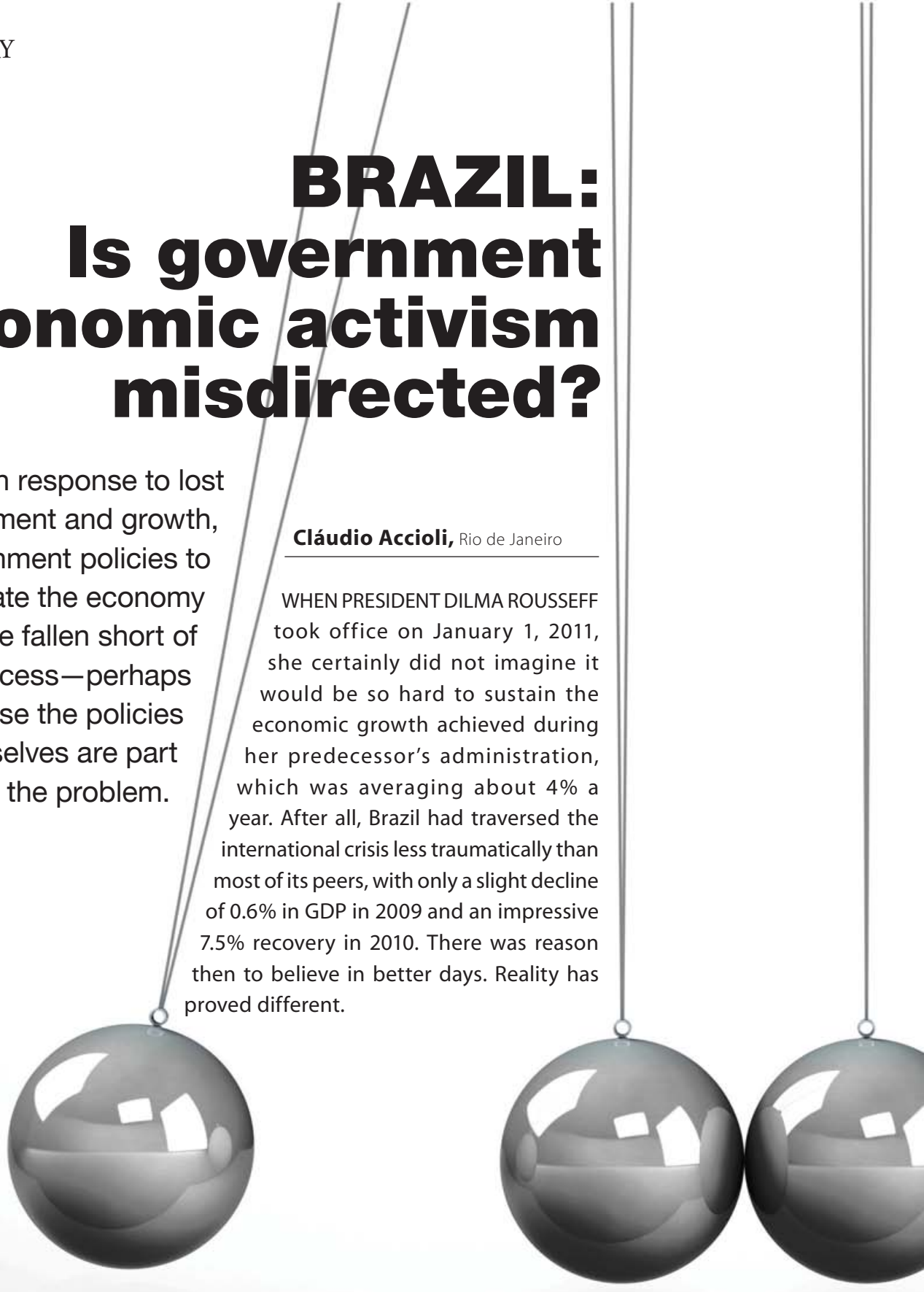
BRAZIL: Is government economic activism misdirected?

In response to lost investment and growth, government policies to stimulate the economy have fallen short of success—perhaps because the policies themselves are part of the problem.

Cláudio Accioli, Rio de Janeiro

WHEN PRESIDENT DILMA ROUSSEFF took office on January 1, 2011, she certainly did not imagine it would be so hard to sustain the economic growth achieved during her predecessor's administration, which was averaging about 4% a year. After all, Brazil had traversed the international crisis less traumatically than most of its peers, with only a slight decline of 0.6% in GDP in 2009 and an impressive 7.5% recovery in 2010. There was reason then to believe in better days. Reality has proved different.



Despite government action to boost consumption and economic activity—cuts in interest rates to historic lows and tax breaks for certain industries—Brazil's growth rates have been disappointing, mainly because investments have been sinking. They closed 2012 with a drop of 4%.

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There is no shortage of attempts to explain the anemic economy, for example, the Brazil cost, the difficult business environment, the inventory adjustment cycle, the lagged positive effects of loose monetary policy. The newest hypothesis to gain credence, however, is that government's policy activism to revive investment and growth has created uncertainty. The policy has become part of the problem.

In May 2012, the *IBRE Letter* warned against the government being tempted to micromanage the economy. It distinguished between systemic measures, such as reducing the benchmark interest rate, which can benefit the whole economy, and actions intended to benefit specific sectors, such as exchange rate interventions, control of fuel prices, changing taxes on credit and financial flows, credit subsidies, barriers (tariff and nontariff) to foreign trade, and sectoral tax exemptions.

As the *IBRE Letter* said a year ago, each discretionary benefit given to one sector generates side effects. Often the next discretionary measure has to attempt to correct damage done by the previous one. When the government sends confusing signals to the market, businesspeople become more defensive, and less inclined to invest. If this hypothesis is true, the medicine may be aggravating the disease. Micromanaging the economy and showing favoritism to this or that sector intensifies the loss of competitiveness and profitability of the economy as a whole.

REALITY CHECK

Marcelo Salomon, chief economist for Latin America at Barclays Bank, not only agrees with the hypothesis but has the numbers to validate it. In a recent Barclays study,[1] Salomon and economist Guilherme Loureiro identified a structural break in Brazil's fixed investment growth as a major cause of the poor performance of the Brazilian economy. They found that fixed investments began dropping when the government began to intensify protectionist measures and incentives to industry in early 2012.

"Based on the evolution of investment growth in Brazil since 2003, we did two simulations for [fixed investment] in 2012, based on a simple regression model . . . . The simulations suggest that without the uncertainty, actual investment would have grown more than 6% in 2012, reaching almost 20% of GDP," says Salomon. The exercise also shows that in 2012 uncertainty reduced economic growth

[1] Marcelo Salomon and Guilherme Loureiro, "Brazil: Structural break in fixed-investment leading to stagflation?" BARCLAYS Emerging Markets Research, January 18, 2013.

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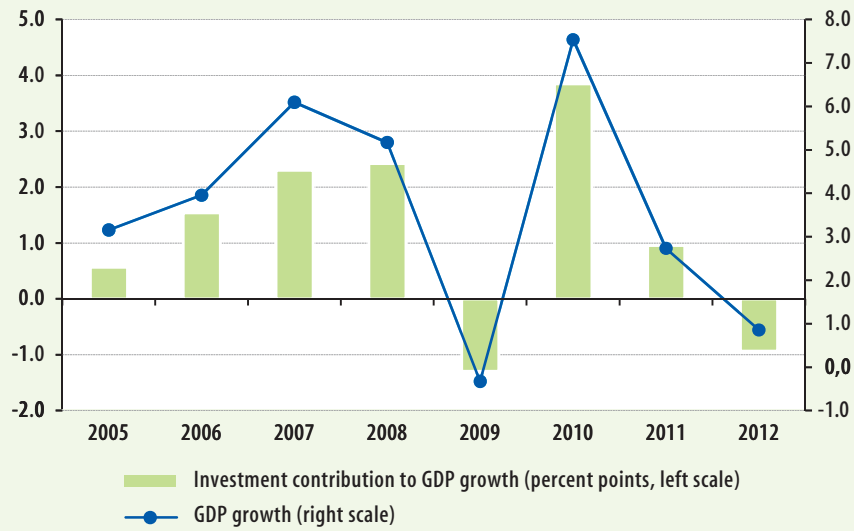
by 2.1 percentage points (US$45 billion), which means that Brazil's GDP could have grown 3% rather than its meager 0.9%.

The Barclays study compares Brazil's investment growth with that of Argentina, Chile, Colombia, Mexico, and Peru, weighted by GDP. It found that fixed investment in Brazil recovered from the 2009 crisis faster than in other countries in the region, probably because of the favorable outlook: at the time for economic growth in 2010. But then investments in Brazil took a sharp downward turn, underperforming the rest of the region.

According to Salomon, the poor performance of the Brazilian economy cannot be attributed to the international crisis alone. "While part of the blame has fallen on the global scenario," he says, "other Latin American economies, which suffer from the same uncertainties, are experiencing much higher and more stable growth . . . We believe that the problem is the structural break in fixed investments caused by government interventionism."

According to the Barclays study, in recent years, Brazil has adopted over 20 measures to stimulate economic activity and two score capital controls. "The heavy emphasis on short-term growth has limited the government's ability to tackle structural problems. The lack of a consistent long-term strategy to address infrastructure deficiencies and stimulate private investment is also taking a toll on productivity and growth," the study says.

Brazil's low fixed investment growth is a major cause of poor growth of the economy.



Sources: IBGE and Barclays.

SENSE OF URGENCY

The government seems pressed for time to recover lost ground. IBRE economist Silvia Matos says, "It was expected that investment would react

to the measures to stimulate activity, especially the significant cut in the benchmark interest rate. But there was no clear [investment recovery]. Given this adverse scenario, the government started looking at the economy with a magnifying glass and taking local measures. The question is how to do it without killing investor animal spirits."

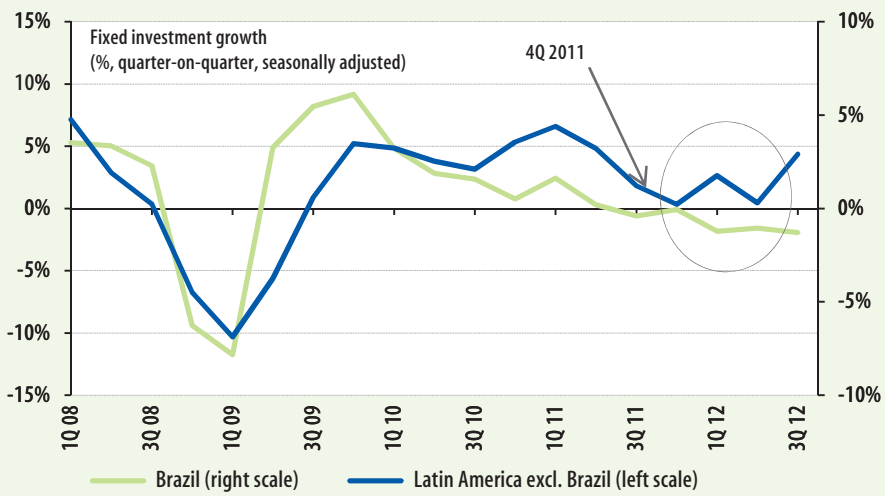
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Similarly, Marcos Lisboa, executive director of the Institute of Education and Research (Insper) and Secretary of Economic Policy in the first Lula administration, distinguishes between the problems to be faced and the government strategy for solving them. As he explains, "On the one hand, Brazil has become a country where it is increasingly difficult to invest and produce. It is difficult to import goods, construct a building or a dam, because the authorization processes are complex, often with overlapping agencies. This leads to uneven behavior, penalizing sectors that are more dependent on fixed investment, such as industry, while those less dependent [on fixed capital], such as services and commerce, keep growing and hiring large numbers of workers. This is the structural side of the story. The other side concerns the way to tackle this situation."

Lisboa thinks it is understandable, although not the most appropriate option, that the government is trying to find short-term solutions to persistent problems: "The government has sought through ad hoc measures to reduce the costs of some services or improve conditions for investment. The problem is that sometimes what we imagine as protection or encouragement to one sector of the economy ends up burdening some other productive sector, where it becomes a disincentive to new investments."

"The great risk of micromanagement is the loss of efficiency in the economy. A problem is addressed, often inefficiently,

Fixed investment in Brazil has underperformed the rest of Latin America since 2010.



Sources: Haver Analytics and Barclays.

Measures to stimulate growth

2010

Dec. 3 The Central Bank introduces macro-prudential measures to safeguard the financial system. It raises bank reserve requirements, increases capital requirements for household credit operations with more than 24 months of maturity, and increases the minimum deposit guaranteed by the Guaranty Fund for Credits (FGC).

Dec. 16 The government grants incentives to foster infrastructure project investments, including tax incentives for long-term corporate bonds to finance infrastructure projects, and the creation of a fund to stimulate liquidity of those bonds in the secondary market. The National Bank for Economic and Social Development (BNDES) is allowed to issue bonds to reduce its dependence on National Treasury funding.

2011

Apr. 7 To contain domestic household credit expansion, the Central Bank doubles the Tax on Financial Transactions (IOF) levied on household credit to 3.0%.

Sep. 16 The government raises the Tax on Industrial Products (IPI) on imported vehicles that do not meet the new requirements of domestic content.

Nov. 14 The Central Bank eliminates some of the increases in capital requirements for new consumer loans.

Dec. 1 The government lowers the IOF tax on household credit from 3.0% to 2.5% and reduced the IPI tax on home appliances.

2012

Apr. 3 The government announces: A reduction from 20% to 0% of the social security contribution on payroll for 15 sectors of the economy; a new BNDES capitalization totaling R$45 billion, or 1.0% GDP, more resources for the export financing program; a higher PIS/Cofins social contribution tax on imports, and public sector purchase rule prioritizing domestic goods and services.

May 4 Government changes saving account interest rate rules to give room for the Central Bank to cut its policy rates below 8.5%.

May 21 To stimulate growth, the Central Bank reduces bank reserve requirements to free resources to finance auto loans, the government cuts taxes on new autos and lowers the IOF on car loans, and the BNDES establishes a credit line for investments.

Jun. 27 The government allocates R$8.4 billion (US$4.2 billion) to accelerate the government purchase of goods, favoring domestic industry.

Aug. 15 The government announces the first part of a broad infra-structure investment program to attract private sector investments in toll roads and railroads.

Aug. 29 The government extends the IPI tax cut on vehicles until the end of 2012.

Sep. 4 The government announces an import tariff hike on a list of 100 products.

Sep. 7 The government announces a cut in energy prices for both industrial and consumption segments for next year.

Sep. 17 The Central Bank cuts bank reserve requirements to boost inter-bank liquidity.

Dec 7 The government announces new rules for port concessions in Brazil.

Dec. 19 The government extends the IPI tax cut on vehicles, appliances and furniture until June 2013. This tax cut will be gradually phased out thereafter. It extends the payroll tax cut to all retail sectors after April 2013.

Dec. 20 The government announces the third part of a broad infrastructure investment program, including the privatization of Rio de Janeiro Galeão and Minas Gerais Cofins airports. The announcement also includes subsidies to stimulate regional aviation and new concession rules.

2013

Jan.15 The government requests that the cities of São Paulo and Rio de Janeiro postpone the hike of bus fares to avoid a higher IPCA inflation reading in January, which could fuel inflationary expectations for the year.

Jan. 24 The government reduces energy prices by 18% for households and 32% for industry.

Mar. 11 The government reduces tax on basic food and toiletries.

Mar. 30 The government extends the IPI tax exemption on cars to the end of the year.

Apr. 2 The government eliminates the IOF levied on loans for infrastructure projects related to concessions to the private sector. 6% IOF on foreign investment in government bonds is maintained.

Apr. 5 Government extends the elimination of payroll taxes to more sectors of the economy.

and later creates other problems," adds Samuel Pessôa, IBRE/FGV associate researcher.

"The discussion about interventionism and micromanagement does not seem to be a careful assessment of what actually is happening with economic conditions in Brazil and what we are implementing," says Marcio Holland, Secretary of Economic Policy of the Ministry of Finance. He underlines the context of Brazilian economic policy: an adverse global scenario still surrounded by uncertainties.

A recent Barclay's study found that fixed investments began dropping when the government began to intensify protectionist measures and incentives to industry in early 2012.

Another explanation for the private sector's lack of appetite, Holland says, is the sudden change in expectations about economic growth in the transition from 2010 to 2011. "The fall in investment last year is much more associated with clear business logic than the perception of government activism. From the second half of 2011, there was an increase in inventories and lower capacity utilization. It was a natural process of accommodation of an economy that grew at 7.5% in 2010, fell to 2.7% in 2011, and signaled even smaller numbers ahead, although at the time no one foresaw 0.9%. In this environment, entrepreneurs do not invest. This is probably one of the most important variables to explain investment performance in Brazil in 2012," Holland says.

NEW FRAMEWORK

Holland maintains that the country now has a new macroeconomic framework formed by a tripod that is different from what was the mainstay of Brazilian economic policy in recent decades. He emphasizes that "We reduced the interest rate to finance production, we managed the exchange rate to ensure external stability and competitiveness of domestic industry, and we implemented fiscal consolidation, which made it possible to reduce and improve the public debt profile, in addition to monetary easing. These changes are permanent and affect the productivity and competitiveness of the economy very positively. We are also taking important steps in tax reform, with changes in the VAT and social contributions and reduction of payroll taxes. These measures will take a little longer to impact investment, since they were adopted recently. But definitely, it is not micromanagement."

Disagreements aside, most experts recognize that the government's efforts have merits, especially when it comes to measures of more prolonged effect. Former Minister of Finance Delfim Netto says it is "overkill" to believe that government activism could be an obstacle to resumption of investment. "President Rousseff has made some interventions that are structural and will produce results in the long term, correcting problems that have

Capital Control Measures

2008

Mar. 12 The government introduces 1.5% IOF tax on all investments fixed income (investment) by foreign investors.

Oct. 22 The government eliminates the IOF tax on all investments fixed income (investment) made by foreign investors.

2009

Oct. 20 The government raises from zero to 2% the IOF on all fixed income and equity investments by foreign investors.

2010

Oct. 4 The government raises from 2% to 4% the IOF tax on all fixed income investments by foreign investors.

Oct. 18 The government increases from 4% to 6% the IOF tax on all fixed income investments by foreign investors, and raises from 0.38% to 6% the BM&F commodity exchange margins for foreign investors.

2011

Jan. 6 Cash reserve requirement on short spot US dollar positions of more than US$3 billion was raised to 60%.

Mar. 25 3.8% IOF tax levied on all international credit card transactions.

Mar. 28 6% IOF tax levied on all short-term external borrowing operations (less than one year).

Apr. 6 The government extends the 6% IOF tax on all short-term external borrowing operations with a duration of less than two years.

Jul. 8 The government extends the 60% reserve requirement on short spot U.S. dollar positions to positions larger than US$1 billion.

Jul. 27 The government establishes 1% IOF tax on onshore U.S. dollar derivatives transactions that increase the short US dollar position by more than US$10 million in one day.

Sep. 16 The government introduces a new bill with a more comprehensive structure but in line with the measures of July 27.

2012

Dec. 1 IOF tax on foreign equity investments is reduced from 2% to 0%, and on long-term private debt instrument debentures is reduced from 6% to 0%.

Mar. 1 The government extends the 6% IOF tax to all external borrowing operations maturing in less than 3 years (from 2 years).

Mar. 2 All export financing of more than 360 days becomes subject to the 6% IOF.

Mar. 7 The Central Bank increases the pace of easing and slashes its policy rate by 75 bps.

Mar. 12 The government extends the 6% IOF tax to all external borrowing operations maturing in less than 5 years (from 3 years).

Mar. 16 The government eliminates the IOF tax on local derivatives markets for exporters hedging their flows.

Jun. 14 The government relaxes the 6% IOF tax on all external-borrowing operations maturing in less than 2 years (from 5 years).

Dec. 5 The government relaxes the 6% IOF tax on all external-borrowing operations maturing in less than 1 years (from 2 years).

Dec. 18 The government increases the threshold to US$3 billion from US$1 billion of short spot US dollar positions that are exempt from reserve requirements.

2013

Jan. 31 The government reduces from 6% to 0% the IOF levied on foreign investors who invest in real estate funds in Brazil.

accompanied us for a lifetime. For example, the reduction of interest rates, the payroll tax relief, mainly for export industries, and interventions in ports and energy. These are difficult policies with management problems and some noise in the short term, but they point in the right direction. When the measures for the ports have matured, we will have the solution to a problem that was there for 30 years without anybody doing anything," he says.

The study shows that in 2012 uncertainty reduced economic growth by 2.1 percentage points (US$45 billion), which means that Brazil's GDP could have grown 3% rather than its meager 0.9%.

However, he is not all compliments. Netto criticizes interventions whose effects are not permanent: "I do not think it is effective to combat inflation with ad hoc measures . . . . This is clearly a structural issue, linked to wage increases beyond the growth in labor productivity. Ad hoc policies of delaying price adjustments for short-term results, rather than mitigation, stimulate inflationary expectations, and the losses end up being greater than the gains."

The example of inflation, which remains near the upper limit of the government's inflation target (2.5% to 6.5%), has been emblematic of what happens when the government adopts ad hoc policies. IBRE's Matos says, "The government cuts interest rates, expands credit from state-owned banks to stimulate private consumption, but supply does not follow and inflation rises. To try to work around the problem, it controls some prices but that affects the performance of state-owned oil company Petrobras and the alternative energy sector. The intention is good, but you need to pay attention to all the gears."

In defense of government policies, Holland says that Brazilian inflation has been within the target range determined by the National Monetary Council (CMN) since 2004, and that the food supply shocks that have occurred in recent years, both domestically and abroad, cannot be neglected. "Shocks severely affected the prices of agricultural commodities," he says, which pushed inflation up. In addition, Brazil has low unemployment and the average income of workers has increased. "In this context, it is natural that Brazilian inflation would be higher than the world average. In any case, I do not think it is correct to say there is inflation management in Brazil. The government is implementing reforms and tax measures."

Another sensitive area is fiscal policy, in particular measures the government has taken to meet its primary surplus target—what some have called creative accounting. According to the Barclays study, the "accounting tricks" used to meet the primary fiscal surplus goal in 2012 cast doubts on the government's commitment to fiscal stability. Holland maintains that Brazil is in 12th place

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Marcelo Salomon

in the ranking of 100 countries in terms of greater budget and fiscal transparency. "Look at the crisis in Europe and the U.S. debate about the fiscal situation. Brazil is far from that," he points out. "The debt-to-GDP ratio has been falling consistently, which means that we are generating a primary surplus that is even larger than necessary . . . . Brazil has surpassed any predictions of insolvency risk."

WHAT NEXT?

Regardless of right and wrong or good intentions, to what extent might the government's activism since early 2011 interfere in the decisions of private investors? For the analysts at Barclays, Brazilian policymakers seem to be in wait-and-see mode, recognizing that growth was worse than expected, but thinking it is now likely to recover. "Better business and consumer sentiment, lagged effects of monetary easing, credit, recovery and an expansive fiscal policy all support a better investment environment," the study says, but it warns, "The uncertainty issue is critical and could more than offset these positive factors." The study sees the possibility that a stagflation scenario could emerge if the government continues its activism, which would reduce investor confidence. Fixed investments would continue to trend down, pulling real GDP growth lower. The negative confidence shock could also depreciate the exchange rate, fueling inflation expectations and keeping it close to the 6.5% upper limit of the official target. This scenario could occur later this year as the 2014 election cycle begins.

"The attempt to control inflation by means of price administration, without the use of traditional instruments of monetary policy, demonstrates the inconsistency of the government's policies," says IBRE's Pessôa. Salomon adds: "The first thing to be done is for the government to show that it has a medium- and long-term program to increase productivity. We are not talking about providing incentives or benefits to A or B sectors but about a plan that leads the private sector to believe that the government will actually work to reduce the tax burden, improve public spending, increase productivity, and invest in human capital."

Lisboa of Insper also believes that government actions that are perceived by private agents as aimed at the short

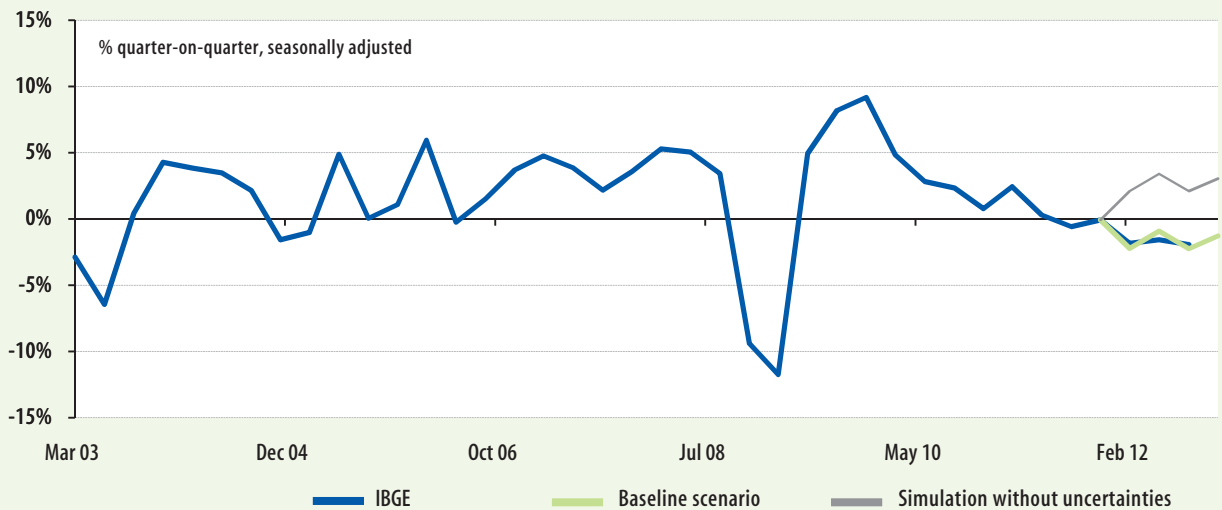
term, though justifiable, can indeed produce undesirable side effects on private decisions to invest: "Energy, for example, took advantage of the renewal of the concession contracts to obtain an ad hoc reduction in electricity rates, but this did not affect the structural conditions of energy supply in Brazil. We know it will continue to be difficult to build hydroelectric plants in Brazil, and this ends up adding not only costs but also uncertainty to investment."

"The fall in investment last year is much more associated with clear business logic than the perception of government activism."

Marcio Holland

Lisboa is concerned that the Brazilian economy lacks systematic analysis that can accurately measure the effectiveness of economic policy. "The National Bank for Economic and Social Development (BNDES), for example, has allocated a significant amount of resources to specific sectors at below-market interest rates. What is the outcome of this investment? How productive has BNDES been?" he asks. He is troubled that there are no mechanisms for measuring how cost-effective policies are. "Several sectors benefit from protectionist measures that imply higher production costs that society should pay, but we do not bother to check if the money was worth it. Such monitoring would also help us learn what kind of protection worked or did not, what kind of subsidized loans generated good results or what did not. That way, we could better assess the impact of public policies and participate more actively in the discussion of allocation of public resources."

Without the uncertainty, investment would have grown more than 6% in 2012.



Sources: IBGE and Barclays.