasture in the Cerrado and the Amazon, not forests and grasslands.

Abundant forests and high biodiversity mean it is uniquely placed to dominate markets in carbon and other environmental services – but this dominance remains in the future.

A new Amazon Fund, financed by a $1bn donation from the Norwegian government and administered by the national development bank, the BNDES, has the potential to transform funding and is giving the environment ministry new clout.

Yet countervailing forces are strong. The same BNDES funnelled a staggering R$10bn ($6bn) into three large beef companies, JBS, Bertin and Marfrig, between 2008 and 2010, unsurprisingly expanding the cattle frontier in the process.

It is yet to enforce effectively its regulations on lending to the beef sector. Boycotting the Amazon only shifts habitat conversion to the Cerrado.

Consumers – 75 per cent of Brazilian beef consumption is domestic – are not yet as demanding on environmental issues as those in western Europe.

Most agribusiness companies have also not yet grasped the potential of monitoring technologies for transforming the carbon footprint of commodity production.

Still, as Ms Silva demonstrated, change is in the air.

David Cleary is director of sustainable harvests, Latin America, for the The Nature Conservancy.