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Wanted: A strategic vision for Brazilian industry

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THE FACT THAT THE FISCAL adjustment may take longer than expected to show results does not postpone the obligation to define what kind of economy and industry Brazil should have after the economic adjustment is completed, says Pedro Luiz Barreiro Passos, president of the Institute for Industrial Development Studies (Iedi) and cofounder and advisor to Natura, the cosmetics company. Passos considers it urgent that the country commit to a long-term strategy that will guide investments. He also considers it necessary that there be a change in the profile of Brazilian industry to permit greater international integration: He advocates a policy directed to improving the productivity of the economy as a whole rather than policies targeted to specific sectors. "We have to let each sector gain muscle. We can support those that are seeking vitality, but we should not create an emergency room for those that are not doing well," he says.

***The Brazilian Economy*—In 2014 manufacturing accumulated a trade deficit of US$64 billion—nine times higher than in 2008. What caused this deterioration?**

Pedro Passos—The main factors in this deterioration have been present for a long time. Fundamentally, for a long time we have had a macroeconomy characterized by an overvalued exchange rate that was virtually impossible

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to overcome with productivity gains. We also had excessively high interest rates for a long time; there was some decline in 2010 but real interest rates were still high. So industry has been losing density and consistency, and most of the demand for industrial products was met by imports. Industry barely took advantage of the recent growth we had. Associated with this, the productivity of labor and total factor productivity have grown less than in our competitors. I have the impression that this scenario is the end of a cycle; now a shift is required to ensure that industry can contribute to the country's growth.

The Iedi survey on trade balance shows that between 1995 and 2014 industry recorded a trade surplus in only six years. What would be a realistic trade balance for industry?

A country like Brazil should not in any way accept that its trade balance must be structurally in deficit. We have to generate a trade surplus. For this, however, Brazilian industry must change its profile—possibly have a slightly different matrix, with both more imports and more exports. It is going to be a difficult process, to turn away from the protected domestic market and seek greater international integration. Both internally and externally it will take time to negotiate this shift so that it will work. Brazilian industry can do it, provided it recognizes that this is a process. As we have seen in the past, making abrupt changes to open up trade can be traumatic for some sectors. We have to be aware of these likely dislocations, but at the same time we must have a clear agenda if we want greater international integration. Brazil has several sectors that could be more aggressive and have a larger presence globally.

What are these sectors?

We cannot assume that we can identify specific sectors. It is up to us to develop internationally competitive sectors. … We should be careful not to protect sectors that today have poor prospects. The transition . . . . will depend on Brazil's making bets on emerging sectors that have comparative advantages … The presence of China and other competitors has definitely changed the scale of production and our ability to compete. Brazilian industry in the future will not necessarily be the same as the

industry we have today. The industry matrix is changing.

In what ways?

First, industry needs to understand that opportunities are global. Today in most of the world, there are no longer vertically integrated industries, especially when it comes to adding value. Today, industries get inputs from all over the world. This is one of the global features that calls for a change in policies that so far has sought to encourage vertical integration. That's a major change, and once again Brazil's aerospace company Embraer is our example of how one should harness the strengths of many suppliers around the world into products.

Second, Brazil has to develop productive chains that have demonstrated competitive advantages, like agribusiness … That is a sector that was exposed to competition, and invested effectively in innovation to be able to compete internationally.

At Iedi, we do not pick sectors. We do not have favorites. If we support better international integration generally, it helps to raise domestic productivity to let sectors choose their own ways. … We have to let each sector gain muscle. We can support those that are seeking to become more vital, but we should not create an emergency room for those that are not doing well.

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In your opinion, do Brazil's policies to support research, development, and innovation follow this principle?

I think Brazil has evolved in recent years with regard to supporting innovation. In general, some policies were in the right direction, such as tax incentives for companies that invest in research and development, creation of the Brazilian Company for Industrial Research and Innovation, and partnerships with universities. But they are still not enough for Brazil to compete with international investments [in innovation]. The economic and fiscal constraints have had some impact on [the effectiveness of programs to support innovation], but the whole process is still very bureaucratic.

For example, the National Institute of Industrial Property works poorly; a major backlog in registration of patents makes many people prefer to patent outside Brazil. There are also major regulatory problems. One is the 2001 law related to access

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to genetic resources (a new law awaits approval of the Senate), which is absolutely inappropriate. It prevents companies as well as the Botanical Garden and the University of São Paulo State from doing research on these resources that could generate innovation, and business ... Brazil has lost food and pharmaceutical companies that could have done research here, intensifying innovation and producing positive results for the economy.

Today, I would say that most companies do not fail to innovate for lack of encouragement and support from the National Development Bank and the Brazilian Innovation Agency. Often the process has been bureaucratic, it does not reach small and medium companies because they lack the structure to access official funding sources, but generally funding was adequate. There is a shortage of skilled labor and some structural problems, it is true, but what I think has prevented us from creating more innovation is the absence of competition—which is enough of a problem that today private investment in innovation in Brazil is lower than in other countries with which we compete.

The government intends to eliminate exemptions for payroll taxes. The main industries argued against this, but several economists have argued that it was ineffective and cost the Treasury billions. What is your opinion?

The tax exemptions granted were disorderly and exaggerated. They were created with the correct purpose, in our view, which was to make Brazilian products more competitive with imported ones. It was a step to level the playing field, not ideal but a step. Then two things that went in the wrong direction caused problems: the subsidy and the extension of the tax exemption to sectors that did not need this competitive advantage, that do not suffer from international competition. The exemption should not have been granted to so many sectors.

We all agree that we need to promote broader reforms and make greater adjustments, and that measures targeted to specific sectors end up exacerbating the problem we want to solve, creating greater complexity. I sympathize with the sectors that face a slowing economy and are feeling the burden. But from the fiscal perspective, we clearly need to adjust; otherwise we will aggravate the problem.

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Today, the policy tightening that the government is proposing will leave little room to stimulate industry. What agenda does the Iedi recommend, and what does it seek from the government to aid industry?

Like all Brazilians, we want some structural reforms. Today we cannot talk about reducing the tax burden, but we can at least recommend simplification of the tax system. We have also identified the need for more horizontal policies. For example, we have said that we need competitiveness at the beginning of supply chains …We need to reduce costs at the beginning of the supply chain to raise competitiveness. This will mobilize company investments to improve international competitiveness.

Recently the National Confederation of Industry has pointed out that between 2002 and 2012 Brazil lost competitiveness against its main competitors: productivity grew by only 0.6% but unit labor cost in dollars rose by 9%, while in South Korea unit labor costs fell by 3%. What can be done to increase productivity?

In the short term, we may see productivity rise and fall with movements in output and employment. But raising industrial productivity sustainably depends on innovation, greater external integration, and better training of workers. That's what works in the long run: to enhance productivity in Brazilian industry, we need to approach world standards of quality and efficiency and encourage competition and innovation. Industry must do its part by investing to increase productivity, and the government also must do its part by improving education and infrastructure, and simplifying regulation of the economy.

What do you consider the most critical point today for resumption of confidence in industry?

The situation calls for fiscal adjustment in the short term, but I do not know what comes after—which direction the country wants for the economy as a whole, and especially for industry. It is true that the situation raises concerns, but we cannot just wait to see whether the fiscal adjustment works. Business investment needs a longer horizon. And it seems that business will go through the crisis without knowing what direction it is going to take. Definition of this strategic vision . . . is part of confidence building. Society's consensus on this vision needs to be discussed. [Otherwise,] talking about resumption of investment is difficult.