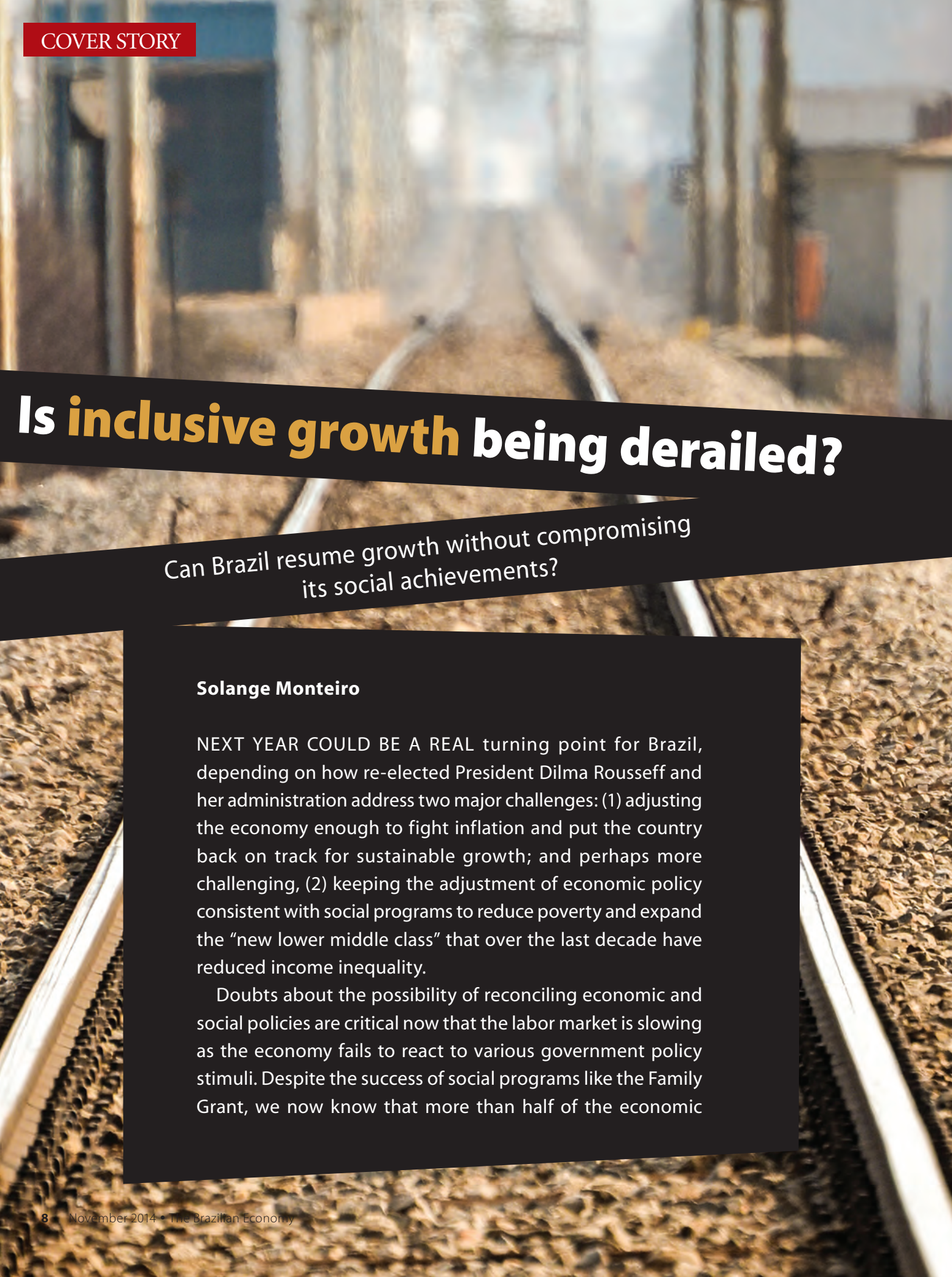


Is inclusive growth being derailed?

Can Brazil resume growth without compromising its social achievements?

Solange Monteiro

NEXT YEAR COULD BE A REAL turning point for Brazil, depending on how re-elected President Dilma Rousseff and her administration address two major challenges: (1) adjusting the economy enough to fight inflation and put the country back on track for sustainable growth; and perhaps more challenging, (2) keeping the adjustment of economic policy consistent with social programs to reduce poverty and expand the "new lower middle class" that over the last decade have reduced income inequality.

Doubts about the possibility of reconciling economic and social policies are critical now that the labor market is slowing as the economy fails to react to various government policy stimuli. Despite the success of social programs like the Family Grant, we now know that more than half of the economic

inclusion of poorer Brazilians in the last decade was because they were earning more. Between 2002 and 2012, Brazil's middle class increased by 35 million people, from 38% to 53% of the total population, as per capita family income of R$3,492 rose to R$12,228 at 2012 prices. Thanks mainly to rising real wages, the per capita income of the poorest 10% rose by 7.3% a year—3.5 times the growth recorded for the richest 10%. "The income of rich Brazilians grew like the Swedes, and the income of poor Brazilians like the Chinese," notes Ricardo Paes de Barros, undersecretary of the Strategic Affairs Secretariat (SAE) of the Presidency.

This social transformation, Barros explains, was the result of integrating the poor into the modern economy by reducing informal labor and providing credit. He admits, however, that this social change will be worth little if the Brazilian economy remains stagnant. "Today, the most important social policy for the country is economic policy, because sustaining the economic inclusiveness of the poor depends on solid growth," he says. To achieve solid growth, the economy must become more productive; in recent years growth in productivity has lagged behind wage increases. To encourage productivity Brazil needs an attractive environment for investment, incentives for innovation, and continuous improvement of education so that young people are prepared to meet the demand for more skilled labor and thus earn higher wages.

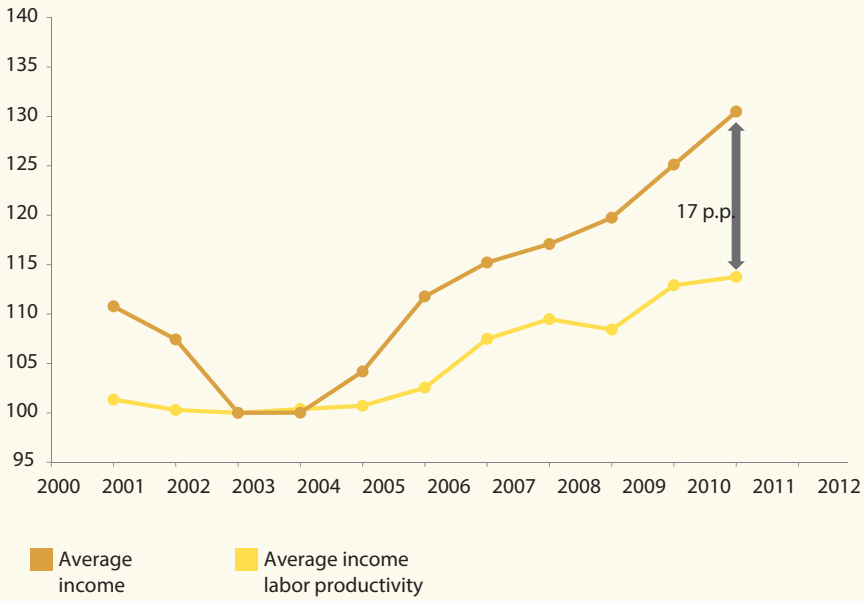
Doubts about the possibility of reconciling economic and social policies are critical now that the labor market is slowing as the economy fails to react to various government policy stimuli.

Between 2002 and 2012
35 million
of Brazilians joined the middle class, which today is **53%** of the population.



Brazil's gap between income and productivity widened in 2001-2011.

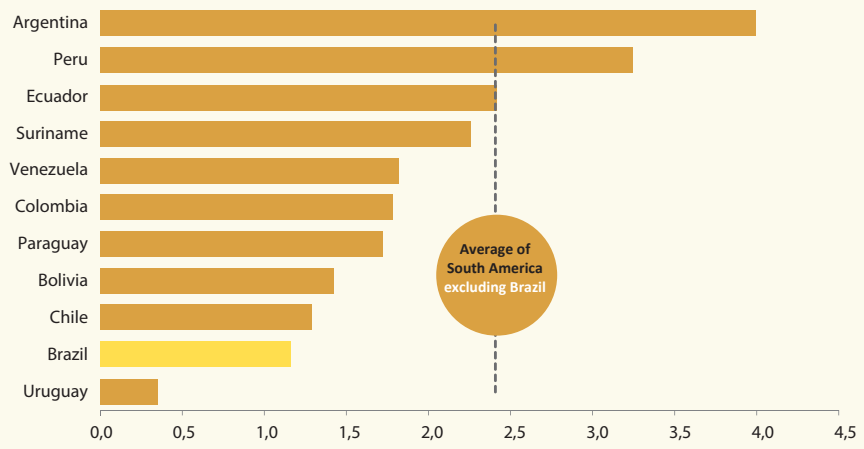
(Indexes 2003 = 100)



Source: Secretary of Strategic Studies of the Presidency.

Growth in Brazil's labor productivity is among the lowest in South America.

(Average 2001-2011)



Source: Secretary of Strategic Studies of the Presidency.

Anemic productivity

Brazilian productivity has not increased significantly since the early 1980s. At that time productivity growth in Brazil was about the same as in South Korea, but today productivity in South Korea is growing four times faster than in Brazil. Between 2001 and 2011, Brazil's productivity rose only slightly more than 1%; the average for all South American countries was 2.4%.

Silvia Matos, Brazilian Institute of Economics (IBRE) researcher, points out that between 2003 and 2012 Brazil's productivity growth was mainly due to the agricultural and finance sectors. As Matos explains, "Agriculture recorded 6.2% productivity growth during this period because its comparative advantage [in terms of natural resources] and the high price of commodities during that the period were a strong incentive to adopt technology" to raise productivity. Financial intermediation and insurance recorded productivity growth of 5.7%. However, services, which are characterized by intensive labor, averaged only 1.7% productivity growth; transport productivity grew 0.6% in the period, and information services productivity actually declined 0.2%.

The productivity of services seems to have reached its limit—today its productivity growth

"Today, the most important social policy for the country is economic policy, because sustaining the economic inclusiveness of the poor depends on solid growth."

Ricardo Paes de Barros

is less than 1%. Matos points out that this makes it harder to heighten growth generally because in Brazil services are responsible for 68% of value added and 63% of employment. "The low productivity of services reflects low worker skills," she says. Using the United States as an example, she noted that "when the country moved from an industrial economy to a service economy in the 1990s, there was no decline in productivity. This is the example Brazil should follow," adding that "To raise productivity, either we attract skilled immigrants, or invest in technology. Otherwise, our growth potential will be reduced."

Possible path

In the short term, Matos believes that the necessary economic adjustment will inevitably reduce employment and wages, explaining that "If productivity does increase as a result of innovation and enhanced skilled labor, it will not be possible to completely protect jobs and income without compromising the profitability of companies."

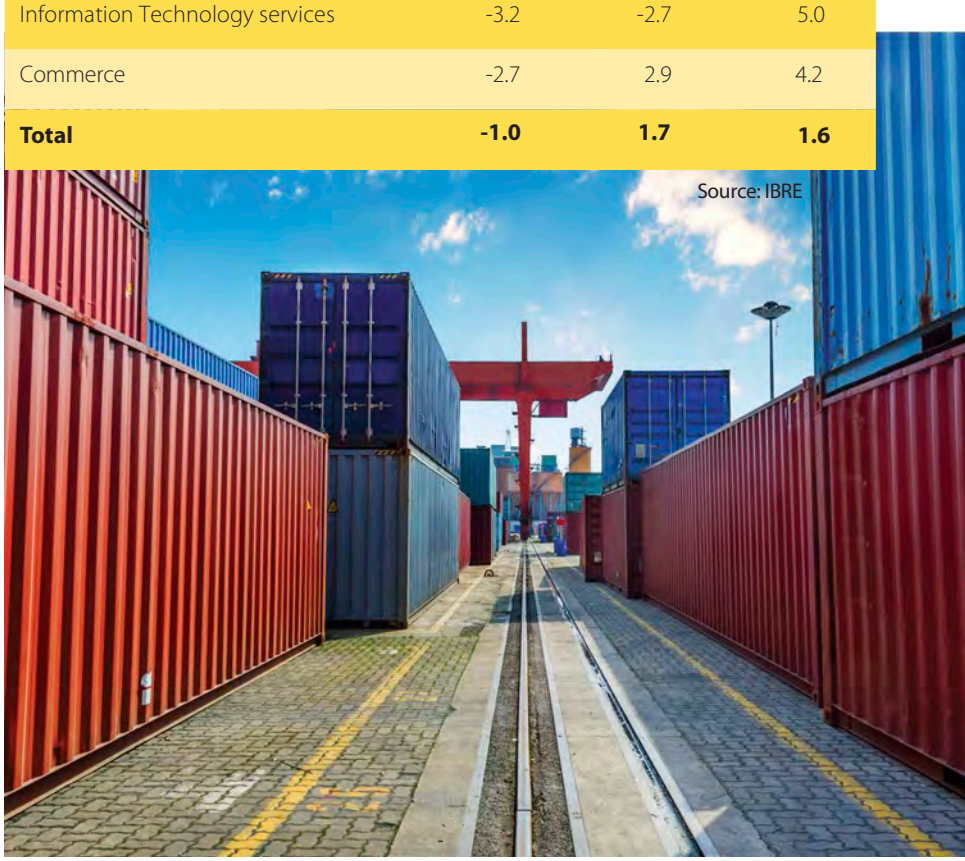
Lack of profitability, incidentally, is the major obstacle that prevents companies from investing in fixed capital, which is essential for increasing productivity. In the past three years, companies operating in Brazil have seen their profits plunge.

Productivity of services in general is low in Brazil.

(% change)

	1995-2003	2003-2009	2009-2012
Transportation, storage and postal	-1.4	1.5	-1.2
Financial services and insurance	-2.2	7.3	2.6
Information Technology services	-3.2	-2.7	5.0
Commerce	-2.7	2.9	4.2
Total	**-1.0**	**1.7**	**1.6**

Source: IBRE



Source: Tooykrub/Shutterstock.com

Today productivity in South Korea is growing four times faster than in Brazil. Between 2001 and 2011, Brazil's productivity rose only slightly more than 1%; the average for all South American countries was 2.4%.



A survey of **700** Brazilian companies shows that return on equity fell from **16.4%** in 2010 to **7,1%** in 2013

A survey of more than 700 non-financial companies showed that their return on equity fell from 16.4% in 2010 to 7.1% in 2013. With less net income to retain, companies have lost a major source of investment financing. Carlos Rocca, director of the Center for the Study of Capital Markets of the Brazilian Institute of Capital Markets, says the main problem has been higher unit labor costs that could not be passed on to the consumer because of competition from cheaper imported products. "Despite the devaluation of the exchange rate, the prices of imported goods in domestic currency increased less than the cost of labor," says Rocca. Moreover, services companies were not able to pass on the higher cost of labor because the government controlled the prices of many services.

Rocca also points out that the rate of return on investment in fixed capital fell from 13.7% in 2010 to 8.1% last year. "In the last two years the rate of return on fixed investment was below the financial cost to companies, which discourages investment in fixed capital," he says. Between 2010 and 2013, companies' investment in fixed capital fell from 9.1% of GDP to 5.8%. "I see little reason for companies to invest in fixed capital until there is a resumption of growth," he concludes.

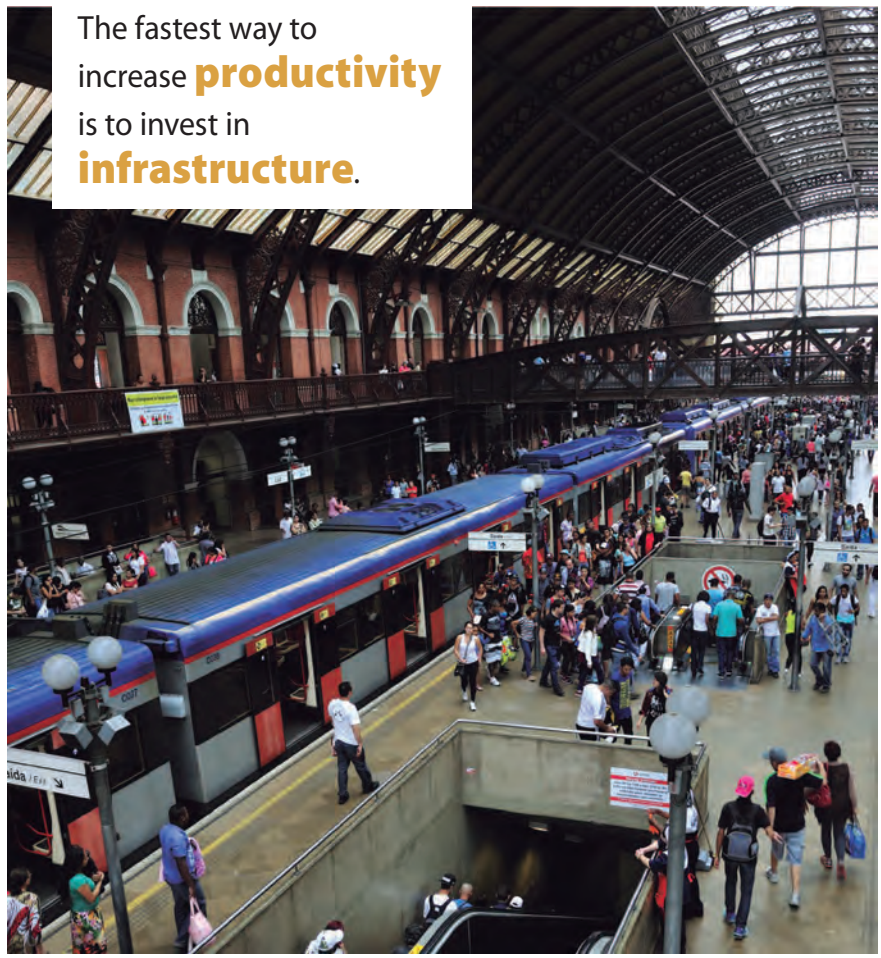
IBRE economist Regis Bonelli believes that the fastest way to generate significant impact on Brazilian productivity is persistent investment in infrastructure. Over time, he says, "These investments could generate a positive demand shock. In the case of transport infrastructure, such investments promote a more dynamic economy." Rocca agrees, but is concerned that because of the fiscal deficit the government does not have the resources to invest in infrastructure. Consequently, he believes, it is necessary "to create all possible conditions to attract private investors" in infrastructure.

"To raise productivity, either we attract skilled immigrants, or invest in technology. Otherwise, our growth potential will be reduced."

Silvia Matos

Matos points out that it is also important to raise productivity in services. "Today policies focus mainly on industry; they do not consider the weight of the service sector in the economy," she says. She sees a great potential to increase productivity particularly in education, health, transport, and trade.

The fastest way to increase **productivity** is to invest in **infrastructure**.



"Despite the devaluation of the exchange rate, the prices of imported goods in domestic currency increased less than the cost of labor."

Carlos Rocca