THE BRAZILIAN ECONOMY

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IBRE Economic Outlook
Brazil's growth outlook worsens for 2013.

Politics
Muddling through: The government has struggled to control its congressional coalition.

Interview
What will be the legacy of the Olympic Games?

THE WORLD CUP, THE OLYMPICS – AND BEYOND

A year from the World Cup and three from the Olympic games, Brazil is working hard to meet deadlines. Will the mega sporting events leave behind a lasting gain for the national economy?

Roundtable
Brazil's emerging fiscal risks.

GETULIO VARGAS FOUNDATION

60 IBRE

The BRAZILIAN ECONOMY

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THE BRAZILIAN ECONOMY









News Briefs

4 Petrobras oil company record bond issue oversubscribed … external current account deficit widens … unemployment up … economy bottoming out … inflation accelerates … lowest trade surplus in more than 10 years … credit rating outlook cut ... Central Bank's benchmark interest rate up to 8% … new port law squeaks through … capital controls lifted.

Politics

8 Muddling through

Because the president doesn't bother much with cultivating relationships with Congress, she very nearly lost the battle to get a ports infrastructure bill passed. João Augusto de Castro Neves analyzes why the government has at times struggled to control its congressional coalition—despite the overwhelming majorities over which Rousseff officially presides—especially when it comes to the more thorny legislative proposals.

Cover Story

10 The World Cup, the Olympics—and Beyond

Between cheers for their teams, those watching the World Cup and the Olympics, whether in the stands or on TV, will also be scrutinizing Brazil's performance off the field in areas like transport and telecommunications. Solange Monteiro reports on a recent IBRE seminar on how the sporting events are likely to affect the Brazilian economy and on expert opinions about what the infrastructure efforts especially will mean for Brazilians after the games.

Interview

18 What will be the legacy of the Olympic Games?

"The motto is 'take advantage of the games' to do what this city needs," according to Maria Silvia Bastos Marques, who as president of its Municipal Olympic Company (EOM) is in charge of the preparations the City of Rio is making. The economist, who has held senior positions in both business and government, talks to Solange Monteiro about the costs and the significant positive consequences she expects for Rio from the World Cup next year.

Roundtable

22 Brazil's emerging fiscal risks

Despite 20 years of foreign debt restructuring and almost 15 years of the Fiscal Responsibility Law, risk factors are now pointing to the need to rethink current fiscal policy, according to participants in an FGV roundtable on Brazil's Tax Risks in the Medium and Long Term, Solange Monteiro reports. The proliferation of accounting gimmicks to make up the budget outturn has made the assessment of government's fiscal stance difficult and hurt public policy credibility. There is also urgent need to address Social Security commitments and states' growing debt.

24 The difficult task of managing oil revenues

Waiting until deep sea oil is actually flowing to start the debate on how to manage the resulting revenues is not the best choice, according to participants in an FGV roundtable. What needs to be decided early, for instance, is whether investing oil revenues in infrastructure or using them to pay down debt could bring Brazil a higher rate of return than investing them in financial assets, as Norway does.

IBRE Economic Outlook

29 IBRE has revised Brazil's growth outlook for 2013, partly because the external environment is much more hostile to Brazil than was expected, even as unfavorable economic results accumulate domestically. Inflation is expected to remain high at 6%.

ECONOMY

Petrobras sells US$11 billion record bond offering

State-controlled Petrobras has sold US$11 billion in the largest-ever bond offering by a Latin American company. Bids topped US$50 billion. Despite sagging revenue the oil giant now has more than half of the US$20 billion it intends to borrow this year to invest in exploration and production. Petrobras plans to spend US$237 billion through 2017, which may be the world's largest investment plan by a single company. (May 14)

Current account deficit widens

Brazil posted a current account deficit of US$8 billion in April as its trade surplus turned into a deficit and foreign companies repatriated profits to headquarters abroad, central bank data showed. After a jump in late 2010, foreign direct investment (FDI) has stagnated, prompting economists to question how long it can continue to make up for the current account shortfall. However, FDI is still relatively robust, reaching close to US$6 billion in April. The central bank has forecast a current account deficit of US$67 billion for 2013 and FDI of US$65 billion. (May 22)

Unemployment rises again

In April Brazil's unemployment rate climbed for the fourth consecutive month, to 5.8%, up from 5.7% in March, and local wages again retreated as tight labor markets continued easing, the government statistics agency IBGE reported. The average monthly Brazilian salary fell to R$1,862 (US$917), down 0.2% from March. (May 23)

Economy grows less than expected

Economic growth in Brazil continued to disappoint in the first quarter as weak industrial production offset a bumper harvest. GDP expanded 1.9% year-on-year, according to IBGE; for the first quarter GDP grew 0.6% compared with the fourth quarter of 2012. (May 29)

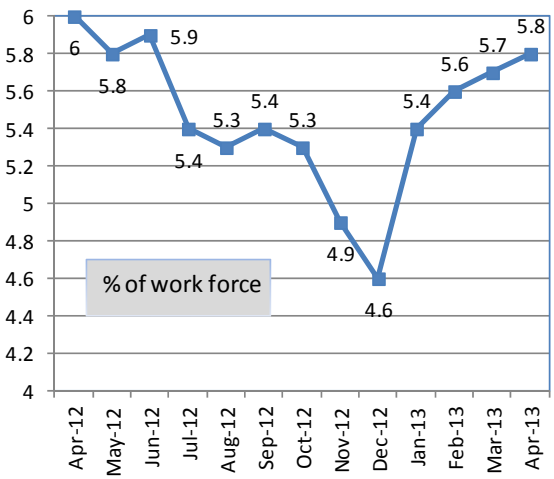
Stock exchange falls in May

The São Paulo stock market index (Ibovespa), ending May at 53,506 points, down 4.3% in nominal terms and 10.1% against the US dollar in the average price of equities. Stock exchange turned over R$162.4 billion in May, down 10.3% from April. The market capitalization of the 365 companies listed on BM&FBOVESPA at the end of May was R$2.46 trillion, up 1.1% over April. (May 30)

Lowest trade surplus in more than a decade

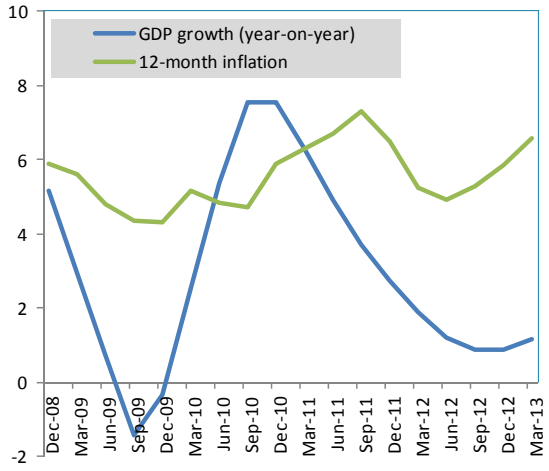
Brazil's trade surplus in May was US$760 million, the lowest since 2002, the Ministry of Development, Industry and Trade said. In May exports dropped 5.9 percent year-on-year to US$21.8 billion and imports increased 4 percent to US$21.1 billion. The trade surplus was 74.3% less than last year. (June 3)

Unemployment on the rise since last December



Source: IBGE.

Inflation accelerates despite weak growth



Source: IBGE.

Industrial recovery picks up speed

Industrial production rose a seasonally adjusted 1.8 percent in April from March, IBGE reported, the second straight month of improvement as capital goods production accelerated; this suggests that a recovery in Brazil's beleaguered manufacturing sector may be gaining steam. (June 4)

S&P cuts Brazil credit rating outlook

Standard & Poor's has lowered Brazil's credit rating outlook to negative, stating that sluggish economic growth and an expansionary fiscal policy could lead to higher government debt. There was no change in its ratings on 'BBB' long-term and 'A-2' short-term foreign currency sovereign credit ratings. (June 6)

Inflation up in May

The Extended Consumer Price Index (IPCA) rose 0.37% in May compared to 0.55% in April, IBGE reported; 12-month inflation reached 6.50%, the upper limit of the government inflation target. Though food prices, one of the main drivers of inflation so far this year, slowed, housing and apparel costs accelerated, highlighting broad-based price pressures. (June 7)

POLITICS

Opinions of government fall

For the first time since she took office in January 2011, the popularity of the Rousseff administration has fallen: According to the DataFolha Institute, found that 57% of Brazilians consider government good or excellent, down from 65% in March. The percentage of Brazilians who expect that inflation will rise went up from 45% in March to 51%. Rousseff, however, remains a favorite candidate for the presidential election in 2014, at 51%. (June 8)



Photo: Wilson Dias/ Agencia Brasil.

President Dilma Rousseff

ECONOMIC POLICY

Central Bank benchmark interest rate rises to 8%

The central bank Monetary Policy Committee's unanimous decision to raise the benchmark interest rate by 0.50 percentage point to 8% was the second consecutive increase; 12-month inflation was 6.49%, almost at the top of the inflation target band. "The Committee considers that this decision will contribute to bringing inflation down and ensure that this trend will continue next year," said a statement released at the end of the meeting. (May 29)

New port law squeaks through

President Rousseff has signed into law new regulations to make Brazil's ports more efficient and attract up to US$12 billion in investments. Despite the overwhelming majorities over which Rousseff officially presides, the government struggled for several months to control its congressional coalition to push through the changes. The law now allows private terminals to handle cargo for third parties as well as their own products. New leases will be auctioned early in 2014. (June 5)



Photo: Fabio Rodrigues Pozzebom/ Agencia Brasil.

Finance Minister Guido Mantega announces the lifting of capital controls.

Government spending on infrastructure slow

The Brazilian government has spent only 17.6 percent of the R$130.4 billion budgeted for investments—less than in the same period last year, when it spent 22.58 percent of budget. While the Rousseff government has promised increased spending on roads, ports, and airports, Ministry of Transportation investments fell from 13.28% of budget last year to 12.85% this year, according to *O Globo* newspaper. (June 11)

Brazil lifts capital controls as currency weakens

Facing capital outflows and a weakening exchange rate, the government eliminated the 1% Financial Operations Tax (IOF) on foreign-exchange futures. Less than 10 days earlier, the government eliminated the 6% IOF on fixed income inflows. (June 13)

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Headwinds for the Brazillian economy in 2015

BUDGET DEFICIT INCREASING, external current account deteriorating, inflation up . . . the situation is not as unbalanced as it was during the Brazilian hyperinflation in the 1990s but the warning signs are enough to make many of us very nervous.

The Brazilian economy has slowed, the government claims, mainly because private investment fell as a result of a transition to a new policy of a more depreciated exchange rate and lower interest rates. Although changing those economic basics should ultimately have a positive impact on companies, in the short term there are negative effects—such as pushing up indebtedness for companies whose debts are in dollars. But over time, it is claimed, the positive effects will finally appear, and the economy will again grow at 4% a year.

However, the longer private investment takes to recover, the more likely that the fiscal and external imbalances will depress fixed investment and growth. Standard & Poor's has just lowered Brazil's credit rating outlook to negative. Meanwhile, Brazilian economists and analysts have again revised their economic forecasts downward—for the fifth consecutive time. IBRE is now expecting growth to be just 2.3% in 2013 and not much better at 2.7% in 2014 (see p. 29).

The longer private investment takes to recover, the more likely that the fiscal and external imbalances will depress fixed investment and growth.

Outside the government many see looming fiscal and monetary problems. The budget surplus has eroded, the center of the inflation target (4.5%) has been bypassed, and the administration keeps intervening in the economy, often sending contradictory signals. The government no longer seems committed to sound fiscal policies.

In an interview in *O Globo* (June 16), the economist Fabio Gianbiagi called for government budget transparency to restore the credibility of the budget and inflation targets. As Teresa Terminassian pointed out (see p. 22), the proliferation of accounting gimmicks has made assessment of the government's fiscal stance almost impossible. As a transparent gauge of the budget deficit, the government should consider a switch from the current primary budget surplus target to a simple nominal deficit target without any adjustments and covering all government spending. To make the budget deficit more transparent and credible, Brazil needs an independent budget office along the lines of the U.S. Congressional Budget Office.

It is also vital to get public spending under control. There is also urgent need to address increasing commitments to Social Security and states' growing debt.

Given the weak economy, the President, with some reason, clearly opposes cuts in spending. However, the persisting fiscal imbalances are likely to depress private investment, which would offset any growth-promoting effects of an expansionary fiscal policy. In contrast, a clear fiscal adjustment strategy would restore confidence. Fiscal adjustment would also resolve the crucial issue of an undervalued exchange rate to support our industry competitiveness, as pointed out by former Finance Minister Antonio Delfim Netto. A tighter fiscal policy would give the central bank more room to cut interest rates, depreciate the exchange rate, and encourage exports—which has to be done to pull the economy out of stagnation.

Unfortunately, 2014 is looking like more of the same: interest rates go up, but just enough so that inflation does not run rampant, a little control of public spending but without jeopardizing the political coalition, and more external deficit. Whoever is elected next year will certainly face very unfavorable conditions and difficult policy choices the year after.

Muddling through

João Augusto de Castro Neves, Washington D.C.

ONE OF THE DEFINING TRAITS OF Dilma Rousseff's presidency is how little she invests in cultivating the relationships in Congress that are necessary for getting key legislation passed. Instead of using political finesse in navigating bills through congressional committees, the president has relied on her consistently high approval ratings (79% in a March CNI/Ibope survey) and the use of provisional executive decrees instead of legislation. The result is that the government has at times struggled to control its congressional coalition, despite the overwhelming majorities over which Rousseff officially presides, especially when it comes to the more thorny legislative proposals.

The government has at times struggled to control the congressional coalition, despite the overwhelming majorities over which Rousseff officially presides, especially when it comes to the more thorny legislative proposals.

Evidence of this came to light once again last month, when the government very nearly lost its battle to get a ports infrastructure overhaul approved. As the government grapples with this new and more difficult situation, more time and effort will probably be spent in appeasing disaffected allies while mitigating the risk of a successful negative legislative agenda with proposals that either increase the pressure for more spending or curtail some of the executive's prerogatives with regard to shaping the budget and legislating through provisional decrees.

But although managing the coalition has been deficient, reports that the government has all but given up on its legislative agenda for the rest of the year are overblown. It is normal for complex issues to generate congressional controversy. Keep in mind that despite the difficulties, in the end the government has more often than not triumphed. Giving the administration the benefit of the doubt, the likely pause should be viewed primarily as a temporary retreat as the dust settles, giving the government time to regroup before it renews the push to negotiate on other key issues.

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After all, in addition to Rousseff's persistently high approval ratings—the chief component of political capital—the structural drivers of some reforms are still very much in place. For the government, a growing sense of urgency to boost investments is driving its desire to get both tax reform and the new mining code through Congress. While there is a possibility that these reforms will be postponed beyond this year, that decision would be more likely if the economic recovery were more robust. But given a still tepid recovery (in the first quarter of 2013 GDP came in at just 0.6% over the previous quarter)) and deteriorating growth forecasts, it is likely that Brasilia's sense of urgency will increase. The urgency is exacerbated by the electoral calendar. Congressional productivity diminishes significantly during an election year, so the window of opportunity to pass important legislation before the next presidential election in October 2014 will close early next year. It will not reopen until 2015. Thus the time to approve reforms that might help growth can only be 2013.

What has kept the government from a more determined drive for reforms and more constructive (and less interventionist) policies? There are a number of reasons, but the most important is that economic and political constraints have not yet reached the point of generating serious urgency in Brasilia. Abundant global liquidity is an incentive for complacency; it allows Brazilian policymakers to let fiscal accounts deteriorate without having to pay much of a market or economic cost. Lower fiscal results have yet to translate into a rising net debt-to-GDP ratio, so there is no immediate risk of a sovereign ratings downgrade. The combination of both liquidity and no fear of a downgrade has helped feed a perception within government that it is not yet critical to curry investor favor.

Economic and political constraints have not yet reached the point of generating serious urgency in Brasilia.

Another reason for complacency, ironically, is the president's popularity. Economic growth has faltered, yet with low unemployment Rousseff's approval ratings are at a record high. As a result, she has not yet had to pay a political price for the economic difficulties. In fact, despite growing uncertainties and challenges, Rousseff is a heavy favorite to win reelection next year.

But economic headwinds and recent troubles in Congress are a reminder that constraints may deepen. On the one hand, next year fiscal policy will probably face increasing pressures from both the unwinding of monetary easing in developed countries and inflationary pressures at home. On the other, the government's coalition management is likely to become more conflict-prone as Rousseff's approval ratings drop somewhat.

While the government is expected to try to muddle through until next year's presidential elections, a more coherent—and constructive—shift in policy will be the order of the day for whoever is sworn in as president in 2015.



THE WORLD CUP, THE OLYMPICS— AND BEYOND

A year from the World Cup and three from the Olympic games, Brazil is working hard to meet deadlines. Will the mega sporting events leave behind a lasting gain for the national economy?

Solange Monteiro, *São Paulo*

ON JUNE 12, 2014, WHEN BRAZIL officially welcomes the teams competing in the World Cup, the country will be through the first half of a tough game to coordinate public and private investments to ensure the success of the mega event in all its dimensions. On lodging, security, power for stadiums, transport infrastructure, and telecommunications, Brazil's performance off the field will be exposed to the scrutiny of billions of viewers.

The result of all this work, however, will only show up after the final whistle at Maracanã stadium when the lights go off at Olympic Park in Rio in 2016. Only then will Brazilians know the legacy of the investments in these mega events for the Brazilian economy. Will Brazil be able to deliver the necessary infrastructure on time and of good quality? Or will Brazil end up like Barcelona or Atlanta?

GREAT EXPECTATIONS

A study by FGV Projects and Ernst & Young in 2010 estimated at US$71 billion the World Cup impact on the Brazilian economy. "Many investments are still going on, many are still to happen, but

it is impossible to ignore their weight," said Antonio Almeida, a partner at Ernst & Young. As for the Olympics, the Research Institute of Administration (FIA / USP) in 2008 estimated turnover of US$51 billion.

To assess the impact of the sporting events, the Brazilian Institute of Economics (IBRE) held a seminar on "The Effects of the World Cup and Olympics on the National Economy" on June 5 in São Paulo city. Samuel Pessôa, IBRE consultant and facilitator, said that from the past it can be seen that "the impacts go beyond the [infrastructure] works. The simple fact of signaling to the world the characteristics of the host country, for example, can be reflected positively even in its exports."

A consensus among the participants was that the success and the legacy of the sporting events will depend much more on advances in transport infrastructure and services, particularly hospitality, than was the case for the World Cups in Germany and South Africa and the London Olympics. "The British capital has had an underground for 150 years; in Germany, European tourists did not need to stay in the host cities to see a game, thanks to the railway infrastructure," Almeida pointed out. "And in the case of South Africa, the distance between the two main headquarters, Johannesburg and Cape Town, was about 500 km, which was possible to travel by bus or car. In Brazil, sport fans will depend much more on air transportation."

On lodging, security, power for stadiums, transport infrastructure, and telecommunications, Brazil's performance off the field will be exposed to the scrutiny of billions of viewers.

Joel Benin, special adviser to the Ministry of Sports, pointed out that the current bottlenecks in transport are the result of two decades of low levels of investment in infrastructure in the country, adding, "Now we have the opportunity to change this situation, with the renovation of the airport system, reforms in seven major airports, and the possibility of promoting quality public transportation."

URBAN CHALLENGE

Just as in London, where the organizers decided to install the Olympic Park in

2014 World Cup's impact on the Brazilian economy.

Total US$71 billion (2.9% of GDP)	
on the economy's demand investiments operational expenditures tourist expenditures	US$15 billion US$11 billion US$1 billion US$3 billion
on the economy's income	US$ 32 billion
tax revenues	US$9 billion

Sources: Ernst & Young and FGV Projects, 2010.

The current bottlenecks in transport are the result of two decades of low levels of investment in infrastructure in the country.

Stratford and direct investments to a less favored region, or Barcelona, which improved its public transportation to the current enjoyment of its citizens, Brazil is also looking to use the sporting events to promote urban redevelopment. In Rio de Janeiro city (Rio), for example, the changes go beyond public transportation.

The Maravilha Port (Marvel Port) project, for example, is revitalizing streets and installing water and sewage systems and telephones in very poor and neglected neighborhoods, such as Saúde and Gamboa. "Because it was the federal capital, and then a city-state, and then the capital of Rio de Janeiro state, Rio has huge administrative confusion. In most cases we have been able to deal with the historical problems," said Maria Silvia Bastos Marques, president of the Municipal Olympic Company (EOM).

In São Paulo, the plan is that Itaquerão stadium—which will host the opening of the World Cup and five other games—will not only promote expansion of public transportation in the area but also rejuvenate the economy of the entire East zone. "Thirty-seven percent of the population, about four million people, live in this region, which is a major supplier of labor," said Rodrigo Gouvêa, leader of Priority Project Delivery Unit of the Government of São Paulo state. Attracting businesses to the area may raise property values and gains in quality of life for residents. Nadia Campeão, deputy mayor of São Paulo city and coordinator of the Committee of Government Management for the 2014 World Cup (SPCOPA), indicates that organizations moving to the East zone include the Military Police and Firemen, Brazilian Social Services for Industry (Sesi), the National Service for Industrial Training (Senai), a technology park, and a cultural center.

PUBLIC AND PRIVATE

Mônica Monteiro,manager of Institutional Relations and Partnerships of the Municipal Sports and Leisure in Rio de Janeiro, pointed out that some of the urban transformation is only possible because governments have pragmatically entered into public-private partnerships (PPPs), so "We recorded more private investment opportunities," she said,

Olympic Games' impact on the Brazilian economy.

In Brazilian economy	US$51 billion (2% of GDP
Additional tax collections until 2027	
Municipal taxes	US$270 million
State taxes	US$583 million
Federal taxes	US$4.8 billion

Source: Fundação Instituto de Administração (FIA/USP), 2009.

noting that the Marvel Port is the largest PPP in the country, involving US$4 billion in investment.

João Viol, president of Sinaenco, acknowledged the importance of accelerating investments in infrastructure but noted that the pace is still slow. "Of 109 projects under the Responsibility Matrix for the 2014 World Cup, only 15 have been delivered: six stadiums and nine projects in airports and urban transportation in Natal city," he says. The number of projects not yet begun is larger—19, including monorails of São Paulo and Manaus cities, the Light Rail Transit (LRT) in Brasilia city, plus three public transportation projects in Curitiba, Manaus and Natal cities, and the expansion of Airport runway of Salgado Filho in Porto Alegre city. The other 74 projects are underway: 45 urban public transportation, 6 stadiums, 17 airports, and 6 ports.

Viol believes the current situation reflects Brazil's lack of long-term planning for major infrastructure projects. "At the institutional level, we have given priority to a culture of haste; we do the work but do not worry about planning and design," he said.

Brazil is looking to use the sporting events to promote urban redevelopment.



Photo: Marcelo Camargo/Agencia Brasil.

Now under construction, Itaquerão stadium in São Paulo city will host the opening of the 2014 World Cup.



Publicity photo.

Demolition of the fly-over road in Rio's port area is part of the Marvel Port project.

Ernst & Young's Almeida stated that reversing this situation will depend on establishing an institutional framework that does not depend on who is running the government. Both he and Viol noted that the political continuity of governments had allowed Rio to get further along in the planning for the Olympics—organization of the event is the responsibility of the city; public transportation and airports are state and federal responsibilities, respectively.

The Maravilha Port (Marvel Port) project is revitalizing streets and installing water and sewage systems and telephones in very poor and neglected neighborhoods, such as Saúde and Gamboa.

To ensure a fruitful relationship in PPPs and concessions, Almeida urged governments to persevere to ensure planning and predictability. "The private sector will always need time, legal certainty, a good business environment, and some freedom to estimate how much profit it will achieve given the risks," he said.

Fernando Naves Blumenschein, coordinator of FGV Projects, emphasized that public policy is the key to PPPs to enhance the substantial long-tern advantages of the sporting events. Flávio Borges Carvalho, who heads up institutional relations for the CCR Group, cited the creation of the Enterprise Planning and Logistics (EPL) in 2012 as a breakthrough for long-term planning, reinforcing the importance of the country prioritizing quality in large infrastructure projects.

INCLUSIVE OPPORTUNITY

Even with the continuing institutional challenges, Almeida identified significant progress in some areas, such as private management of stadiums that will host World Cup matches: "The participation of sport in Brazilian GDP, which is currently 1.6%, could grow to 2% in 2016; in the United States, it is 3%." Carlos Eduardo Paes Barreto, director, OAS Investmentos, which is managing Gremio stadium in Porto Alegre and Itaipava Fonte Nova in Salvador, explained that "in stadiums with a soccer tradition, one can emphasize hospitality for an audience with more purchasing power . . . . In Salvador, for example, the city has a strong tradition of shows and entertainment. It will also be possible to develop areas around the stadium for shopping centers, universities, and other commercial uses." He believes that, after the World Cup, Brazil will see a second wave of privatization of stadiums.

The greatest expectations of return from the sport

Photo: Jobson Galdino/Portal da Copa.



Construction of the Arena Dunas stadium in Natal city, Rio Grande do Norte state, is to be completed in December.

events, however, are in tourism. It is expected that Brazil's higher visibility and better infrastructure quality will result in a considerable increase in the number of tourist and business travelers, especially from other countries. "Currently, we receive only 0.5% of foreign tourists who travel the world, well below our potential," said Neusvaldo Ferreira Lima, director, Department of Tourism Infrastructure, Ministry of Tourism. The ministry expects that because of the sporting events international tourist arrivals will go up from 5.8 million in 2012 to 7.9 million in 2016—8% a year growth—and tourist spending will go up 12% a year, from US$6.7 billion in 2012 to US$10.3 billion in 2016.

Getting small businesses, which represent nearly 90% of Brazil's businesses, involved in the sporting events is a priority for the Brazilian Service of Support to Small and Medium Enterprises (Sebrae). An FGV survey showed that the World Cup will generate almost 1,000 opportunities for small businesses in cities hosting the event. Schmidt Dival, program coordinator for Sebrae 2014, pointed out that, in South Africa, the multiplier effect of investments related to 2010 World Cup offset some of the impact of the 2008 global crisis there. He estimated that the economic boost from the 2014 World Cup could offset part of the sluggishness of the U.S and European economies. "Today, small businesses generate 22% of total value added," he said. "Our goal is to improve management and adoption of technology to raise that share. Taking advantage of these sporting events to spur small businesses to improve their productivity is one of the most important programs for Brazil's economy."

"Of 109 projects under the Responsibility Matrix for the 2014 World Cup, only 15 have been delivered: six stadiums and nine projects in airports and urban transportation. … . The number of projects not yet begun is larger–19."

João Viol



Photo: Jose Zamith de Oliveira Filho/Portal da Copa.

The expansion and reform of Eduardo Gomes International Airport in Manaus are advanced.



One of the tunnels completed in Saúde neighborhood (Photo: Cidadeolimpica.com)

Total of works and projects: 21
11 projects totalling US$5.8 billion

MUNICIPAL OLYMPIC COMPANY, RIO DE JANEIRO CITY
Ongoing projects estimated at US$6.2 billion.

MAJOR WORKS

- **Olympic Park:** 1.2 million-square-meter real estate development in the Barra da Tijuca region. It will be the central point of the event, hosting 14 Olympic competitions. Investment is estimated at US$600 million.
- **Marvel Port:** Urban revitalization of Rio's port, including the impoverished Saúde and Gamboa neighborhoods. It will replace the existing overpass with a 5km tunnel, redevelop 70km of streets and install 700 km of water, sewer, telephone, drainage, and gas lines. This is the largest Brazilian public-private partnership (PPP), involving investments totaling US$4.2 billion.
- **BRT Network:** Mass public transportation system consisting of four corridors with exclusive express bus lanes linking various neighborhoods with Rio's international airport. Investments total US$1.3 billion.
- **VLT Carioca:** 30 km light rail that will link Rio's central bus station, the Santos Dumont airport, and Rio's port. Investment is estimated at US$600 million.
- **Waste Treatment Center of Seropédica:** New landfill, equipped with modern environmental technologies, which will replace the Gramacho landfill. Investment estimated at US$112 million.

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What will be the legacy of the Olympic Games?



Maria Silvia Bastos Marques

President of the Municipal Olympic Company (EOM)

Solange Monteiro, *Rio de Janeiro*

"THE MOTTO IS 'TAKE ADVANTAGE OF the games' to do what this city needs," says Maria Silvia Bastos Marques, highlighting the importance of the Olympics in attracting investment from the private sector and eliminating infrastructure deficits ranging from urban sanitation to vocational training. Deadlines are precise; the Municipal Olympic Company itself will expire in December 2016, hoping to leave a legacy for the public administration about how to coordinate projects. "The first lesson we learned is to have an extensive system of governance," says economist Marques, who has been coordinator for external economic policy of the Ministry of Finance, Secretary of Finance for Rio de Janeiro city, and CEO of both the National Steel Company (CSN) and the Icatu Insurance Group. She says, "The Olympics require not only a very intensive planning system but also a sense of relationship and urgency—and leverage of key works for the city."

The Brazilian Economy — In the application packet in 2009, the budget for the 2016 Olympic Games was US$23 billion for all three levels of government. How much will the actual cost of the Games exceed the original budget?

Maria Sílvia Bastos Marques—This estimate was the basis for specifying an array of responsibilities, which have since evolved. There were changes in the list and the scope of projects to meet International Olympic Committee (IOC) requirements and needs that arose subsequently. The final amount will only be known later, when all the projects are further along, with at least the basic design or the work already started, because then you have more consistent numbers. London made three revisions [to its Olympic Game budget] that ultimately more than tripled the initial budget. This is not to say that we will do the same—quite the contrary. But it is a good indicator of the degree of difficulty and the care needed in the release of these numbers. In Brazil, we are dealing with a very long list of projects; we have three levels of government working, plus the organizing committee of the games. Unlike London, where the federal level did most of the work, here the city has to do most of it. We are working to have disclosure that is easy to understand, grouping projects of similar maturity with similar criteria. The important message is that we have now updated this list of projects with the IOC, which follows up monthly, and the projects are all underway and within their deadlines and costs.

Currently, the Municipal Olympic Company (MOC) website states that the investment value of 11 of the 21 projects listed for the Olympics totals US$6 billion, of which 70% is from the private sector. Is the private funding contribution in line with MOC expectations?

Unlike London, where the federal level did most of the work, here the city has to do most of it.

In 2009, we had little idea how much the private sector could contribute, but the search for private resources has been continuous. Much of the Olympic Park will be built with private investment. It is the first time this has happened in the Olympics, and this way we can anticipate the results. As an example. the IBC [International Broadcasting Center], which hosts the television media, is a huge building of about 80,000 square meters within the park. The IBC creates a problem for all Olympics. It's too expensive, too large, it's hard to find a purpose for it after the games . . . In Rio, we solved this problem before the games. How? The public-private partnership (PPP) for the construction of the Olympic Park will have a plan for this property, possibly a mix of residential and commercial real estate development. So this issue is solved without any public money.

The winning consortium will also have the right to convert part of the Olympic Park into a residential district. What were the foundations for this decision?

The Olympics will occupy all the terrain, 1.18 million square meters. Afterwards, the Olympic Training Center (OTC) for high-performance athletes will be a permanent facility, and part of the rest of the land will be transformed into a residential neighborhood. The PPP contract involves construction and maintenance for 15 years of the entire infrastructure of the Olympic Park and the Athletes' Village, and construction of a 400-room hotel, the Main Media Centre of IBC, and the three pavilions that form the future OTC . . . .

We drew up a plan for the games and another for their legacy . . . . We are also concerned to define today what rules will govern the new neighborhood tomorrow . . . . There are requirements for [ecological] sustainability, energy efficiency, and public access . . . The new neighborhood is expected to house 190,000 inhabitants. We thoroughly investigated the PPPs and in each case we sought to improve the use of resources, already thinking about the legacy.

Today, a common problem in Brazil is how hard it is for municipalities to execute projects because of too few staff, rigid procurement rules, lack of funding, and other regulatory issues. What is the main challenge for the EOM to meet its schedule?

The first lesson we learned with this project is to have an extensive system of governance— something completely new. The IOC is very organized, with consultants in different areas, and systems for planning and monitoring, in which we participate. This is extremely efficient because we have regular meetings on safety, transportation, sports facilities, environment, and communication. The three levels of government and the organizing committee sit at the table and so there is coordination among teams, which for Rio de Janeiro is absolutely fantastic . . . [because normally] Rio has huge administrative confusion. In most cases we have been able to deal with the historical problems of the city. For example, the Port project is only viable today because of the coordination. The project

has existed for decades, but 60% to 70% of the land area of the port does not belong to the municipality, it belongs to state-owned companies, the Union, the Dock Company. . . . The Olympics not only brings a planning system, which is very important, with schedules, because we have a deadline that does not change; it also brings coordination and a sense of urgency and leverage to key works for the city.

The important message is that we have now updated the list of projects with the IOC, which follows up monthly, and the projects are all underway and within their deadlines and budgets.

Based on the EOM's experience, what processes could be corrected to make implementation of municipal projects more efficient?

This is part of a larger discussion that is not related with the Olympics. It's a long discussion: we have to discuss the federal pact, redistribution of resources, greater autonomy, the number of municipalities . . . . What distinguishes Rio today is the mayor's pragmatism. The mayor exercises very strong leadership, he conveys a great sense of urgency. He knows that this is a historic opportunity for Rio, and if we lose it there is no other [opportunity] on the horizon. So the motto is "take advantage of the games" to do what this city needs. And how is this done? Rio has considerable administrative capacity to carry out projects. Recently the federal government made available considerable large funding for retention and stabilization of hillsides. Because Rio has design expertise in this area, it won 80% of the total.. . . Rio also has a well structured Court of Auditors . . . From the standpoint of municipal government, I believe things are going very well in Rio.

What has EOM learned about negotiating PPPs?

It is a novelty to have the private sector working very closely with government. The government is not the only one leading a process of change . . . . Compared with the previous three decades, the government now offers a very favorable business environment, very positive, to attract the private sector to work, because the government alone cannot cope with this big a challenge. We need the private sector, and the private sector has come through. We see activity in all areas, including oil, gas, steel, as well as in others led by the municipality, such as architecture, creativity and innovation . . . We must seize this moment.

Did London leave any lessons for Rio?

Every Olympics is unique, and each city has its own distinction. Barcelona had one kind of governance, Athens another. From the London Olympics, we gathered important lessons we used in developing projects like the Olympic Park . . . Municipal technicians here observed London's transportation management and the flow of crowds. London, which has one of the most complete transportation services in the world, was successful in preventing transport disruptions; encouraging residents to work alternative hours or at home or to take vacations during the games. But Rio and London have different realities . . . What London did was to create a new pole of development for the city, in the Stratford neighborhood. This area has been entirely revitalized. In Rio, the whole city is being renovated. Dredging of rivers and ponds, a complete reshaping of the city, investment in education, English in public

schools, experimental Olympic gymnasiums—there's a lot going on. It will take time for the city to assimilate and understand the transformation we're currently experiencing.

Much of the Olympic Park will be built with private investment. It is the first time this has happened in the Olympics.

The EOM will end in December 2016. What legacy will it leave?

That is something we still have to think about. I have a great commitment to working effectively with all the municipal secretaries. Our role is as a coordinator, resolving issues and being the liaison with the IOC and other governments. We are involved not only in sports projects but with the city itself, establishing a management culture that is already being adopted by the mayor, who has his own project management office.

As construction continues, what will be the EOM's next task?

Services will now have more prominence, and the environment. In July Rio will begin a new approach to waste; we have a intensive campaign and penalties will be imposed, something we have never had. We are seeking a change of culture, because the city needs that. There is a big telecommunications project that is the responsibility of Rio Committee 2016. As for hotels, by 2016 we must increase the supply by as many as 11,000 to 16,000 new rooms. In 2010, the city launched tax incentives for the hotel chains, [such as] write-offs of property taxes and property tax exemptions during construction for buildings acquired before December 31, 2012, and real estate that earns an occupancy permit by December 31, 2015; there were tax exemptions for the purchase and sale of properties to be used as hotels until December 31, 2012, and a lower rate on services for construction or conversion into hotel projects through December 31, 2015. The hotel industry's response has been extremely positive. About 90 hotels are being built throughout the city. When they are completed, the city will have more than 44,700 hotel rooms available . . . We estimate that each new room in a 3 to 5 star hotel generates 0.6 new jobs, so we're talking about 10,000 new jobs. This is also a point that we will address, which is planning training. . . This is important, and under the umbrella of the Olympics Games it gets a sense of urgency, because though it is intangible it is a permanent legacy.



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BRAZIL'S EMERGING FISCAL RISKS

Solange Monteiro, *Rio de Janeiro*

THE CHANGE IN THE RISK OUTLOOK for Brazil announced by international rating agency Standard & Poor's in early June has turned the spotlight on Brazil's fiscal policy problems. Despite 20 years of foreign debt restructuring and almost 15 years of the Fiscal Responsibility Law, both of which contributed to economic stability and the achievement of an international investment grade ranking, risk factors are now pointing to the need to rethink current fiscal policy.

In late April, economists of the Brazilian Institute of Economics (IBRE) and the International Monetary Fund (IMF) met at a seminar on "Brazil's Fiscal Risks in the Middle and Long Term" in Rio de Janeiro to discuss the threats to Brazil's public finances. Teresa Ter-Minassian, former director of the IMF Fiscal Affairs Department, criticized the proliferation of accounting gimmicks "such as transactions with the sovereign wealth fund, use of state-owned banks, and quasi-fiscal operations." The experts also discussed the difficulty of reforming Social Security, which is becoming more and more urgent because the population is rapidly aging. The Brazilian Institute of Geography and Statistics (IBGE) reports that pension-related spending for those over 65 today accounts for 12% of GDP and will reach 23% in 40 years.

There are also challenges that will emerge along with the revenues from future exploration of deep sea oil. The use of bonuses from the bidding for oil blocks to guarantee a primary budget surplus as well as the importance oil royalties have for some municipalities underscore the importance of defining, even before oil begins to flow, how oil revenues are to be managed in order to promote sustainable development.

Finance problems at every level

The experts stressed that public finances need to be improved not only at the federal level but also in states and municipalities. The combination of the control system to enforce contracts to refinance state debts (Law 9496 of 1997) and the limits on states' borrowing (Fiscal Responsibility Law of 2000) has led states to ensure primary budget surpluses over the past decade, contributing to Brazil's fiscal adjustment. Ter-Minassian noted, however, that the

laws have not resolved the country's problems, as illustrated by declining state budget surpluses in the past few years. Because of reduced tax revenues and increased spending, she pointed out, fiscal adjustment has been based primarily on cuts in fixed investments, which were less than 1% of GDP for most of the last decade, which increased Brazil's infrastructure deficit. The situation varies dramatically across the country: some states have low debt and others, mainly those with larger economies, have debt that exceeds 100% of net current revenue.

According to Ter-Minassian, one problem with the current situation is that the ceilings on the debt stock and new debt are very high. She also pointed out that "The Treasury has had substantial discretion to accept changes in [state] fiscal adjustment plans and authorize new borrowing since 2009," and argued that new borrowing should only be authorized after analysis of debt sustainability and the costs and benefits of each planned investment. To avoid future problems and ensure efficient use of new borrowing, both Ter-Minassian and IMF economist Marialuz Moreno-Badia advocate transparency and standardization in information and avoiding excessive use of subsidized credit, for example, from the National Bank for Economic and Social Development (BNDES). "Mexico is a good example," Moreno-Badia said. "There, when subnational governments demanded loans, they used to go to a federal bank for cash transfers, creating the expectation that the federal government would cover what states would not pay. That has ended."

Ideally control of state and municipal debt should pass from the federal government to the financial market, which would enhance the profile and composition of that debt while respecting budgetary constraints.

Market control of public debt

Fabio Giambiagi, BNDES economist, argued that ideally control of state and municipal debt should pass from the federal government to the financial markets, which would enhance the profile and composition of that debt while respecting budgetary constraints: "This is a promising avenue that has been explored by Rio Grande do Sul and Mato Grosso states, and the city of Rio de Janeiro. They refinanced part of their debt to the federal government at very favorable conditions, through external borrowing and extending debt maturities."

What is important, seminar participants agreed, is for states to refinance their debt sooner rather than later: "We do not want to wait for debt to mature in 15 years and then have a debt crisis," Ter-Minassian said. She also advised moderating foreign exchange risk to avoid a significant increase in state external debt, concluding, "It is also necessary to consider the actuarial deficits of state and municipality employee pension funds; there is a need for corrective measures, raising contributions and cutting benefits."



The difficult task of managing oil revenues

Solange Monteiro, *Rio de Janeiro*

SINCE 2007, WHEN THE DEEP SEA OIL reserves were discovered, a whirl of figures has invaded the minds of policy makers and corporate executives. After six years, the numbers are settling, with daily production estimated at about 311,000 barrels, and the first round of bidding for oil blocks is scheduled for October. Maria das Graças Foster, CEO of state-owned Petrobras, estimates that by 2020 deep sea oil will be responsible for half of Brazilian oil production, which is currently about 800 million barrels a year. Some people venture to predict that the reserves are as much as 100 billion barrels, compared to 15.7 billion of proven reserves today. That would make Brazil on of the top five global producers.

Even if the best estimates are confirmed, the country is far from becoming a petroleum economy like Venezuela or Middle East. Currently, the share of oil in GDP is only about 1%. Still, the fact is that oil revenue will grow significantly, and waiting until the oil is actually flowing to start the debate on how to manage the revenues is not the best choice, according to participants in a roundtable on Brazil's Tax Risks in the Medium and Long Term.

The discussions on distribution of royalties to states and municipalities are focused on spending oil revenues, with little concern about whether they will be used efficiently or saved. Samuel Pessôa, IBRE consultant, points out that so far there are no measures to mitigate Dutch disease—the economic distortion caused by an excess of

exports, which generates serious exchange rate appreciation and causes a country's industry to lose international competitiveness.

Choosing a model

The main factors leading natural resources–rich economies to establish specific management systems for these revenues are that such resources are limited and their prices are therefore volatile. "In such cases, the budget framework has to be associated with appropriate management of public spending to ensure long-term solvency. If the country greatly increases its current spending in accordance with revenues [resulting from exploration of natural resources], then it might not be able to pay for increased spending in the future," IMF economist Alex Segura-Ubiergo said. Country experiences vary considerably. "To reduce volatility, Russia, for example, does not use the current price of oil in calculating revenues for its public budget but takes an average of the last five years," Segura-Ubiergo said. Another example, Chile, has been dependent on its earnings from copper exports; since 2001 it has replaced the concept of a budget surplus with a structural budget balance based on potential GDP growth and trends in tax revenues.

To these measures it can be added, for example, a rule that limits the growth of public spending so that it does not generate demand that is incompatible with economic stability, which would push up inflation. As an example of a sustainable fiscal strategy, Segura-Ubiergo cites the Norwegian model, in which all revenues and financial resources are saved in a separate fund, and the government spends only the return on investment of the fund, generating a permanent income. "This model is less flexible, but good for developed countries," Segura-Ubiergo said. He pointed out, however, that in countries like Brazil, investing oil revenues in infrastructure could bring a higher rate of return than investing it in financial assets as the Norwegian model does. In any case, he said, "What is especially important is to make sure that these natural resources funds are not able to spend autonomously."

The discussions on distribution of royalties to states and municipalities are focused on spending oil revenues with little concern about whether they will be used efficiently or saved.

According to Sergio Gobetti, an economist with the Secretary of Economic Policy of the Ministry of Finance, besides saving oil revenues for future generations or investing them, the country could also use oil revenues to pay down public debt. "In theory, the idea of the permanent income model [for managing natural resources] is the most appropriate, because it allows for more balanced treatment of [the distribution of benefits to] intertemporal generations. But the profitability of accumulating any assets in Brazil is lower than the opportunity cost of rolling our public debt," he added.

Gobetti thinks that using oil revenues to narrow the public deficit could increase fiscal space, which could be used both to raise public investment and reduce the tax burden.

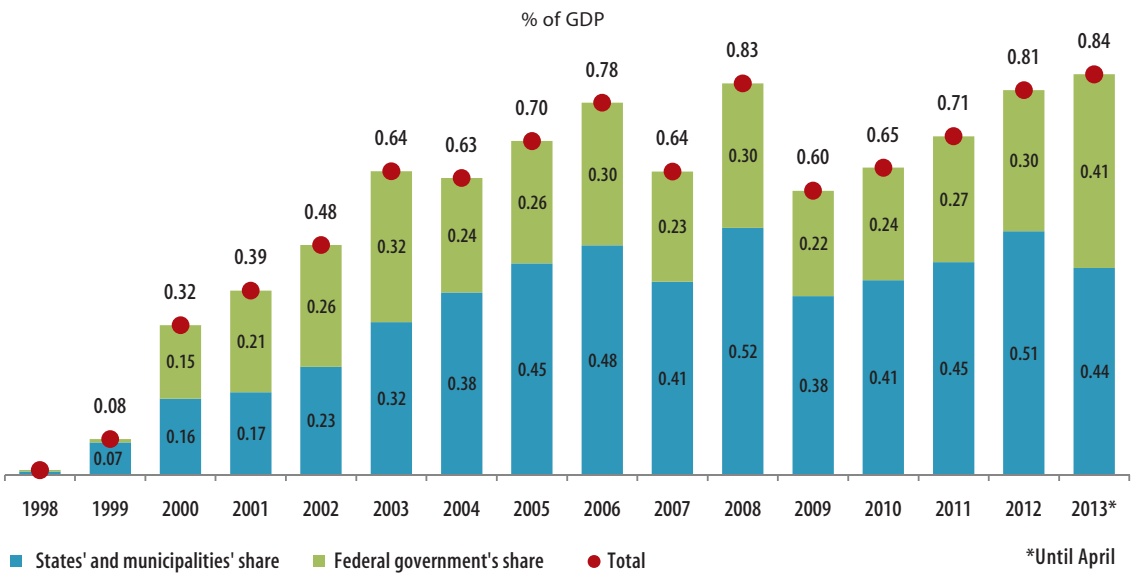
IBRE's Pessôa encourages the idea of accumulating part of oil revenues in a fund. "We could invest part of the return on the fund in education," he said. "But I think the ideal would be spending part of this oil revenue on imports to renew Brazil's infrastructure." Lia Valls Pereira, coordinator of IBRE's International Economics Studies, believes that greater openness would avoid negative economic effects. "A good result will depend on the efficiency of public administration, investments that are long lasting and open the economy to import inputs," she said.

> "There is no evidence that royalty revenues have brought improvements in the provision of education, health, and infrastructure compared to cities which did not benefit from such royalties."
>
> *Joana Monteiro*

Avoiding repeating mistakes

Roundtable participants agreed on the need to intensify the debate to ensure that the oil revenues resulting from deep sea oil exploration provide tangible benefits to society. It is best to avoid the temptation to increase spending without planning, and also to limit discretionary spending. "The Brazilian Sovereign Fund [created in 2008], for example, is not a sovereign wealth fund. It is simply an instrument for managing fiscal policy,"

Brazil: Oil royalties



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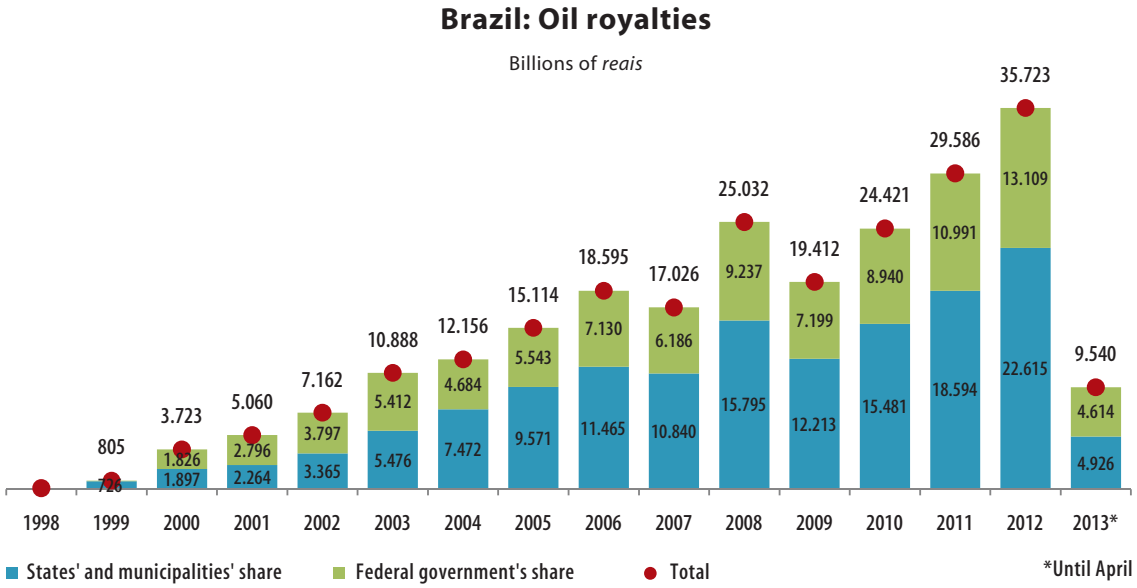

Fonte: FGV/IBRE.

Pessôa said, and so it should not serve as an example for managing oil revenues. "Sovereign wealth funds … allow for better management of public revenue when a substantial part comes from highly volatile sources," Pessôa explained. In the case of Brazil, the government saves little and has accumulated considerable international reserves. Instead of saving more, however, the government has used the fund's resources to purchase shares of state-owned companies and in 2012 to meet the budget surplus target.



Without planning and a focus on management, roundtable participants pointed out, revenues from deep sea oil exploration will hardly become the ticket to development, as they are being sold today. "Just look at the history of municipalities that have benefitted from oil royalties," says IBRE researcher Joana Monteiro, Between 1997 and 2010 royalty revenues of municipalities in Rio de Janeiro state grew 34-fold, reaching R$3.3 billion—but, she says, "there is no evidence that royalty revenues have brought improvements in the provision of education, health, and infrastructure compared to cities which did not benefit from such royalties." For every royalty dollar received, the municipalities spent 67 cents on current expenditure and only 24 cents on investment.

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IBRE has revised Brazil's growth outlook down to 2.3% for 2013. Inflation is expected to remain high at 6%.

SINCE THE OUTBREAK OF THE GLOBAL crisis, Brazil's economic policy has been based on expansion of credit from state-owned banks to boost private consumption, greater tolerance for inflation, looser fiscal policy, and more state activism in general. This policy will be put to the test as the economy moves into a new phase. This transition, as has happened more than once in the past, reflects both a difficult international environment and domestic problems.

The external environment is much more hostile to Brazil than was expected. The world economy is changing rapidly, especially due to the possible recovery of the U.S. economy this year. Although this is a positive factor, the repercussions in the short and medium term will bring both opportunities and difficulties for Brazil. As the U.S. economy recovers, the Federal Reserve Bank is likely to unwind its extraordinarily loose monetary policy; a rise in its interest rates will have a negative effect on emerging economies like Brazil.

Moreover, much of the depressing view of Brazil in the market is related to the perception that this year the country will grow far less than anticipated. Thus, since the beginning of this year, and more rapidly recently, the value of shares on the São Paulo Stock Exchange, Bovespa, has fallen more than in almost any other developed or emerging economy.

The slow growth outlook in 2013 has been consolidating as unfavorable economic results accumulate. The 0.6% quarter-on-quarter GDP growth in the first quarter surprised almost all analysts. If it were not for agriculture, GDP would have had virtually no growth compared to the previous quarter. As a result, we revised the 2013 GDP growth forecast down from 2.7% in March to 2.3%.

For 2014, we project marginally stronger growth of 2.6% (see table). Thus, the average rate of growth during the Rousseff administration would be only 2.0%, half that of its predecessor, President Lula. The inflation outlook is worrisome, despite lukewarm economic activity. We expect inflation to be 6.1% in 2013.

The domestic scenario is still quite uncertain. Brazil has come out of stagnation achieving only modest growth rates in a context of rising inflation. Accordingly, there is evidence that potential output growth has declined in recent years. Furthermore, the external environment has been an additional concern. In other Latin American countries, such as Chile, Peru, Colombia and Mexico, the challenging external environment is less worrying because inflation there is under control and growth has been more robust. Slowdown in those countries could be mitigated by countercyclical policies. In Brazil there is not much room for that kind of policy. Thus a worsening of the external sector would further limit Brazilian growth.

Brazil: IBRE baseline scenario, 2010–2014

	2010	2011	2012	2013 March Proj.	2013 June Proj.	2014 June Proj.
Real GDP growth (% change)	7.5	2.7	0.9	2.7	2.3	2.6
Inflation (% change)	5.9	6.5	5.6	5.9	6.1	5.8
Central Bank policy rate (end-period, %)	10.75	11.00	7.25	8.75	8.75	8.75
Exchange rate (average, reais per U.S. dollar)	1.8	1.7	1.9	2.0	2.1	2.1
Budget primary surplus (% of GDP)[1]	1.2	2.5	1.7	1.5	1.4	1.2
External current account balance (% of GDP)	-2.3	-2.1	-2.2	-2.7	-3.2	-3.4
Trade balance (US$ billions)	20	30	18	16	7	9
Export (US$ billions)	202	256	243	254	243	254
International reserves (US$ billion)	289	352	378	390	390	390

Source: Brazilian Institute of Geography and Statistics, Central Bank of Brazil, IBRE staff projections.
[1]Excludes interest payments on public debt, and revenues from dividends and concessions.

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