

Time for a route correction

With performance less than is necessary to meet Brazil's infrastructure demands and with funding scarce, investment needs to become more efficient.

Solange Monteiro

BRAZIL'S INFRASTRUCTURE HAS BEEN a central topic of discussion—and contention—since the Lula administration created the Growth Acceleration Program (PAC) in January 2007. With transport and ports then deteriorating after nearly three decades of low investment, there was hope that Brazil's economy would regain its dynamism.

Seven years later and with the second PAC program about to end after awarding a large number of concessions for infrastructure, the preliminary results show that the anticipated acceleration of infrastructure projects has not occurred. According to InterB Consulting, infrastructure investment has grown slightly above 2% of GDP, but at least 4% is needed to meet the country's needs. "In 2013, we recorded 2.4% of GDP; in 2014, the forecast is 2.5%. At that rate it would take 25 years to reach 4%," says Claudio Frischtak, InterB president.

The investment program is now undergoing a mandatory review. It will be the central topic at the Seminar on Infrastructure and Heavy Construction in Brazil on September 30, in Rio de Janeiro, sponsored by the Brazilian Institute of Economics of Getulio Vargas Foundation (IBRE).

There is no room for inefficiency if Brazil wants to attract investors. High on the reform priorities to accelerate infrastructure investment are reducing excessive red tape, streamlining regulation, and numerous microeconomic reforms. "We have the tools, but we get the execution wrong," says Eduardo Zaidan, vice president of the Construction Union of São Paulo (SindusCon). "We need a strong business environment to support decisions to invest when the backdrop is lower growth."

CONSTRUCTION SLOWDOWN

The current uncertainty has had a depressing effect on the construction industry. IBRE staff estimate that in 2014 the construction sector will contract by at least 5.1% and perhaps as much as 8% if sector confidence indices show no significant improvement in the second half of the year. "If these projections are confirmed, construction GDP will have fallen by 0.7% a year for 2012–14 compared to annual growth of 5% for 2005–11," says Armando Castelar, IBRE coordinator of applied economics. In the most pessimistic IBRE scenario, fixed investment would fall by 8.4% in 2014—the worst contraction since 1996.

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Zaidan points out that construction has been slowing down since 2012, and the construction industry has a large weight in total investment—"42% of investment in Brazil goes through the construction sector." He adds, "The construction activity we see today is a result of decisions taken in the past. If new investment decisions are made slowly, there will be no possibility of a strong rebound next year."

In the quarter ended in August, the IBRE Construction Confidence Index showed a slight improvement but was still 9.9% lower than in the same period last year. Ana Maria Castelo, coordinator of IBRE construction surveys, says that "The current sluggish activity and uncertainty in the construction industry underscore the limiting factors for business. In August, for the first time, the survey shows more concern about demand than about a shortage of skilled labor."

MY HOUSE, MY LIFE PROGRAM

One factor weighing on the housing sector is the high price of real estate. "It is true that in the last seven years, mortgage lending increased six fold as a proportion of GDP, and it continu One factor es to grow, but there are also limits on household borrowing capacity. Property prices have tripled and incomes have not kept up," Castelar says. There is also uncertainty about whether the My House My Life program will be renewed. That popular program, which subsidizes housing for low-income households, has financed 3.2 million homes. Zaidan notes that "In 2003, before the program, only 30,000 properties were financed in Brazil."

José Carlos Martins, president of the Chamber of the Brazilian Construction Industry (CBIC), advocates extension of the second PAC for six months, until the third phase is in place: "The transition from the first PAC to the second took 10 months … That can really disrupt the construction sector." He also advocates changes in the lending terms to expand the benefits to other income groups: "Today, someone earning R$1,600 pays R$80 in mortgage payments, but someone earning R$1,601 pays nearly R$400. A more gradual schedule of interest rates and subsidies would be better."

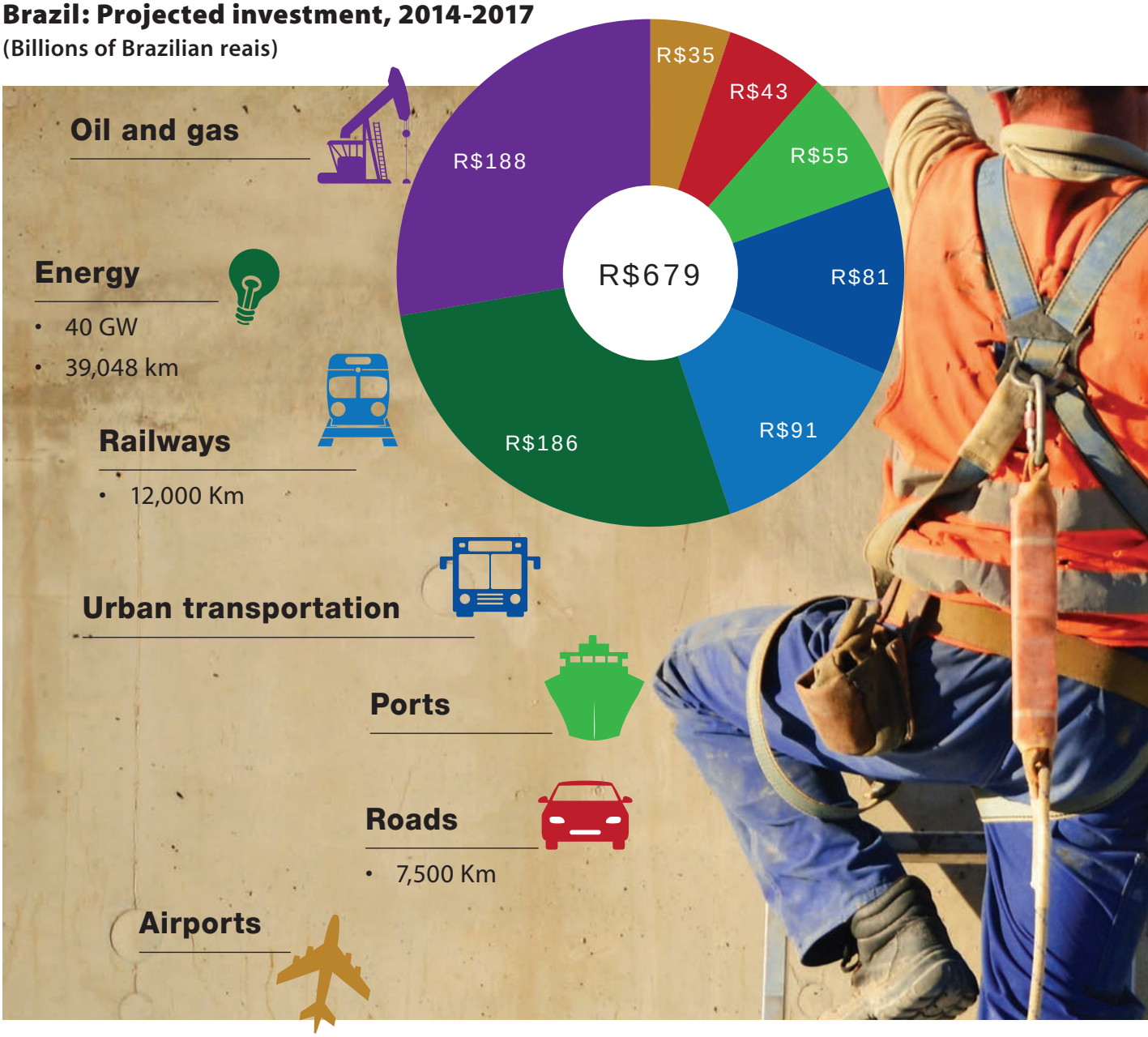
HEAVY WORK

Like residential construction, industry, which is a major factor in demand for heavy construction,

has clearly reduced its fixed investment because it has not been performing well either. Public works and the large number of infrastructure concessions should support fixed investment, but they do not. Armando Castelar and Claudio Frischtak highlight some reasons: (1) The public sector continues to dominate in some infrastructure sectors, and it has major problems of bureaucracy, mismanagement, and corruption. (2) The unstable economic situation, with high inflation, increases uncertainty about the long term. (3) Government puts pressure on concessionaires to reduce their rates of return. (4) Finally, regulatory agencies have been weakened and privatization of public assets has been politicized.

Joisa Campanher Dutra, coordinator of the Center of Studies in Regulation and Infrastructure (CERI) of the Getulio Vargas Foundation, describes

Brazil: Projected investment, 2014-2017
(Billions of Brazilian reais)



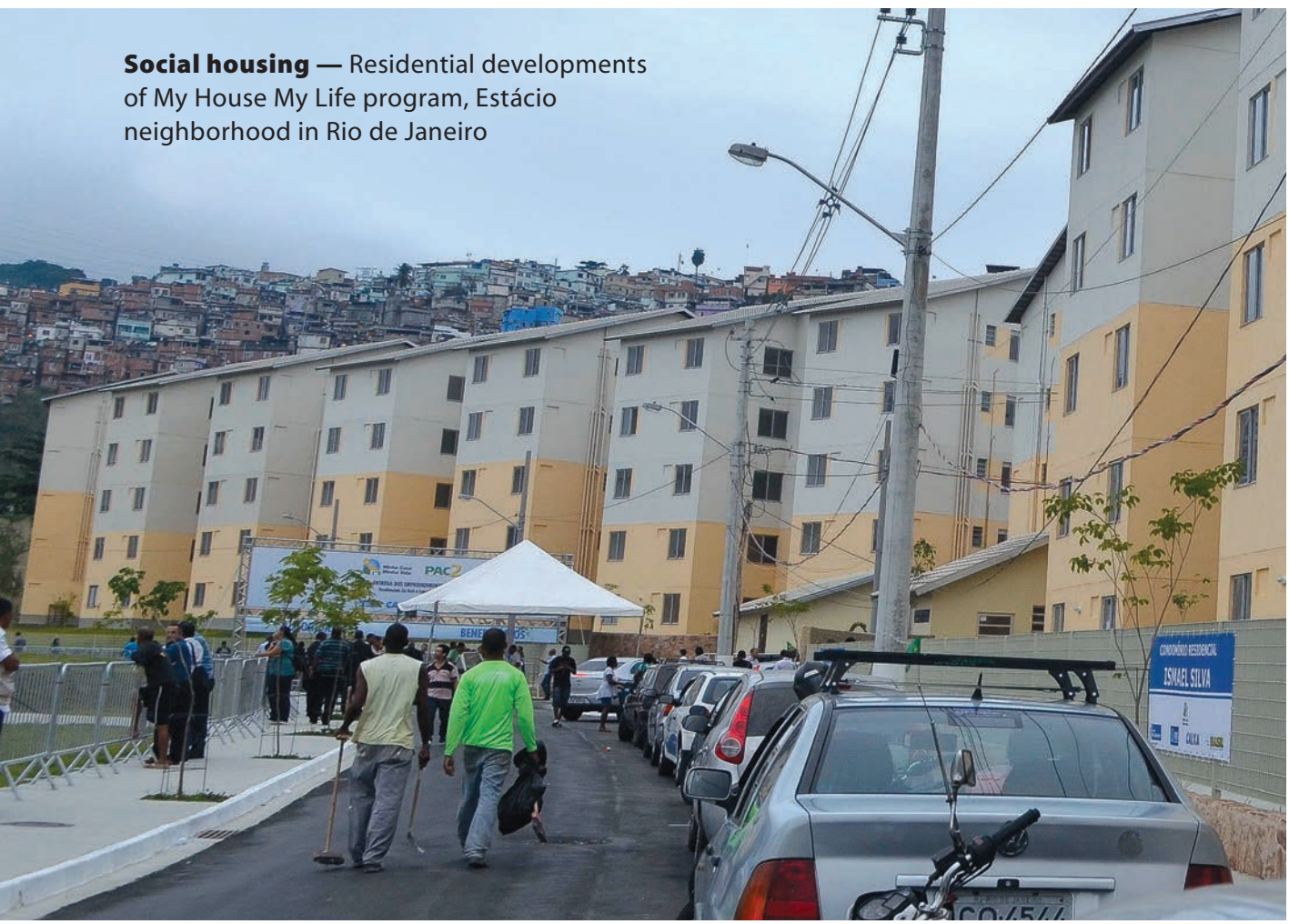
what has been happening with regulators in the last 20 years: "The initial motivation was to build up a competitive market and improve its efficiency. The scenario has changed recently, and the influence of politics on regulation has increased significantly. This does not create a good business environment, or attract new concessions," she says. Adds Vinicius Benevides, president of the Brazilian Association of Regulatory Agencies (Abar), "More stable regulation is a necessity because, as we know, decisions about investing in infrastructure take into consideration primarily the size of the market, the political environment, and the stability of the regulatory framework."

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"It took more than a year to reorganize the highway system. The concession plan was announced in August 2012 and construction contracts were expected by April 2013. But so far, we have no railways and ports. All this creates uncertainty about the future," says CBIC's Martins.

Carioca Engineering, a construction company, must live with this uncertainty. The

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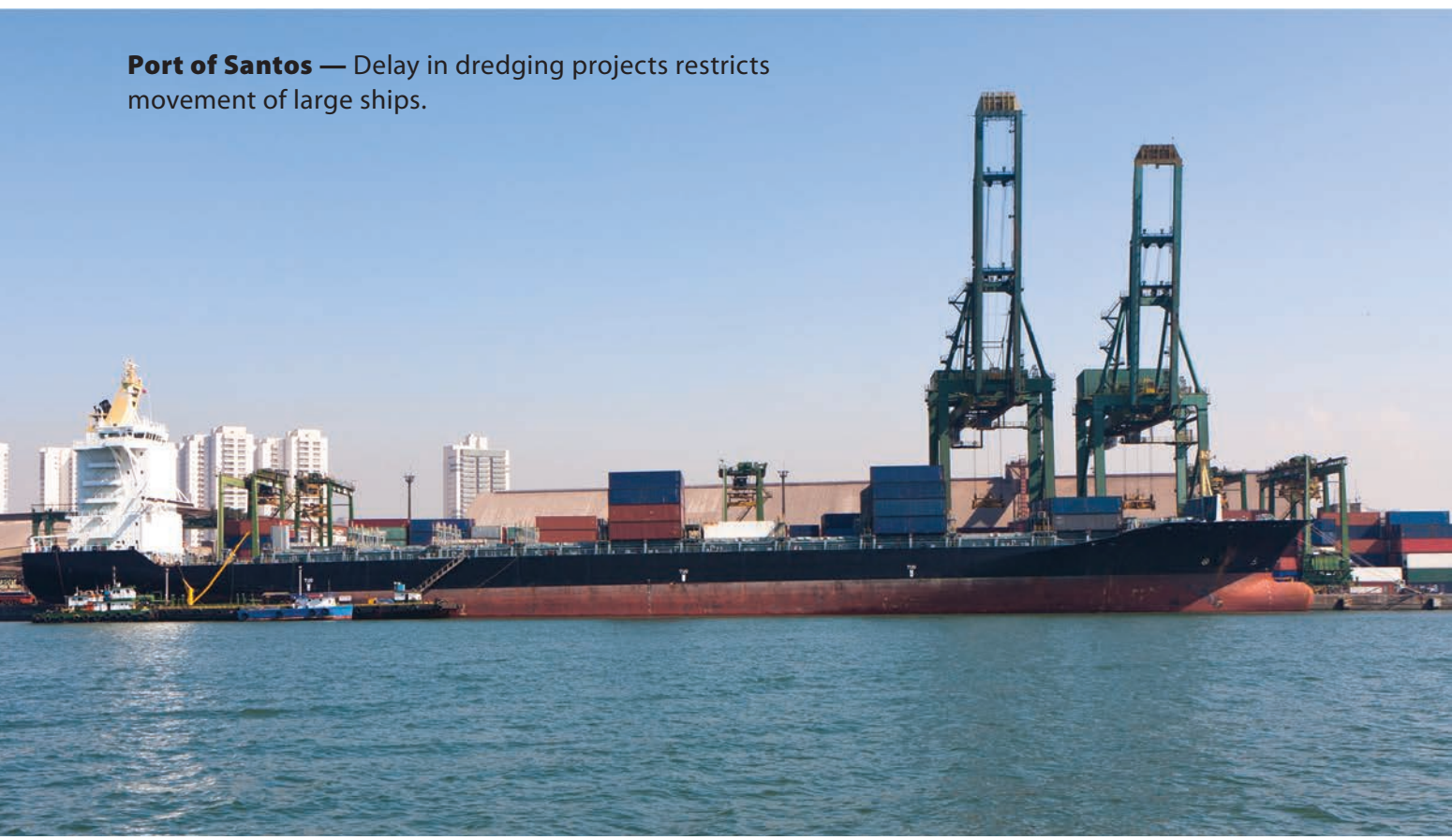
Social housing — Residential developments of My House My Life program, Estácio neighborhood in Rio de Janeiro

company is active in bidding for concessions and public-private partnerships (PPPs). Even though its contracts cover airports, sanitation, oil and gas, and ports and it expects to bring in R$2 billion in revenues this year, it expects its revenues to drop 40% in 2015. Why? Roberto Moscou, general director of the company, explains it's the slowness of the concession process. "In the case of ports, for example, the law is stranded in the Court of Audit. Who will invest in private port terminals if the rules are not clear?"

Moscou says that, knowing the limitations that are still present in the process, the focus of his company is structured deals and private clients, although he acknowledges that "concessions bring balance to the billing of a construction company, which is cyclical."

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>
> *Ana Maria Castelo*

Public procurement is a very slow process, Moscou points out. Carioca Engineering built 20km of the Rio de Janeiro metropolitan beltway. "We could have completed it in a year and a half and we took six years because there were 600 land expropriations to be made," Moscou says. "The expropriations went slowly, we had to stop the work, and we lost money. In contrast, when we built the port terminal of



Port of Santos — Delay in dredging projects restricts movement of large ships.

the Companhia Siderúrgica do Atlântico (CSA), it was negotiated with the German executives for seven months, but the day after we signed the contract, we were working with all permits in hand."

The research of economist Carlos Campos of the Institute of Applied Economic Research (IPEA) illustrates how inefficiently federal resources are used, as measured by the difference between resources authorized for fixed investment by the government and state-owned enterprises, and those that are effectively executed. Campos says that "Between 2003 and 2013 the country failed to use R $70 billion of funds authorized for the transportation sector."

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> *Rodolpho Tourinho Neto*

Mauricio Muniz, PAC secretary, argues that "PAC 2 saw a large improvement in planning and execution. Through last April, R$871 billion were executed, about 85% of the total authorized investment. We almost doubled investments compared with PAC 1." CBIC's Martins thinks that to really improve PAC budget execution, it is necessary to improve the whole planning

Rails grow — Expansion of investments in railways is expected



system, starting with the quality of the projects chosen and clarifying the responsibilities of federal agencies to streamline project controls.

WHO PAYS?

So far no initiative has provided enough funding to raise public investment in infrastructure, and in coming years the government will have even less fiscal room to fund more investment. In the 2015 budget, the PAC and My House My Life program have additional resources totaling R$65 billion, only a 2.7% nominal increase over 2013.

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> *José Carlos Martins*

Rodolpho Tourinho Neto, president of the National Association of the Construction Industry (Sinicon), is skeptical that funding for infrastructure projects will go up much: "Over R$200 billion projected in the Program of Investment in Logistics will only make up for the current deficiencies in infrastructure. But we will still have to meet and finance the future demand for infrastructure."

The National Development Bank (BNDES), the principal long-term lender in the country, is more optimistic. The bank expects to steadily increase its

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Urban transportation — Bus rapid transit (BRT) Transcarioca is part of PAC.

disbursements for infrastructure. "Since 2003, disbursements for transport and logistics grew on average 37% per year, reaching R$9.5 billion last year. This year we hope disbursements will reach R$12 billion and will continue to grow between 20% and 30% for at least the next three years," says Cleverson Aroeira da Silva, head of the BNDES Logistics Department.

Although the BNDES disbursement plans sound encouraging, they also worsen the country's fiscal situation, Castelar observes. BNDES subsidized loans are funded by large Treasury's transfers. "These transfers, negligible in the past, reached 9% of GDP. That increases gross public debt," he warns. InterB's Frischtak says it is difficult for the private financial system to compete with BNDES subsidized credit. According to BNDES, in July, the bank was financing 377 infrastructure projects totaling R$187 billion, representing 55% of the total cost of the projects. Fritschak says the market has become used to cheap BNDES funding, considering it a compensation for Brazil's high regulatory risk premium.

Castelar warns that a better balance between the BNDES and other lenders is imperative. "The situation in which almost half the credit in the Brazilian economy is not sensitive to the policy interest rate causes the Central Bank to raise the interest rate much more because it only affects the other half of credit in the economy," Castelar says. Frischtak agrees: "We have a deep financial and capital market, well regulated, which usually works well, but we are not leveraging." He believes the risk should be shifted from the government to the private sector, restricting the BNDES share of project financing.

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COURSE CORRECTION

Economists agree that it is necessary to reduce political and regulatory risks, which are clouding the horizon for investment. "When this is done, we will be able to reduce subsided loans and improve the fiscal situation," says Castelar. Frischtak says that "a credible economic policy" would raise the economy's potential growth, increase fiscal space, and improve the mood of investors.

The good news, Castelar thinks, is that there has been progress in planning, with better analysis and more qualified people. PAC secretary Muniz highlights several improvements in recent years: "The Ministries have strengthened their planning by hiring 720 infrastructure analysts, including engineers, architects, and geologists; setting up plans for transportation and energy; and improving regulatory frameworks." Castelar says, "We have a lot of waste. … We could save about 30% to 40% of the money simply by managing projects better."