THE BRAZILIAN ECONOMY

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20 years after the Real Plan, why does growth remain elusive?

Brazil celebrates two decades of monetary stabilization and introduction of the *real*, but has yet to find the formula for sustained growth.



Foreign Policy

Will a new president make any difference in foreign policy?

IBRE Economic Outlook

Markets are jittery about Brazil's economic fundamentals.

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The BRAZILIAN ECONOMY

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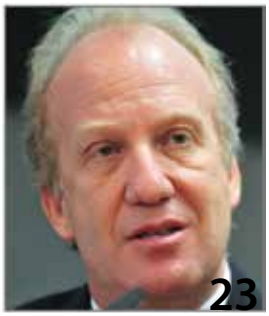
Regional Economic Climate
Lia Valls Pereira

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Brazil is celebrating two decades of monetary stabilization and introduction of the real , but has yet to find the formula for sustained growth. Solange Monteiro explains the trajectory of the Real Plan but asks the experts: Why can Brazil not grow in a sustainable way? There are concerns that not only have efforts to address the economy's imbalances failed, but the problems have been exacerbated by policies to increase consumption.

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A middle way that reconciles economic and social policies is best for Brazil according to Marcelo Neri, Minister of Strategic Affairs of the Presidency of the Republic and Director of the Institute for Applied Economic Research (IPEA), tells Kalinka Iaquinto. In particular, he emphasizes that "We have not given early childhood education the importance it deserves."

IBRE Economic Outlook

27 Brazil is now considered one of the fragile five emerging countries and is second only to Turkey on the Fed's economic vulnerability index. That does not bode well for the economy in 2014. The IBRE assessment of the Brazilian economy has not yet changed substantially but the risks have become more worrying.

ECONOMY

Central Bank economic activity index slips

Economic activity in Brazil contracted more than expected in November—0.31% from October in seasonally adjusted terms—despite a surge in retail sales, throwing cold water on hopes of a modest recovery from a third-quarter slump. (January 17)

Household debt up, defaults down

Although the rising cost of credit and the slowdown in real wage gains in early 2014 have increased both household debt and the share of consumer income committed to debt service, fewer households were in default, says the National Confederation of Trade in Goods, Services and Tourism. The share of households that declared bankruptcy fell to 19.5% in January from 20.8% in December 2013. (January 22) Although defaults by corporations grew by 2.5% in 2013 compared to 2012, according to Serasa Experian, the growth was much less than in the previous two years: in 2012 corporate defaults went up by 10% and in 2011 by 19%. (January 30)

Current account deficit tops US$81 billion in December

Brazil ended 2013 with a current account deficit of US$81 billion (3.7% of GDP), compared to US$54 billion (2.4%) in 2012. The deficit was covered partially by foreign direct investment of US$64 billion during the year, about same as in 2012, despite the economic slowdown since mid-2011. (January 24)

Growth estimates cut for 2014, 2015

According to a weekly central bank survey of 100 economists, they have cut their outlook for 2014 growth from 2% to 1.9% and for 2015 from 2.5% to 2.2%. They also raised their inflation expectations, to 6.0% for 2014 and 5.7% for 2015. (January 27)

Business investment likely to slow in 2014

Several years of slow growth have made businesses wary of investing in new production. A National Confederation of Industry survey showed the lowest level of intentions to invest since 2010, when the survey began; 61% of respondents cited "economic uncertainties" as the main risk for investments in 2014. (January 28)

Credit grew less in 2013

According to the central bank, in 2013 total credit supply was up 14.6% in 2013, to R$2.7 trillion (US$1.1 trillion), 56.5% of GDP, compared to 53.9% of GDP in 2012. The default rate fell to 3%, the lowest since 2011, when the central bank began monitoring credit offers. (January 29)

Manufacturing confidence falls in January

The Industry Confidence Index of the Getulio Vargas Foundation fell 0.4% in January from December as industry's perception of improvement in the present were more than offset by worsening expectations for future months. The proportion of companies expecting to hire more personnel in the next three months also fell, from 21.9% to 18.1% (January 29)

Stocks down, U.S. dollar up in January

The wave of risk aversion that has toppled emerging markets has reached Brazil. In January the Bovespa stock index fell by 7.5%, and the dollar appreciated against the real by R$2.412, a 2.3% rise for the month. With global liquidity tightening and economic slowdown in China, investors have fled to assets considered safer, such as U.S. Treasuries. (January 31)

Trade balance deficit widens

Brazil's trade deficit was US$4.1 billion in January—the worst since 1994—according to the Ministry of Development, Industry and Foreign Trade. There was a decline in manufacturing exports and a broad-based increase in imports. (February 3)

Industrial output meager in December

Output at Brazil's mines and factories rose slightly in 2013 as a weak second half undercut growth, according to the statistics agency IBGE. Industrial production rose 1.2% in 2013 after contracting 2.5% in 2012, but it sank by 3.5% in December from November. Demand fell with higher interest rates and the end of tax breaks on big-ticket purchases, such as cars, home appliances and furniture. (February 4)

Inflation slows to 0.55% in January

The official price index (IPCA) rose 0.55% month-on-month in January, less than the 0.92% in December. Inflation for 2013 totaled 5.63%, according to IBGE. A 15.88% reduction in airfares helped suppress inflation growth, but food inflation picked up because of weather problems. (February 7)

POLITICS

President rejuggles the cabinet

As the administration gears up for the October elections, Education Minister Aloizio Mercadante will replace Chief of Staff Gleisi Hoffmann, who is expected to run for governor of Paraná state. Ministers who want to campaign for office must leave the government at least six months before elections. Rousseff also named Arthur Chioro as health minister and José Henrique Paim Fernandes as education minister. Rousseff said in December that Guido Mantega would continue as Finance Minister. Though there has been no official announcement, Rousseff is expected to seek a second four-year term; opinion polls place her well ahead of likely rivals. (February 3)



Photo: Elza Fiuza/Agencia Brasil

New Chief of Staff Aloizio Mercadante

Campos and Silva enter the fray

Governor of Pernambuco Eduardo Campos and former Senator Marina Silva (both Brazilian Socialist Party, PSB) have launched their campaigns, Campos for president and Silva for vice-president. Their announcement stated that their alliance proposes political reforms that would allow candidates not affiliated with parties to run for office, no re-election and five-year terms for executive positions, and a lower minimum number of signatures for bills proposed by popular initiative. (February 4)



Photo: Joao Cruz/Agencia Brasil.

Former Senator Marina Silva and Governor of Pernambuco Eduardo Campos

ECONOMIC POLICY



Photo: Wilson Dias/ Agencia Brasil

Central Bank Governor Alexander Tombini

Benchmark rate hits 10.5%

To contain Brazil's highest inflation in over a decade, the central bank has brought its benchmark interest rate up 50 basis points to 10.5%. The total rise in the past nine months has been 325 basis points. (January 15) Central Bank President Alexandre Tombini recently stated that policy makers will continue to fight inflation as the real weakens, which suggests that the tightening will continue. (January 28)

Mantega: Brazil prepared for global currency volatility

Brazil is prepared to withstand a sell-off of emerging-market currencies triggered by the withdrawal of U.S. monetary stimulus and a possible slowdown of the Chinese economy, Finance Minister Guido Mantega has announced. Large foreign currency reserves and low external debt put Brazil in a good position to ride out the currency roller coaster, which Mantega said could be temporary. (January 28) The IMF Director for the Western Hemisphere, Alejandro Werner, agreed that the Brazilian economy is ready to handle increased market volatility. (January 30)

Budget surplus falls short, downgrade risk rises

For 2013, at R$91 billion (1.9% of GDP) the primary budget surplus—the excess of public revenues over expenditures before debt payments—was short of the R$111 billion goal. To even reach the lesser surplus, the government had to rely heavily on billions of dollars in extraordinary revenues from corporate tax settlements and an oil-rights auction. The situation has raised the specter of a credit ratings downgrade for Brazil. (January 31)

FGV Brazil

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Unfinished business

THE 1994 REAL PLAN not only stabilized the national currency, it stimulated an impressive and politically difficult series of structural and institutional reforms under President Fernando Henrique Cardoso (1995–2002): The federal government refinanced state and municipal debts through bilateral agreements; the social security system got a new face; a constitutional amendment in 1998 raised the retirement age for new public employees to 60 years for men and 55 years for women and led to changes in how the pension benefits of private workers were calculated; state-owned enterprises were privatized; many banks were closed or restructured; and the Fiscal Responsibility Law was approved.

In a remarkable political U-turn, leftist President Luis Inácio "Lula" da Silva (2003–2010) stuck with the policy framework of the Real Plan, though apart from introducing an income tax on pensions of retired public employees, reforms virtually came to a halt. Nevertheless, the Lula administration enjoyed enviable international and domestic conditions for introducing pro-growth and poverty reduction policies. However, consumption-led growth eventually proved to depend too much on external financing, making Brazil's trade less competitive.

Since 2011 with a less favorable international outlook and the exhaustion of consumption-led growth, the economy has stagnated and the external current account has deteriorated steeply. Dilma Rousseff's administration (2011–2014) correctly identified many of the structural constraints on the Brazilian economy—high interest rates, high energy prices, low fixed investment... but its attempts to correct them by government-led growth has so far had at best mixed results.

Since the Real Plan was introduced, no administration has yet addressed the crux of the matter: government consumption has exploded, and so has the tax burden on Brazilians. Two decades ago, total public spending—federal, state, and municipal—was 25% of Brazilian GDP, already higher than in countries with similar per capita incomes. Today, government eats up 40% of GDP—about the same as Europe, but certainly without the same quality of public services. In 2013, while nominal GDP rose by just 8%, public spending shot up almost twice as fast, by 15%.

No doubt Brazil has been more successful than other emerging countries in social integration and reducing inequalities, but that success has come at the cost of lower investment and growth. As former Finance Minister Delfim Netto points out, we urgently need a better balance between income distribution and pro-growth policies.

No administration since the Real Plan was introduced has addressed the crux of the matter: government consumption has exploded, and so has the tax burden on Brazilians.

To avoid stalling the economy further, in 2015 the next president must curb the gargantuan government appetite. Growth in current public spending must be held below growth in nominal GDP. A solid ceiling for spending growth needs to be complemented with a reduction in budget rigidities, less earmarking of revenues for specific expenditures, and more transparency in spending, tax benefits and subsidies.

Obviously, that will be politically difficult. Vested interests will arise in all directions. But as the precedent of the Real Plan itself makes clear, major reforms are possible in Brazil even under extremely difficult conditions. Many of the reforms put in place by the Cardoso administration required negotiation of constitutional amendments that at the time were also considered politically impossible. We can only hope that political leaders do not validate the opinion of Brazilian anthropologist and folklorist Câmara Cascudo, who famously said, "Brazil has no problems. Only delayed solutions."

Will a new president make any difference in foreign policy?

João Augusto de Castro Neves, *Washington, D.C.*

IIN BRAZIL PRESIDENTIAL ELECTIONS are never about foreign policy. Even when international issues gain domestic salience, the attention seldom leads to meaningful discussion of the state of the country's foreign policy and what changes should—or could—be made. Unfortunately, this is likely to be the case again this year.

But if the main presidential candidates were to have an earnest debate on foreign policy, what issues would most likely arise? How would criticisms of the government's current policy options metamorphose into viable policy alternatives? In essence, what would Brazil's foreign policy look like in 2015?

Historically, Brazilian diplomacy has been directed by its economic policy goals. While ideology matters somewhat, more often it is the economic context that sets the tone. In the 1990s, much of Brazil's international agenda was determined—perhaps limited—by the imperative need to stabilize the economy. In the 2000s, as the country began to benefit from a robust economic growth cycle fueled by Chinese demand and high commodity prices, Brazilian foreign policy makers became emboldened to broaden their repertoire as expectations rose about what the country could achieve in the world.

Throughout much of the Lula administration (2003–10) a favorable global economy allowed Brazil to augment its international standing and explore new initiatives (coalitions of emerging powers, closer ties with Arab and African countries, an attempt to broker a deal on Iran's nuclear program) without much harming more traditional ones. There were renewed, though again unsuccessful, efforts to deepen regional integration. A trade deal with the EU died mainly due to differences between Argentina and Brazil. Suspension of trade talks with the US revealed prolonged though tacit reluctance—if not opposition—on both sides to reach agreement.

Ultimately, the successes and failures of Brazil's new foreign policy were obfuscated by the impressive numbers at home. The economy grew, trade boomed, the middle class expanded, and most socioeconomic indicators improved.

The question now is how a far more unfavorable global and domestic economic environment will affect the foreign policy of the next government. While a more assertive diplomacy has its costs, they will most likely be lower than what it would cost the country to retrench. As the economy vacillates, Brazil's international presence has been increasingly supported by more solid pillars, from political stability and economic muscle to demographics. To a large extent, Brazil's recent rise was not an isolated event but a function of successful economic and social policies. To withdraw from the international stage would be to turn evolution into a dead end.

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A more challenging economic environment should in fact press the next government to take up to a more pragmatic foreign policy, especially when it comes to trade. After all, given the risk that major trade initiatives like the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) may sideline WTO negotiations and split Mercosur, the opportunity cost of Brazil not having a proactive trade agenda will surely increase —as the deteriorating trend of its trade balance already suggests.

All things considered, then, the foreign policy of the next government may have to change regardless of who wins the election. The intensity, however, will vary. The main opposition candidate, Senator Aécio Neves, would try for a dramatic shift. The rhetoric will definitely turn more pragmatic, and structurally the country will continue to seek close economic ties with all major economies. The main challenge will be promoting a more proactive trade policy, which would necessarily entail rethinking Mercosur's role as a customs union and kick-starting trade talks with the US.

The tea leaves are harder to read for an administration run by Eduardo Campos and Marina Silva. So far Campos's thinking on trade policy seems similar to that of Neves, but Silva is more of a wild card. Much would depend on her actual role in a Campos government (probably vice-president), but she would most likely push for a more principled approach in terms of human rights and environmental issues. That may cool political relations with China and other authoritarian countries, although no major changes in economic relations are likely.

Finally, a second Dilma Rousseff administration, without making a clean break with the policies of her first term, will slowly take on the challenges outlined. Without an actual paradigm shift, her government will also seek a more balanced approach in its relations with major economies and a gradually more proactive trade policy, though much more slowly than the other two candidates would. The need to deliver more to a burgeoning middle class could also add pressure for less trade protectionism.

The common factor facing all three presidential contenders will be a harsher economic context that may not only limit the scope of their immediate diplomatic action but also exacerbate skepticism about Brazil's role in the world. In the end, their main task will continue to be to bring together the channels of foreign and domestic policies. If that can be done, foreign policy may have more relevance to future presidential campaigns. ■

A more challenging economic environment should in fact press the next government to take up to a more pragmatic foreign policy, especially when it comes to trade.

The opportunity cost of Brazil not having a proactive trade agenda will surely increase—as the deteriorating trend of its trade balance already suggests.

20 years after the Real Plan, why does growth remain elusive?

Brazil celebrates two decades of monetary stabilization and introduction of the *real* but has yet to find the formula for sustained growth.

Solange Monteiro

IN ITU CITY IN THE STATE of São Paulo, Allan de Oliveira Melo works in his mother's cleaning products business. He already has his own car and wants to study law. He loves going out with friends but now "gasoline, restaurants, and entertainment have become more and more expensive," he says.

The almost 6% inflation that worries Melo is quite different from the 2,477% hyperinflation that afflicted Brazil in 1993, the year he was born. His generation has been able to enjoy monetary stability thanks to the plan that introduced a new currency—the Brazilian *real*—to deal with out-of-control prices. At that time, after six stabilization plans had failed in seven years, with the population frightened by a roller coaster ride of price controls, currency changes, and traumatic confiscation of banking deposits, President Itamar Franco nominated Senator Fernando Henrique Cardoso to be the fourth Minister of Finance in less than a year.

In late February 1994 the new economic team unveiled its plan: First, all Brazilian prices and wages were converted to a temporary unit of value pegged to the price index (URVs). The URV was then replaced in July 1994 with the Brazilian *real* at parity with the U.S. dollar.



The new plan worked beyond expectations. The hyperinflationary cycle was broken, bringing stability to the Brazilian currency. Later in the same year Finance Minister Cardoso was elected president, in no small measure because of the plan's success.

"President Fernando Henrique Cardoso brought in the best possible team. And his administration excelled in transparency, making sure the people knew everything that would happen," says former Finance Minister Antônio Delfim Netto. "There were no wage controls, income distribution was stabilized, and prices were freed, allowing the economy to adjust. It was brilliant."

Today, 20 years later, the economy is still stable. Yet despite numerous achievements, real interest rates in Brazil are among the highest in the world; inflation, though happily not astronomical, is high and edging up; and economic growth is disappointing.

"President Fernando Henrique Cardoso brought in the best possible team. And his administration excelled in transparency, making sure the people knew everything that would happen."

Antônio Delfim Netto

THE NEED FOR FISCAL REFORM

Why can Brazil not grow in a sustainable way? The Real Plan did bring about reorganization of state finances, privatization of state-owned enterprises and banks, adoption of macroeconomic targets, and the Fiscal Responsibility Law. "We managed to make the necessary changes to fight inflation, but . . . the end of growth led by import substitution in the 1980s required a fiscal reform focused on investment," says Fernando de Holanda Barbosa, professor of economics at the Graduate School of Economics of Getulio Vargas Foundation (EPGE). Instead of dealing with low domestic savings that still limit investment and growth,

Taming inflation

1993 ..... 2,477.1

1994 ..... 916.4



Source: Government Statistcs Agency (IBGE).

Instead of dealing with low domestic savings that still limit investment and growth, governments adopted far less promising policies.

however, governments adopted far less promising policies. Efforts to address the economy's imbalances, such as excessive currency appreciation and rising tax burdens, slackened. Recently the problems have been exacerbated by policies to increase consumption. Even as Brazil benefited from rising prices for commodities exports, it became dependent on external investment to finance its excess spending and the external current account deficit.

"Public investment was sacrificed to allow more income redistribution. Less accumulation of capital contains the seeds of its own destruction," says Delfim Netto, pointing out how the economic winds have changed since 2011. "Without a doubt, the last decade has been a period in which we practically ended absolute poverty and improved school attendance. But to grow, we need now to harmonize improving income distribution with investment."

THE EXCHANGE RATE PEG

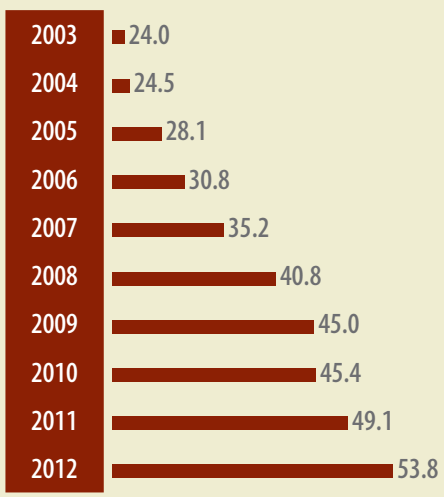
Talking about the Real Plan, Renato Fragelli, EPGE lecturer, argues that, in hindsight, "Any knowledgeable economist who could make policy decisions would plan differently, starting with fiscal adjustments for a more consistent plan to end inflation quickly, without excessive exchange rate appreciation and high real interest rates, which cost the country so much … But if we take into account the decisions that had to be taken in the face of so much uncertainty, it was a success."

Gustavo Franco, a member of the Real Plan economic team and president of the Central Bank from mid-1997 to early 1999, remembers that "Many of my colleagues on the Real Plan (such as Pérsio Arida, André Lara Resende, and Edmar Bacha), who had participated in previous stabilization attempts, warned that it was possible to bring inflation down, with wonderful effects, but if politicians did not carry out reforms, inflation would come back, and another politician would call us again to do the same trick."

Franco compares the second phase of the plan, from 1995 to 1998, to an infantry battle. "It was hand-to-hand combat against inflation, painful and exhausting," he says. "It was natural to lose allies, suffer casualties,

Brazilians have more access to credit

(% of GDP)



Source: Central Bank of Brazil.

and have difficulties with Congress. … All those affected by the reforms who did not like its consequences become hostile—they liked the Real Plan until its effects were not favorable for them," he recalls.

Holanda Barbosa points out that it took four years to complete the adjustment by ending the peg of the new currency to the dollar, establishing a primary fiscal surplus regime with a flexible exchange rate system, and the central bank adopting an inflation target, which had negative effects on economic growth. Consequently, many grew dissatisfied because the cost of the protracted adjustment was large. "Maintaining an exchange rate peg to the dollar during that period meant that the average inflation-adjusted interest rate at the end of the first Cardoso administration was about 22% per year. It was blistering, but keeping the exchange rate peg was necessary [to break the back of inflation]," he says.

Flavio Castelo Branco, executive manager of the Economic Policy Unit of the National Confederation of Industries (CNI), says that monetary stability was essential for extending the planning horizon for businesses. Lia Valls Pereira, IBRE researcher, adds that, "The problem was that the peg was carried too far, until 1998, which reduced our external competitive edge." The impact of the exchange peg on the export sector was large, as was reflected clearly in the external trade balance deterioration.

At the time, rising imports helped to contain inflationary pressures after the 1990 tariff reform program—on average, in four years import tariffs plunged from 45% to 14%. "The textile industry was one that sacrificed, losing 250,000 jobs. Trade barriers to importing computers in the 1980s had delayed the process of modernization, and the impact was great," says Valls Pereira.

"Many of my colleagues on the Real Plan . . . warned that it was possible to bring inflation down, with wonderful effects, but if politicians do not carry out reforms, inflation will come back, and another politician will be calling us again to do the same trick."

Gustavo Franco

Julio de Almeida, lecturer at the University of Campinas (Unicamp), estimates that the losses were necessary for monetary stabilization. "We can say that the exchange peg lasted longer than it should have, that there was no industrial and innovation policy to support industry, but the gains are undeniable," he says. After the severe exchange rate devaluation in 1999, "The problem was that in the last decade we let the currency appreciate again. Prolonged exchange rate appreciation reduces the incentive to invest to export more; companies turn to the domestic market and lose potential to innovate to increase productivity."

SOARING TAX BURDEN

Since the Real Plan was introduced, the federal budget has been balanced mainly by increased tax collections; meanwhile, public spending has surged relentlessly. With the Real Plan having reduced inflation, the government could no longer print more money and pay for its spending with a

> **"We can say that the exchange peg lasted longer than it should have, that there was no industrial and innovation policy to support industry, but the gains are undeniable."**
>
> *Julio de Almeida*

debased currency. The imbalance between revenues and expenditures became clearer, requiring a prolonged process of adjustment that included substantial tax increases. In addition, points out IPEA's Mansueto de Almeida, the 1988 Constitution had significantly expanded social programs by introducing the Unified Health System, universal public education, and expanded income transfers.

Fiscal tinkering and cuts in public investment were not enough to pay for the spending on new social programs. The tax burden increased from 25% of GDP in 1994 to 36% today. "Brazil entered a perverse dynamic that still continues—government spending (even excluding interest payments) growing at double digits and taxes rising to ensure a primary budget surplus. But we cannot do in the next 10 years what we did in the last 20 unless the tax burden reaches 40% of GDP. As a middle-income economy with low productivity, that is too high for us to support," Mansueto de Almeida says.

NEW GOVERNMENTS, OLD POLICIES

To ensure its consolidation, monetary stabilization had to overcome political uncertainty during the 2002 transition from the moderate Social Democratic Party government to the leftist Workers' Party. Market anxiety about the policies of President Lula triggered capital flight and devaluation of the exchange rate. But in a



Ups and downs of the trade balance

(Billions of U.S. dollars)

Source: Central Bank of Brazil.

remarkable political U-turn the President and Finance Minister Antonio Palocci stuck with the Real Plan.

The Lula administration enjoyed enviable international and domestic conditions for introducing pro-growth policies. "Between 2003 and 2010, credit in Brazil doubled in relation to GDP. Adding 25% of GDP in credit in 10 years and doubling the size of the banking system could be considered a bubble, but Brazil did it without undermining the quality of bank assets, because banks were well-capitalized," says Franco. Thanks to buoyant Chinese demand for agricultural commodities and minerals and high commodity prices, surging exports allowed Brazil to accumulate large international reserves. At the same time, the entry of many young people into the labor market and the social programs gave the country a thriving new middle class.

But consumption-led growth eventually proved to depend too much on external financing at the expense of Brazil's competitiveness. Since 2011 the less favorable international outlook and exhaustion of consumption-led growth has brought about a steep deterioration of the external current account, to a deficit of US$81 billion in 2013.

According to Franco, there has also been a shift in policy focus. "Instead of the pro-growth policies of a market economy, we see a government-led investment growth policy, with little results," he says. "The National Development Bank tripled its lending, but fixed investment and domestic savings remain low." EPGE's Fragelli argues that Brazil needs to recognize that its domestic policies affect its attractiveness to international investors: "If Brazil has foolish policies, investors will take their business to Chile, Mexico, and India."

"We cannot do in the next 10 years what we did in the last 20 unless the tax burden reaches 40% of GDP. As a middle-income economy with low productivity, that is too high for us to support."

Mansueto de Almeida

RETHINKING POLICY

How can Brazil achieve sustained growth? The solutions are old and unpopular: tighter control of public spending, structural reforms, and meeting macroeconomic targets. "For 10 years the 4.5% inflation target has not been changed. … We need to think about lower inflation targets as Chile does, between 2% and 4%," says Salomão Quadros, IBRE prices expert. Holanda Barbosa points out that the foundation of inflation targeting has to be trust: "On the day the central bank can convince society that it will deliver the inflation target, we all will adjust our prices to the inflation target," he says.

Rubens Penha Cysne, EPGE director, points out that adjusting policies is a process that takes time: "If we compare Brazil to Portugal, France, England, and the United States, our institutional evolution is very recent. Behind institutions there is culture, and behind culture there is history, which in our case is still very short," he says. He believes what is needed to address public expenditure and administration is a broad debate on institutional development.

"On the day the central bank can convince society that it will deliver the inflation target, we all will adjust our prices to the inflation target."

Fernando de Holanda Barbosa

Delfim Netto argues forcefully that policies should aim to harmonize income redistribution and investment, although he recognizes that "Politically coordinating changes to approve budget cuts is always tricky."

Holanda Barbosa believes that Brazil needs to fundamentally rethink its growth strategy. The difficulty resides in reaching political consensus, so that everyone sacrifices some consumption to increase savings and investments today so that the economy can grow faster, benefiting all. If Brazil grew at 6% a year, in 15 years Brazilian incomes would double.

Brazil's growth has been relatively low for an emerging country.

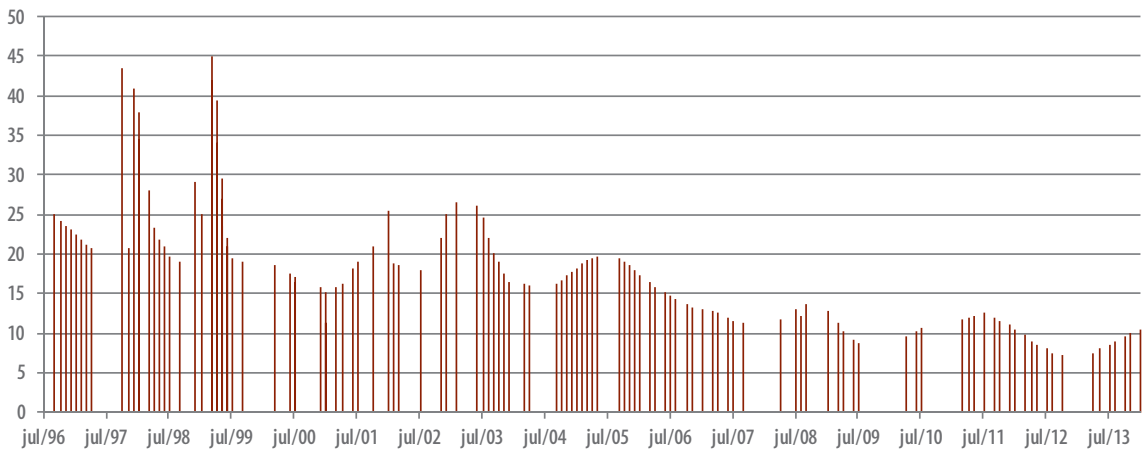
(% change)

1993	4.7
1994	5.3
1995	4.4
1996	2.2
1997	3.4
1998	0.04
1999	0.25
2000	4.31
2001	1.31
2002	2.66
2003	1.15
2004	5.71
2005	3.16
2006	3.96
2007	6.09
2008	5.17
2009	-0.33
2010	7.53
2011	2.73
2012	0.87

Source: Government Statistics Agency (IBGE).

Today Brazil has one of the highest interest rates in the world at 10% a year.

(Central bank's benchmark interest rate)



Source: Central Bank of Brazil



Gustavo Franco

The need for "economic common sense"

Solange Monteiro and Bertholdo de Castro

FORMER PRESIDENT OF THE CENTRAL BANK Gustavo Franco, one of the creators of the Real Plan, reminds us of the daunting obstacles to economic stability in 1994. He also reminds us of when inflation reached its lowest point at the end of 1998. Today, he says, there is a relentless pursuit of economic policies to sustain economic growth worldwide, and the formula is "perhaps well-known but difficult to carry out." Today, Franco would be pleased to see something done about the policy setbacks of the last two years.

***The Brazilian Economy*—Is the Real Plan exhausted?**

Gustavo Franco—You would have to go back as far as the Old Republic in the early 1900s to find inflation so low. If in 1993 you had said that inflation, which was at 45% a month, would in four years reach 1.6% a year, half the population would have said that was impossible—and the other half would have said it was taking too long.

What can be done to foster growth?

This is the billion-dollar question. I remember in 1995, when I was director of the central bank and we were thinking about how to foster development, I argued that once past the first phase of the Real Plan we could see inflation gradually falling, and it would be important to carry out other reforms, such as fiscal consolidation. … We promoted privatization not merely to resolve a fiscal issue of state-owned enterprises being unprofitable but also, and primarily, to recover investment capacity in the steel, telephone, and railway sectors that were being privatized. ... But something happened that we had feared: Many of my colleagues on the Real Plan warned that it was possible to bring inflation down, with wonderful effects, but if politicians did not carry out reforms, inflation would come back.… We also felt that though initially political support to promote reforms was great, riding on the euphoria of the plan, it would run out gradually.

What reforms are needed now?

Around the world, people are seeking the perfect formula for economic growth. The formula is known, but it is difficult to implement. Very few countries have grown sustainably. (Perhaps in Asia.) Accelerated growth is more complex than stabilization; it involves collective coordination, incentives, and correct government policies, in the right measure.

In Fernando Henrique Cardoso's second term, there was less political support to push ahead with reforms; initial turbulence with the devaluation in early 1999 weakened the government. In 2003, when the Lula administration came in, there was a perceived threat that the president could become Hugo Chavez and destroy the Real Plan. By 2004 the economy had survived the

political transition and, with a much improved international environment, the political climate became less risky. Maintaining the same economic policy allowed the new government to introduce pro-growth measure, such as payroll loans. It was a spectacular moment in terms of favorable international commodity prices and population demographics. … The 2008 crisis interrupted the consumption-led economic growth brought about by propitious demographics [more workers entering the labor force], ample credit growth, and favorable commodity prices. … Investments and savings continued to be low. In the Rousseff administration, consumption-led growth has slowed sharply, because household debt has no more room to grow.

Why does Brazil not grow now? Fixed investment depends on a favorable business environment. According to the World Bank's Doing Business report, Brazil ranks far down at 120th among 180 countries. The ranking covers all the very basic needs for development, including time it takes to open and close a company, time spent to fulfill tax obligations, labor law, protection of property rights, and access to credit.

Today we have high interest rates, inflation, a looming downgrading of Brazil's investment grade by international rating agencies, and elections. Do you think the new government will carry out reforms?

Whoever wins in October, including Rousseff herself, I hope will bring back economic common sense. There is a well-established international set of good policy practices that either we do or do not. In the last two years we followed Argentina and Venezuela, and we got close to [their] dysfunctional results.

We have the Asian countries' successful examples, but ... [in all cases of successful growth] they had reforms, often contentious, that created institutions to foster economic grow as opposed to traditional ones.

South Korea is an example of growth through investment in education. Why is education not part of the debate?

Brazil spends a lot on public education but spends it badly. Here discussion of more investment and improvement in education becomes a discussion on teacher salaries. Not that teacher salaries are not important, but education management is the crucial issue, especially in elementary and secondary education. But there is absurd teachers' union opposition against setting goals, plans, and meritocracy in education. We do not have proposals for national education reform. There were important initiatives in the Cardoso administration, such as the National High School Exam, which introduced meritocracy. Increasing the productivity of investment in education is much more important than increasing the education budget.

What should we expect in the immediate future?

I would be pleased to see the policy setbacks of the last two years reversed. Fiscal policy has deteriorated a great deal, pushing inflation up and forcing the central bank to fix it the wrong way, by increasing interest rates. We are abandoning a trend toward lower interest rates. This is the fault not of the central bank but of lax fiscal policy. This has to be corrected in the first year of the new administration in 2015, not in an election year. It would be great if we, as a country, had already moved beyond adolescence on fiscal and monetary affairs. I thought we had, but the last two years seem to prove the contrary.



Delfim Netto

"Tell the truth to society"

Solange Monteiro

FORMER MINISTER of Finance, Planning and Agriculture Antônio Delfim Neto speaks of the Real Plan as "absolutely brilliant." However, he says, the plan should have been complemented by fiscal consolidation. He also says that "a country that has a tax burden like Brazil's could have infinitely better public services." He supports the goals of last year's demonstrations, when many thousands took to the streets calling for better transport, health, and education services. But, in the run-up to the presidential election, he believes that "neither the opposition nor the government will have the courage to tell the truth to society: we are facing an exhausted growth model."

The Brazilian Economy—The Real Plan is now 20 years old but Brazil has not been able to sustain growth. What went wrong?

Delfim Netto—The Real Plan was absolutely brilliant. The idea and design honor the economists who carried it out. The plan taught us one thing: transparency is critical. The plan was superior to all previous attempts to curb inflation. But the Real Plan has never been finished. Its necessary complement should have been fiscal consolidation. When the plan began, Brazil had a 3% to 4% fiscal deficit. Along with execution of the Real Plan, we needed a fiscal adjustment at once to eliminate that deficit, by increasing tax revenues, cutting expenditures, or both. It was absolutely necessary to eliminate the fiscal deficit. Unfortunately, that was never done. The great success of the Real Plan was produced in the midst of a disastrous policy of pegging the currency to the U.S. dollar; that might have been necessary initially, but it was taken too far. In the second term of President Cardoso, the economy improved a lot because the exchange rate to the U.S. dollar was allowed to float and the Fiscal Responsibility Law was enacted.

The Cardoso administration did really important things, but we never got to the essence of the problem: excessive public spending. The central bank alone cannot control inflation. What is essential is a correct fiscal policy. … Today, fiscal policy is not a total tragedy, but my feeling is that the fiscal deficit is slowly growing. The outlook is very bad. We had a huge victory in terms of social inclusion, but some of the economy's difficulties are due to that victory … . The economy has to have a balance between income distribution and production.

Has society changed?

People are now aware that certain of the government's priorities are dubious. In some cases they are right. The federal Family Grant program is ultra-efficient at reducing poverty. In 12 to 14 years we have almost eliminated absolute pov-

erty in Brazil. But we need an exit strategy for the program. We are heading into the second generation that depends on the Family Grant program, and that is not sustainable. We have the resources [to address this issue] – just look at the waste in education and health.

What is missing for sustainable economic growth?

All the reforms were on the right direction to promote sustainable economic growth. The outcomes were not as glowing as expected ... . We abandoned very important problems that will have dramatic consequences, such as Social Security reform. We are putting it off. Unions are … opposing the outsourcing law, which gives more flexibility and is much better for workers who are non-union members. Today, Brazil is the country of oligopolies, government-built oligopolies. If an industry is protected, why invest in technology? There is no competition.

Will we have debates about economic programs during the presidential campaign?

Do you want a cynical but accurate view? No major issue will be discussed. Neither the opposition nor the government has the courage to tell the truth to society: we are facing an exhausted growth model. What is being proposed is a return to the past or the deepening of what we have. I would very much like to see policy issues discussed during the elections. However, the government will say that it did everything and that Brazil is a success, and the opposition will say that everything is bad. No proposals.

Do you think there will be popular demonstrations that press for policy change?

I hope we have demonstrations. I believe last year's demonstrations raised society's awareness —people suddenly understood that instead of improved metro rail services they will have a football stadium. Once a stadium is done, it is done; nothing will come out of it. It's just a waste of public funds. It is an illusion that building stadiums will increase the confidence of the country, bring trillions of Martians to visit our country, and perhaps increase our exports to Mars.

Do you think the president who takes office in 2015 will change how the economy is managed?

Whoever is elected president will have to deal with the economy's problems, there is no way out. The president will have to address the minimum wage. There are more efficient ways to reduce poverty and labor market deficiencies than raising the minimum wage above inflation. Also, we cannot peg all the rest, such as social security pensions and benefits, to the minimum wage.

Is there a formula for growth?

No. Growth is a state of mind …. Look at what is happening in Mexico. If you have a political organization capable of sustaining the government program, you make it work. The Real Plan sustained itself. Not only was Cardoso elected but so was a Congressional majority to give continuity to the *real.* Today there is much more hopelessness and discouragement than is necessary. If you look closely, everything is moving in the right direction … but in the short term, there is a lot of attrition. We are not in a situation where there are no exits, but we have to accept that current growth policies are exhausted. We have to balance income distribution and production.

The high cost of generous tax benefits

Kalinka Iaquinto

BRAZILIANS HAVE NO IDEA of how costly the federal government's tax breaks are terms of lost revenues and state-owned banks' subsidized credit to the private. These tax benefits and credit subsidies, which are mostly not apparent in the federal government budget, have grown so rapidly that tax experts are calling vigorously for more transparency and accountability on tax breaks and subsidized credit costs.

"This is not about whether or not tax benefit policy is correct, but about the fact that estimates of policy costs should be transparent. They should be discussed and evaluated. Only then we will be able to revise the policy in a more orderly fashion," say Brazilian Institute of Economics (IBRE) researchers José Roberto Afonso and Érica Diniz, who have published a study on tax breaks and subsidized credit using official data since 2011. That is when the federal government began measuring the cost of subsidized credit on the basis of differences between the interest the government pays on its borrowing and the interest rate at which state-owned banks lend to the private sector.

Unchecked growth

The study found that the generosity of total tax benefits went from R$196 billion in 2011 (4.7% of GDP) to an estimated R$323 billion in 2014 (6.2%). Its authors also underscore the magnitude of the gap between growth in GDP and growth in tax benefits: "Between 2012 and 2013, tax benefits grew by almost 20% while GDP rose only 2.3%," Diniz says. Expectations are for a similar result in 2014: tax benefit growth of 11% and GDP growth of 2%.

Tax benefits amount to more than the budgets of some ministries. In 2013, the health budget was R$99 million and the education budget R$81 billion. Tax benefits cost a staggering R$273 billion.

"Tax benefits are … amounts that the government fails to collect or grants as financial subsidies. But the government is not monitoring them carefully and systematically," Diniz comments.

Typical of what has been driving up tax benefits and credit subsidies in recent years is the broadening of exemptions from payroll taxes and the National Development Bank's subsidized loans to the private sector. In 2013 together they amounted to R$20 billion. Payroll tax exemptions alone have shot up from R$400,000 in 2008 to R$5 billion in 2013 and are expected to rise to R$23 billion in 2014. "When the government adopts a policy of tax exemptions, it is not committing to anything at present but it is committing future tax revenues," Diniz says.

Tax benefits are not transparent. Of total benefits in 2014, the budget makes less than 10% explicit; the other 90% are implicit. "Only financial benefits are in the budget; tax and

credit benefits are not shown," Diniz observes. What is the outlook for tax benefits and subsidies? "It will be very difficult to change tax benefits in the short run because the estimated volume is too large and they are associated with tax exemptions and subsidized loans already granted for a long time," Afonso says. "What we hope is that the government at least assesses the results of its tax benefit policy and be more judicious in granting tax benefits."

The generosity of total tax benefits went from R$196 billion in 2011 (4.7% of GDP) to an estimated R$323.17 billion in 2014 (6.2%).

Total tax and financial benefits and credit subsidies have surged since 2011.

(Billions of reais, constant prices as of December 2013)

	2011	2012	2013	2014 Est.
Total	**219**	**229**	**274**	**305**
Taxes not collected	169	183	204	236
Financial benefits	37	33	60	54
Subsidized credit	13	13	10	15



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Time for a whole new policy agenda?

Marcelo Neri

Minister of Strategic Affairs of the Presidency, and Director of the Institute for Applied Economic Research

Kalinka Iaquinto

A MIDDLE WAY that reconciles economic and social policies is best for Brazil, according to Marcelo Neri, Minister of Strategic Affairs of the Presidency of the Republic and Director of the Institute for Applied Economic Research (IPEA). He believes that inequality will continue to fall, but he points out that it is essential to invest in early childhood education, gradually lengthen the school day, and improve the quality of education. For the next decade, he says, it is necessary to step outside the electoral field to understand what will happen, and suggests that besides the well-known problems of health and education—the country needs to understand the new digital democracy into which Brazilians have been inserted. He also warns his fellow economists that it is necessary to observe the data as an integrated whole.

***The Brazilian Economy*—One of the major changes that occurred in Brazil in recent years was social development. What's your perspective?**

Marcelo Neri—If we compare the country today with 2, 12, or 22 years ago, we can see how much it has changed. I think that social development is to Brazil what economic growth is to China. In 1991, 85% of the municipalities were very low on the Human Development Index (HDI), which in addition to income takes into account education, health, life expectancy, school enrollment, and education. In 2000, 41% of Brazil's municipalities were low on the HDI and in 2010 only 0.6% were. Infant mortality fell 48% in the last decade—58% in the Northeast. In the past 19 years life expectancy has gone up by eight years. Every social indicator we look at has shown a significant long-term change.

How is social development likely to perform now that the economic situation is no longer so positive?

The 2012 National Household Survey (the PNAD) found that inequality plateaued between 2011 and 2012, after 10 consecutive years of significant narrowing. But our analysis of 2013 data shows that inequality fell again. This is just from looking at the labor market, which is directly related to the economic scenario … Obviously, though, there are limits, so inequality may not always fall.

Social development is to Brazil what economic growth is to China. … Every social indicator we look at has shown a significant long-term change.

In recent years there has been a great divergence between national accounts data and PNAD social data. Labor income in the PNAD and labor income in the national accounts have diverged noticeably. ... In 2012, the difference was nearly 8 percentage points: GDP grew by 1% and the average income from the National Household Survey was 9%, which is a very significant gap.

What is the role of programs like the Family Grant?

Of course, programs like the Family Grant, which was created in 2003, reduce inequality more easily at the beginning, when there is a larger number of poor people. But the data show that such policies in Brazil have not lost their income-distributive efficiency. ... The Family Grant—a relatively inexpensive program in fiscal terms—has continued to expand at the same rate as before .... The program certainly has a limit, but the data make it clear that we have not yet reached it.

In an election year, what is the future of the program? Should it be kept?

Certainly, it will be retained. A few years ago we heard some criticisms, but today that is no longer the case. Actually the Family Grant is not a fiscal problem, because at 0.5% of GDP the cost is very low. Today there is consensus on the program, and it has become an export as much as soybeans or iron ore ... Part of the support of the Family Grant program is external. For instance, it has just received an international award for excellence, Switzerland's Award for Outstanding Achievement in Social Security. In addition to what it has achieved domestically, I think outside support helps to consolidate the program whatever the political scenario may be.

In its survey on social perception indicators [SIPS], IPEA has found that one of the main concerns of Brazilians is education. Access to education has been greatly expanded, but there are concerns about its quality.

Today, we have a system of educational indicators, such as the Brazil Exam and the Development Index of Basic Education, to measure the quality of our education. More than that, we have goals for 2022. We know where we are, how we are, and where we want to go in relation to the quality of education. Brazil has made a breakthrough in the last 20 years [in terms of access]. In 1990, 16% of Brazilian children aged 7 to 14 were not in school, in 2000 that was true for

only 4%, and today that is down to less than 2%.

Although the number of students increased, the quality was neglected. ... We need to increase the quality and number of school hours. Another concern is early childhood education. We have made advances in primary education [grades 1– 9]; we are meeting the challenge in high school [grades 10–12], but we have not given early childhood education the importance it deserves. Now we have an examination to assess the reading ability of children aged 6 to 8, and a program for building kindergartens.

We have education goals for 2022. We know where we are, how we are, and where we want to go in relation to the quality of education.

What other concerns do the SIPS surveys reveal?

In general health appeared first, education second, but among younger respondents education leads. This is a very robust result. Health and education are miles ahead of the third and fourth items on the list of 16: 88% identified health as a priority, 73% quality of education, 61% security against crime and violence, and 60% better job opportunities. Education was once the seventh priority... As for health, when we asked what are the main problems of the unified public health system, the answers were the shortage of doctors and limited time to attend patients.

How do you assess the Real Plan that curbed hyperinflation and strengthened the national currency 20 years ago?

[The plan that introduced the real currency] was crucial: It allowed us to look and think about the future optimistically, without worrying about day-to-day inflation. I was one of the first economists to estimate what impact the Real Plan would have on poverty and inequality. Although its goal was simply to fight inflation, it had definitely a positive effect [on poverty]. I think it was a key precondition for effective economic and social policy-making... . Since 2004 a combination of economic growth and reduced income inequality have brought about the rise of the new middle class. Now, last year's protests in 2013 and the election this year challenge us to think about a new policy agenda for the future.

What could be the next big change for Brazil?

There are many, but I think the main thing is to walk the middle way by looking at and listening to the people. The voices of the streets tell us what we have to deal with, such as digital media, which is a new kind of democracy, and urban challenges —public transport, education and health care—which are not new. I think the ideal is to combine in the best way possible a social policy of equality with markets that operate well. Over the past decade, we have brought the poor into the economy, but we need a more efficient government, quality public policies, and a vibrant labor market that promotes consumption. Summing up, the demonstrations and the prospect of the election are spelling out a whole new policy agenda.

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Markets are jittery about Brazil's economic fundamentals.

THE YEAR BEGAN with a new round of concerns about emerging countries. As occurred in mid-2013, the group of countries an investment bank has nicknamed "the fragile five"—Brazil, India, Turkey, Indonesia, and South Africa (BITIS)—was particularly penalized.

In its monetary policy report of February 11 the U.S. Federal Reserve Bank (Fed) lists the same five countries as those most vulnerable to changes in U.S. monetary policy, having selected them because among emerging countries they have recorded the largest currency devaluations and the highest rises in interest on their bonds.

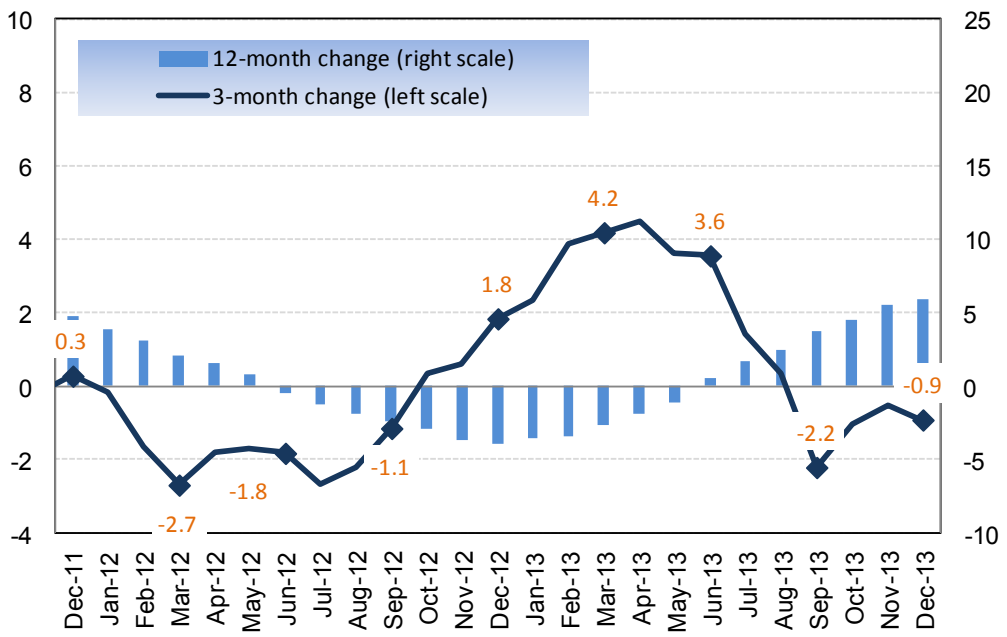
One view is that the BITIS were affected because they have more developed and liquid domestic financial sectors, which allows investors to buy or sell large quantities of their assets at any time at a low transaction cost and buy foreign currency. Another view is that the BITIS have suffered more than other countries because they have weaker economic fundamentals. According to the Fed's vulnerability index, among 15 emerging countries, the only one more vulnerable than Brazil is Turkey.

The change for the worse in market views of Brazil could significantly affect external financing inflows and consequently the real economy. In the second half of 2013, market jitters about Brazil's economic fundamentals helped to slow fixed investment significantly, as the IBRE Monthly Fixed Investment Indicator (IMI) shows.

Our assessment of the Brazilian economy has not changed substantially from previous issues. We estimate that in the fourth quarter of 2013 GDP grew only 0.3% quarter-on-quarter, and only 2.1% for the whole of 2013. Although we hold to our forecast of 1.8% in 2014, we realize that the downside risks to the Brazilian economy are very high, and the pervasive uncertainty that marked the economy in 2013 is likely to continue throughout 2014.

IBRE´s Fixed Investment Indicator is going nowhere.

(Percent change over the previous quarter and 12-month moving average, seasonally adjusted)



Sources: IBGE, Funcex, and IBRE staff.