

Brazil's to-do list for growth: Where to start?

Economists discuss how to make the economy more efficient and growth sustainable

Solange Monteiro

THE SECOND QUARTER CLOSED WITH negative numbers for the Brazilian economy and fading hope that it will soon be possible to discern whether the economy was heading to recovery. The government has reacted to the dim economic prospects with measures directed to two sectors considered vital for growth: infrastructure (the Investment Program in Logistics, PIL) and exports (the National Export Plan, PNE). Their success, however, will depend on the ongoing macroeconomic adjustment and structural reforms to increase efficiency and enhance quality and economic stability.

What are the best policies for Brazil will be addressed at the "Agenda for Brazil's Growth" seminar sponsored by the Brazilian Institute of Economics on August 6 and 7 in Rio de Janeiro. "We are gathering researchers to discuss the dynamics of sources of growth and the structural changes needed to accelerate the country's growth potential," says Regis Bonelli, IBRE researcher and seminar organizer.

Participants will begin by identifying the relative weight of the international crisis and domestic factors in Brazil's recent economic turndown. "At the end of last year the debate [on the causes of the economy's turndown] was polarized, but binary views are unable to give a satisfactory explanation," says Bráulio Borges, chief economist at LCA Consultancy. Using the International Monetary Fund database on 183 countries, Borges found that Brazil's GDP per capita grew 1.6 percentage points less in 2011–14 than in 2003–10, while the average for all countries was only 1 percentage point less growth. He concluded that about 60% of Brazil's downturn was due to the global slowdown and 40% to domestic factors. "Brazil came out of the 2009 crisis very fast. GDP did not suffer because the government administered large doses of stimulus to the economy in that period, but that has since taken its toll on the economy," he says. Borges explains that, when consumption is stimulated, growth improves in the short run but then loses strength.

IBRE researcher Silvia Matos believes that government efforts to support growth at the height of the crisis have generated more domestic imbalances in the economy than gains. "Most countries that are dependent on commodities exports, like Chile and Peru, have not slowed as much as Brazil," she points out, which suggests that the quality and credibility of the economic policy of the two countries have to some extent offset lower external demand and commodities prices. Matos and

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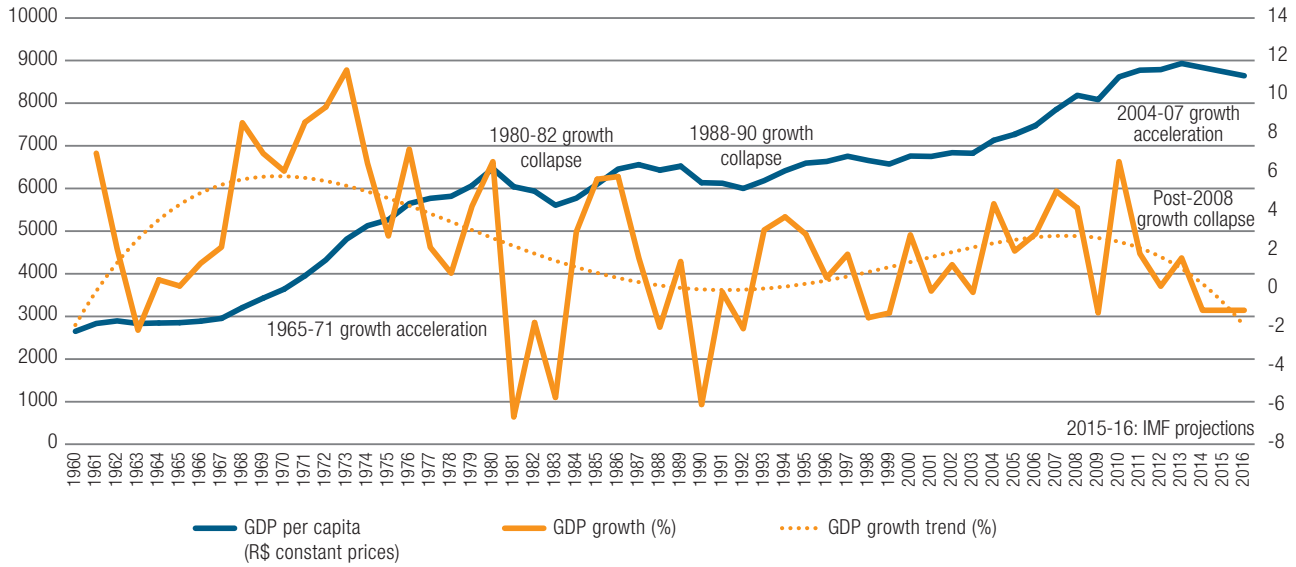
her IBRE colleague Vinicius Botelho compared recent growth of developing economies. In six countries—Brazil, Argentina, South Africa, Russia, Turkey, and India—growth slowed more than expected, and Brazil's slowdown is explained in part by less private sector confidence, which generally indicates poor management of the economy. This reinforces the theory that Brazil's slowdown is related more to structural than to cyclical factors. In Brazil, Matos says, "The loss of confidence is related to a mix of expansionary fiscal policy, higher inflation, a larger external current account deficit, and price mismatches of fuel and energy. This has generated imbalances in the economy that are difficult to correct."

Volatile growth and demographics

The lack of capacity to promote balanced and sustainable growth is not new for Brazil. Jorge Arbache, professor of economics at the University of Brasilia, points out that the country's growth is among the most volatile in the world, even compared with some African nations. Arbache says that periods of expansion and contraction since 1960s each took six to seven years, punctuated by many swings and large variations. The growth

Brazil's GDP growth is among the most volatile in the world

(GDP per capita in R$ constant prices, and GDP growth)



Sources: IMF, and Jorge Arbache.

volatility has not been neutral, he says: "Reactions are asymmetric. While investment may fall less when an economy is contracting than when it rises during the expansion period, income inequality and poverty deteriorate more during the contraction than they improve during expansion," he explains. As a result, growth in Brazil's GDP per capita is relatively low compared to other emerging economies.

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Arbache thinks that Brazil's volatile growth calls for policies to help sustain growth, such as incentives for innovation and adoption of technology. But he notes that the country has lost room for maneuver. A main limiting factor is demographic: Families are reducing the number of children fast for an emerging economy and eventually that will reduce the workforce.

João Ronaldo de Castro and Paulo Levy, researchers at the Institute for Applied Economic Research (IPEA), point out that since 1970 Brazil's workforce has grown faster than the total population, allowing GDP per capita to grow above productivity. "This situation will be reversed after 2020," Castro says. "To raise the standard of living, labor productivity will have to grow much faster than it has in the last 30 years."

The end of the demographic bonus will reduce the number of people of working age. This will reduce savings and raise the number of people dependent on pensions and health care, pushing up public spending. Castro and Levy estimate that the reduction in workforce growth will limit the growth of the Brazilian economy to no more than 2% a year, assuming savings and investment at current levels and constant total factor productivity (TFP) of 1% a year—close to the historical averages estimated by Regis Bonelli and Edmar Bacha.

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Dwindling savings

Brazil's low personal savings exacerbated by historically low public savings raise the cost of capital and reduce fixed investment. Mansueto Almeida of IPEA points out that "In the 1970s, public sector savings were between 6% and 7% of GDP and boosted fixed investment. Those savings vanished during the 1980s, especially after the Constitution of 1988, which created a fiscal stance not propitious to increasing public sector savings. … If the current fiscal stance continues, even if the economy grows more, the public sector will still record savings that are negative or close to zero."

Without domestic savings, increasing fixed investment by 4–5 percentage points of GDP will require foreign savings, which with the end of the commodities supercycle would make the current account deficit unsustainably large. "Australia has done this for more than two decades, but it has consequences," said Almeida, noting that countries that use foreign savings to grow need strong capital inflows, which implies currency appreciation, and that undermines industry.

Almeida believes that changes in access to unemployment insurance, salary bonuses, and sick leave pay are only the beginning of what is needed to correct anomalies in the social safety net, which eventually will have to address social security pension reform, especially the minimum retirement age. "That does not mean we have to solve everything in three years. When Margaret Thatcher reformed the social security system in the UK, it took two decades. Nevertheless, we have to begin a serious debate about it," he says. "The government estimates a social security deficit of 1% of GDP by 2020, but it was already 1% last year. If we add in other demands, such as health and education, the government will have to increase the tax burden by 10 percentage points of GDP over the next 20 years, as it has done since the 1990s."

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Almeida believes this scenario of restrictions should also stimulate corrections in government budget planning. "Today we have a budget with unrealistic inflated revenues that forces government to control spending," he says. In his opinion, programs should only be expanded when there is fiscal space. "Over the past five years, National Development Bank–subsidized loans to the private sector have cost the Treasury nearly R$40 billion a year," he explains. "The My House My Life program cost R$18 billion in 2018. Are these expenses bad? No—as long as we have the resources to pay for them."

Infrastructure

IPEA's Marco Antonio Cavalcanti says that better fiscal management is critical to a more promising scenario for investment in the long term. "We have to look at the ongoing adjustments in the economy with optimism; it is a cost to pay for a better situation in the future," he says.

Marcio Pochman, professor at the University of Campinas, believes that consumption-led growth could be partially reversed with the change of interest rate policy. "Since 1990s, Brazil has had one of the highest interest rates in the world. That's a premium for nonproductive investment. As a result, growth in recent decades was limited to consumer cycles," he says. Pochmann argues for a long-term investment plan as a way to take the focus of the Brazilian economy off consumption and the short term. "We need to address a broader issue: the lack of a national project. Unfortunately, the country is completing four decades of being tied to a short-term plan," he said. Since the 1970s, he notes, Brazil has not been able to boost an investment-led expansion cycle, which is critical for sustainable long-term growth.

With R$189.4 billion budgeted for fixed investments, the new phase of the new PIL investment program is government's tap to turn on the virtuous investment-growth cycle. IBRE researcher Armando Castelar thinks the program has benefited from lessons learned from previous mistakes: "Now there are concessions for shorter sections of roads that can attract more businesses; also rules for the railway sector were changed." But, he adds, a lot has not yet been defined,

highlighting uncertainties about such barriers to investment as the government's emphasis on low tariffs. He also pointed out the need to make spending on infrastructure more efficient. Castellar emphasizes the importance of better management of such regulations as environmental licenses. For example, "The project to divert part of the São Francisco River to supply drinking water was planned for completion in 2010 at a cost of R$4.5 billion; the cost is now estimated at more than R$8 billion without a drop of water yet flowing."

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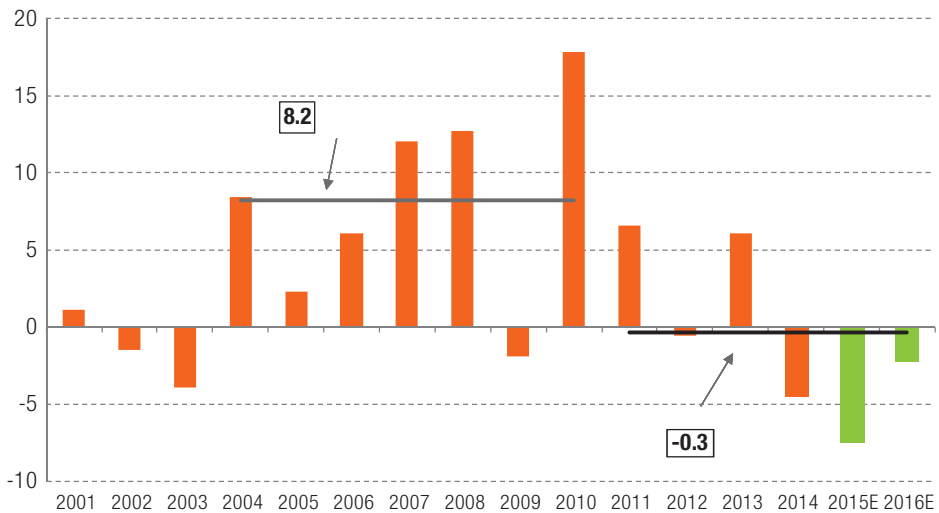
João Ronaldo de Castro

Productivity

There is a general consensus on the need for more efficient use of production inputs. Pedro Ferreira Cavalcanti of FGV Growth and Development, points out, for example, that low production efficiency accounts for almost two-thirds of the 80% income gap between Brazil and the United States. Among factors that depress productivity are bureaucracy, corruption, and micromanagement of the economy, all of which affect the business environment.

Brazil's fixed investment growth declined substantially during 2011-2014, and is expected to fall by 7% in 2015

(Annual % growth)



Sources: IBGE and IBRE.

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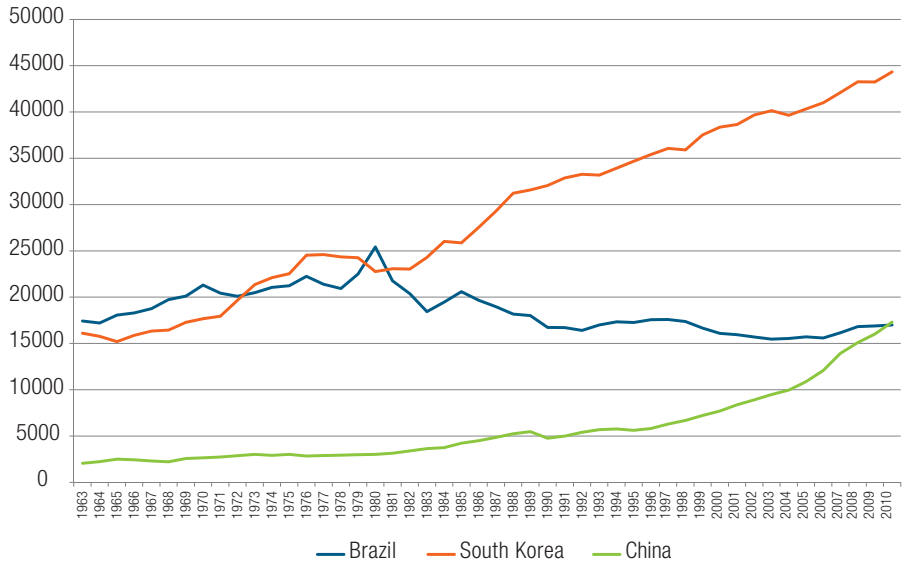
"An infrastructure investment plan is a virtuous adjustment that promotes productivity," IPEA's Cavalcanti says. "The only way for economic growth to resume in the short and medium term is to increase exports of manufactured products, and that depends crucially on better transport infrastructure, wage moderation, and careful adjustment of the exchange rate," says José Luis Oreiro of the Federal University of Rio de Janeiro. Oreiro believes that the competitiveness of Brazilian exports depends on an exchange rate of more than R$3.50 per US dollar. "If we again stop adjustment of the economy, we will reap the worst of both worlds: we will have a stagnant country and high inflation," he says. In his opinion, "The central bank could reasonably work with a longer horizon to meet the inflation target, possibly in 2017 or 2018. If the period to meet the target was extended, we could stop raising interest rates, with less sacrifice in terms of income and employment."

Nelson Marconi, IBRE researcher, argues that the competitiveness of Brazilian industry depends on policies to reduce costs. "This requires an appropriate tax structure for the productive sector, with differential treatment for imports used by those who export," he says. Marconi also suggests an improvement in the cost of financing, with special credit lines for companies that fulfill export targets. "This could also apply to investment in innovation, with a line of credit. Rather than being inconsequent protectionism, this would create incentives and encourage companies to invest in innovation," he says.

Fernanda De Negri of IPEA points out that investment in innovation, which is a major productivity-enhancing factor, is cyclical and has declined in recent years. Data from the Innovation Survey by Pintec and IBGE show that the largest recent investment in innovation occurred in 2005–08, but the distance separating Brazil from the technological frontier has not changed because similar expansion happened elsewhere in the world and, in relative terms, Brazil remained in the same place. The risk, in fact, is going backward. According to the Brazilian Agency for Industrial Development (ABDI), in late 2014 the rate of innovation in Brazilian industry was back to one of the lowest values at the start of the series in 2010. The share of manufacturing firms with more than 500 people that have invested in product and process innovation dropped from 27.8% in the first quarter of 2011 to 17.1% in the fourth quarter of 2014.

Brazil's service sector has low and declining productivity compared to South Korea and China

(US$ of 2005 per worker)



Source: IBRE.

Enhancing productivity in services

Supporting growth will require making the service sector more productive, because that sector accounts for 70% of GDP. "Brazil's service sector became large prematurely, making a structural transformation in reverse by transferring resources from more productive sectors to less productive service sector," Arbache says. "A large, inefficient, and expensive service sector like ours contaminates other sectors of the economy."

Fernando Veloso, an IBRE researcher, points out that unlike South Korea, where services have high added value, in Brazil they are concentrated in low-skilled activities. "In Korea, highly skilled workers represent 51.4% of the total workforce; in Brazil skilled workers account for only 23.3%," he says.

Arbache believes that today Brazil's economic structure and poor-quality education reflect an excessively closed economy. "Because the economy depends too much on agriculture and mining, and industry is protected from competition, there is not much demand for skilled workers," he says. "Brazil started paying attention to education in the 1990s, when the country began to open up the economy to international trade, but South Korea, Singapore, Japan had already done it," he says. "Today we have to take a quantum leap. We should consider education as a wealth creation tool and include it definitively in the policy agenda," he concludes.