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IBRE Economic Outlook

Deterioration in Brazil's economic indicators has significantly exacerbated the risk of lower GDP growth in 2013, and casts doubts on economy performance in 2014

Politics

Brazil's different kind of political spring



Energy sector in transition

Regulatory changes in the Brazilian energy sector raises questions about the energy sector's expansion and electricity prices

IBRE Seminar

How can Brazil compete globally?

Interview

Antonio Delfim Netto
"Back to basics"

GETULIO VARGAS FOUNDATION

60 IBRE

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News Briefs

4 Fewer jobs created … industry and consumer confidence both down … worst drop in the stock market since 2008 … record first-half trade balance deficit … IMF lowers Brazil's growth forecast … Rousseff calls for a referendum on political reform … her popularity down 27 percentage points … Congress backs down on limiting corruption prosecutions … WTO takes on Brazil's protectionism

Politics

8 A different kind of spring

In analyzing the recent protests, João Augusto de Castro Neves explains that more and more the middle class is focusing on the quality of life agenda. They don't just want cars; they want cars that can ride on a street without traffic jams or potholes. This revolution, he says, translates into a challenge to governance.

Cover Story

10 Energy sector in transition

At IBRE's Third Seminar on Brazilian Energy, panelists discussed, among other things, how Law 12,783, intended to benefit consumers and ease the expectations of concessionaries about the possibility of new bids, has had the opposite effect. But the main theme was how to secure the investment required for both expanding the electric sector and supplying industry at competitive prices. Solange Monteiro reports.

Seminar

24 How can Brazil compete globally?

Protecting industry from international competition is a barrier to the competitiveness of Brazilian exporters, experts at the IBRE seminar on "The Challenges of Competitiveness" contended. Among the other problems they identified were lagging labor productivity, a lack of investment in fixed capital and innovation, and legal and regulatory uncertainty for investors. One solution proposed? Brazil must build an entirely new tax system. Kalinka Iaquinto reports.

Interview

30 Back to basics

Former Minister and Ambassador Antonio Delfim Netto explains to Solange Monteiro why after 50 years of experience in the Brazilian political and economic scene he has a calming perspective on the deteriorating fiscal situation and rising inflation. But he does believe that fiscal policy should abandon "alchemy." He also believes that for the next few years, financing the external current balance deficit will be the main problem, and that eventually the exchange rate will have to depreciate.

IBRE Economic Outlook

35 The recent deterioration in Brazil's economic indicators has significantly exacerbated the risk of lower GDP growth in 2013, for which IBRE lowered its forecast to 2.3% last month. It also casts doubts on economy performance in 2014.

ECONOMY

Brazil creates fewer jobs in May

Brazil's economy added a net 72,028 payroll jobs in May, the labor ministry said, compared to 197,000 in April. Yet unemployment remains at record lows as businesses hold on to workers in the hopes of an economic recovery. (June 21)

Industry and consumer confidence both down

The Industry Confidence Index of the Getulio Vargas Foundation (FGV) fell by 1.1% in June to 103.8 points, the lowest rate since July 2012, and the FGV Consumer Confidence Index dropped 0.4% to 112.9 points, below the recent historical average of 114.8 points for the fourth consecutive month. (June 26)

Brazilian stock market falls in the first half of the year

The main stock index of the Brazilian stock exchange, the Bovespa, closed 22% lower for the first half of 2013, the worst performance since the second half of 2008, the height of the U.S. crisis, when losses amounted to 42%. (June 28)

Trade balance records large first-half deficit

Brazil's trade balance in the first half of 2013 showed a deficit of US$3 billion compared with a surplus of US$7 billion in the first half of 2012, mainly because US$4.5 billion on fuel imports made last year were recorded this year and there has been a slump in exports of major commodities. (July 1)

Inflation slows in June

IPCA official inflation came in at 0.26% in June but is at 6.7% year-on-year, above the 6.5% upper limit of the central bank's target range. (July 5)

IMF reduces expectations for Brazil's growth

Because the larger and more prolonged slowdown in emerging economies, deeper recession in the euro zone, and fiscal tightening in the U.S. have poured cold water on the global economic recovery, the International Monetary Fund reduced its projections for the growth of Brazil's GDP from 3.0% to 2.5% for 2013 and from 4.0% to 3.2% for 2014. (July 9)

ECONOMIC POLICY

Brazil's rising protectionism

A new World Trade Organization (WTO) report shows that G20 countries have not fulfilled their promise to withdraw measures that could create obstacles to world trade and named Brazil as the worst offender for adopting 18 such measures, mostly to protect industrial products. (June 17)

Central Bank moves on inflation, GDP prospects, and interest rates

Brazil's central bank raised its inflation forecasts for 2013 from 5.7% to 6.00% and for 2014 from 5.3% to 5.4%, suggesting it may have to accelerate the pace of rate hikes in coming months to bring down persistently high inflation. This month, as expected, it raised the policy interest rate 50 basis points, to 8.5%. It also revised down its estimate 2013 for economic growth from 3.1% to 2.7%, saying the pace of the recovery remains "gradual." (June 27)

Consolidated budget deficit increases in May

Public sector consolidated deficit increased from R$7.7 billion in April to R$14.5 billion in May. Gross public debt reached 59.6% of GDP. (June 28)

POLITICS

Brazil protests expand beyond bus fares

Brazil's student bus fare protests spread throughout the country's major cities with hundreds of protesters invading areas of the national Congress complex in Brasília and attempting to set fire to the state legislative assembly building in Rio de Janeiro. The protests, which began as a rally against an increase in public transport fares in São Paulo, have now become an expression of general dissatisfaction with the nation's politicians. With the opening of the Confederations Cup—the dress rehearsal for the World Cup—protesters are also increasingly attacking the large sums being spent on infrastructure for the games and the Olympics in 2016. (June 17-19)



Photo:Tomaz Silva/Agencia Brazil.

Popular protests in Rio de Janeiro city.



Photo: Marcelo Camargo/Agencia Brasil.

Popular protests in São Paulo city.

Responses to the protests

President Dilma Rousseff yesterday sought to defuse the massive protest movement by acknowledging the need for better public services and more responsive governance. Speaking the morning after more than 200,000 Brazilians marched in more than half a dozen cities, Rousseff said her government remains committed to social change and is listening attentively to the grievances expressed at the demonstrations. (June 18)

She also surprised Brazilians with a call for a referendum on what would be the country's most ambitious political reform in decades. In a meeting with governors and mayors the week after the country's largest protests in 20 years she proposed a national vote on amending Brazil's constitution. There were immediate questions about whether she could deliver as she heads to what may be a more difficult re-election in 2014. Brazil's last sweeping political reform was 25 years ago, when the current Brazilian constitution was ratified in 1988. Political observers are skeptical and do not believe the proposal will be carried out. (June 25)

Meanwhile Congress scrapped a proposal that would have restricted the power of prosecutors to investigate corruption and worked until the early hours to approve an increase in the allocation of oil and gas royalties to education and health, from R$25.8 billion to R$335.8 billion. But economists complained that throwing more money at Brazil's public services will not solve the problem. (June 27)

The popularity of the president has plummeted by 27 percentage points: The percentage of those who consider her management good or excellent fell from 57% in the first week of June to 30% by the end of the month, according to a *Datafolha* survey. (June 29)

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There are reasons for the protests

THE SUCCESS OF THE WORKERS' PARTY administration in the last 13 years in increasing social mobility and expanding opportunities has built up a middle class that now demands better public services and a more efficient and honest public administration.

Certainly the expansion of the middle classes is an auspicious political trend in Brazil. One of the depressing characteristics of Latin American populism has been the exploitation of the poor for political purposes and the pitting of the poor against the middle class. That may work when the middle class is small. Usually, though, a large and wealthy middle class is the rock foundation of political stability.

So why this outburst now? People taking to the streets about a very modest fare hike in the city of São Paulo? Until a week before the protests broke out, 60% of the population thought the president and her management were good to excellent. Just a month or so later the president's popularity is down by 27 percentage points. What happened?

Brazilians are becoming more anxious about the future as economic prospects fall, fewer jobs are being created, and incomes are stagnating. Industry and consumer confidence have both been falling. The economy is showing more and more cracks, and the global economy is still struggling to recover, so that the government has far less money to pay for its social transfers and subsidies. Not only has the Brazilian economy been stunted for two years but prospects for growth are so far from promising that the IMF has again reduced its growth forecast for Brazil and with the Central Bank of Brazil raising interest rates to contain inflation, prospects are even murkier.

So far, the president, political parties, and state governments have reacted to the burgeoning protests haphazardly, promising more money for health and education without making clear where the resources will come from and rolling back increases in bus fares and road tolls, which will reduce resources for public transportation and thus worsen it. President Rousseff's proposal for a popular referendum on political reform proved impracticable. Clearly, nothing is likely to happen in the political realm until the next administration takes over in January 2015.

Brazil is unlikely to explode any time soon. However, given the present fragility of the economy, popular expectations must be managed with great skill so that the current discontent does not degenerate into more active unrest. To make things even more difficult, as Antonio Delfim Netto explains in the interview in this issue, for the next three to five years Brazil's main problem will be financing the external current balance deficit, which will eventually require a depreciation of the exchange rate.

With less than 18 months to the next election, President Rousseff will have to devise reforms that are politically feasible and economically sound.

With less than 18 months to the next election, President Rousseff will have to devise reforms that are politically feasible and economically sound. If she cannot solve all the problems by then, she must state clearly what she would do in a second term. Certainly the first thing would be to disclose without any accounting gimmicks the total nominal public sector deficit and gross public debt. Transparent public accounts would certainly improve her government's credibility. She must also protect ministries, government agencies and state-owned enterprises from undue political influence. For instance, some have suggested drastically reducing the number of ministries. Granting legal operational independence to the central bank could help contribute to stabilize inflation expectations. And certainly opposition candidates for president need to more clearly articulate their vision and plans for the country.

A different kind of spring

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

IN AN UNPRECEDENTED CHAIN OF events, protests over a modest bus fare hike in the city of São Paulo last month swelled into Brazil's largest demonstrations in nearly two decades. Like recent events in Tahrir Square in Egypt and Taksim Square in Turkey, millions of people hit the streets of Brazil's major cities to voice their discontent with the country's political class.

Though there are many similarities between the urban movements in the Middle East and those in Brazil, there is a major difference: While what became known as the Arab Spring consists mainly of movements against government oppression, recent protests in Brazil are chiefly against corruption and government incompetence. The former type of protest usually targets the head of state and the ruling party; the latter type is more diffuse, targeting all levels of government and every major political party after years (generations?) of disregard with the quality of public services.

Although protests will probably dwindle or fragment into the fringes of the political system in the next several weeks, the environment will be tension-prone until next year's presidential election.

It is difficult to pinpoint one single factor that triggered the recent demonstrations, but a demographic shift with major repercussions was brooding over Brazil's political landscape. In an attempt to analyze the high turnover of mayors during last year's local elections, I wrote in the November 2012 issue of *The Brazilian Economy* that

> One very plausible explanation is that several years of rapid economic expansion in Brazil have been accompanied by changes in the political sphere. To start with, economic growth in the past decade or so—and the rise in consumption it brought about—played a role in deepening a few urban problems, such as traffic congestion and pollution, which have generated dissatisfaction with local governments. More importantly, economic growth has also led to the rise of a new middle class that has higher political expectations and demands.
>
> The challenge for local governments in these cities today is to respond to these rising demands for better public services. But as growth slows and revenue dwindles,

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local governments must adjust to a more challenging economic environment while juggling the new political and socioeconomic challenges. In the longer term, the message produced by the local ballots this year may be a harbinger of a more profound shift of political behavior at the national level. In other words, a middle class with higher expectations can easily become frustrated with the status quo.

More and more the middle class is focusing on the quality of life agenda. Newly enfranchised Brazilians don't just want cellphones; they want cellphones that work well.

More and more the middle class is focusing on the quality of life agenda. Newly enfranchised Brazilians don't just want cell phones; they want cell phones that work well. They don't just want cars; they want cars that can ride on a street without traffic jams or potholes. In other words, governing becomes less a matter of facilitating access to goods and more an issue of improving the services that make those goods more useful. It is not only about cash transfer programs and creating jobs but also about providing better education, healthcare, and public transportation.

From a political perspective, this revolution translates into a challenge to governance. In a more unfavorable global economic environment, or at least less favorable than in the first decade of the century, leaders will have to deliver more to this new middle class, but with less.

So what is next? For starters, expect political volatility in the next few months. And recent polls suggest that the president's hyperpopularity is probably over. While President Dilma Rousseff's approval ratings have plummeted, however, it is too soon to say that someone will tap into the popular discontent and benefit politically from these demonstrations. In general, the polls show that most leaders at every level of government have suffered politically. But what has been an anti-political movement so far may be expressed as political apathy in next year's elections. In this situation the possibility of a major surprise or a dark horse candidate is definitely growing.

Until then, the risk for President Rousseff, and politicians in general, is that it will be tough to govern over the next couple of years. Although protests will probably dwindle or fragment into the fringes of the political system in the next several weeks, the environment will be tension-prone until next year's presidential election, with a reasonable chance of protests rekindling during the World Cup, which will be held less than four months before the election.

However, while Brazilians are finally coming to terms with the cost of hosting major international sporting events, in the end the government will probably pay the price of delivering beautiful and expensive stadiums and not the much-needed infrastructure to surround them. Lessons learned for the next generation of leaders: in the long run, policy options must go beyond bread and circuses.

Energy sector in transition

Regulatory changes are transforming the Brazilian energy sector in ways that raise questions about its future expansion and electricity prices.



Solange Monteiro, *Rio de Janeiro*

SIGNS THAT THE BRAZILIAN GROWTH model based on consumption is exhausted have led the federal government to adopt numerous measures, ranging from tax exemptions to tweaking industrial policy, to improve the competitiveness of the economy. The government's competitiveness cavalcade came to the power sector in September 2012 with the announcement of Provisional Measure 579 (MP579), which provided for anticipation of generation, transmission, and distribution concessions. When the Provisional Measure was converted into Law 12,783, the government sought to respond to an old plea of Brazilian industry: reduce electricity prices, which are among the most expensive in the world.

However, the law, which should benefit consumers and ease the expectations of concessionaries about the possibility of

new bids, has had the opposite effect. Market acceptance was only partial, and decline in hydropower reservoir levels dropped at the end of last year, challenging the reliability of supply and requiring activation of more expensive thermal power generation. In order to reduce electricity prices, the government issued a sequence of decrees and resolutions that caught companies by surprise and triggered a series of court challenges from which the energy industry now needs to recover if it is to return to normal. "There must be a convergence to restore the electricity sector to proper functioning," Paulo Pedrosa, executive president, the Brazilian Association of Large Industrial Energy Consumers (Abrace), said. How to secure the investment required for both expanding the electric sector and supplying industry at competitive prices was the theme of the 3rd Seminar on Brazilian Energy, organized by the Center for Studies in Regulation and Infrastructure of Getulio Vargas Foundation (FGV)and Brazilian Institute of Economics (IBRE) on June 4 and 5 in Rio de Janeiro.

Luiz Fernando Vianna, president, Association of Independent Power Producers, illustrated the damage suffered by the industry after the MP579: "About 8GW of power generation were converted into quotas to meet power distributor needs. This energy, which had been selling at R$100 per MW-hour, is now sold at R$35. Companies like Eletrobras had to adapt to this hard reality," he said. "In power transmission, the 40% reduction in the revenue allowed left distributors cash-strapped. The sector will take time to absorb it all, because the impacts were huge," he said.

Law 12,783, which should benefit consumers and ease the expectations of concessionaries about the possibility of new bids, has had the opposite effect.

One of the major concerns for power companies was a new regulation of the National Energy Policy changing the calculation of the Price of Settlement of Differences (PLD), which before was mostly paid by consumers. "The new calculation will take into account risk aversion, will raise PLDs, and will surely affect the marginal cost and spot energy prices," said Luiz Eduardo Barata Ferreira, president, Board of Directors, Chamber of Electric Energy Commercialization (CCEE).

The power companies rejected the new calculation. Within the first half of the year, court actions piled up against the determination, paralyzing the activity of the CCEE. For Luciano de Castro, director, Electricity Market Forum, Kellogg School of Management, using the courts means less productive industry dynamics. "Models that lead to legal questioning have harmful consequences," he said, because companies have to focus more on legal issues than on administrative efficiency. "The increase in the number

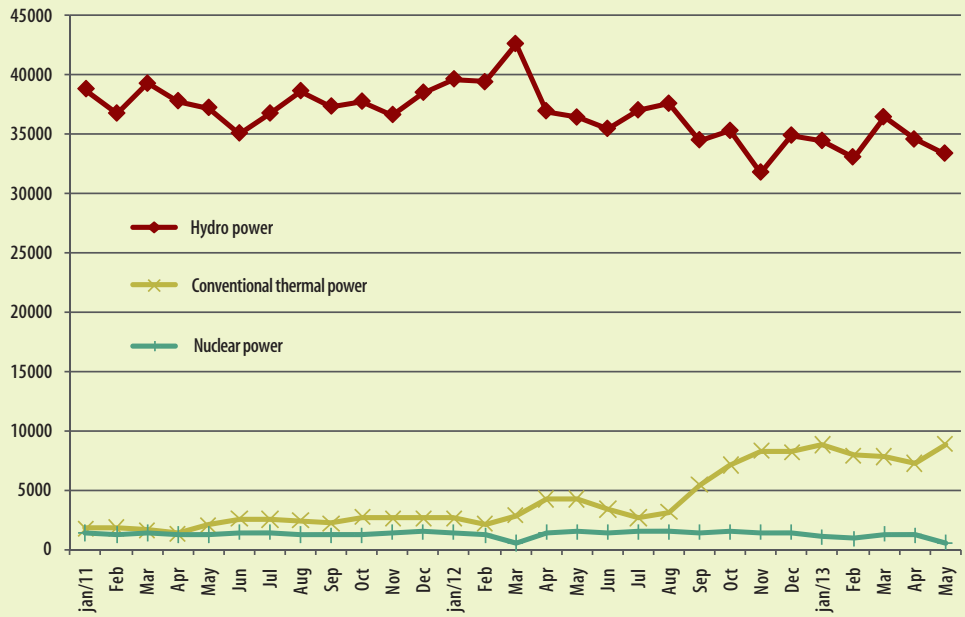
"About 8GW of power generation were converted into quotas to meet power distributor needs. This energy, which had been selling at R$100 per MW-hour, is now sold at R$35."

Luiz Fernando Vianna

of court actions reflects the difficult dialogue between the energy sector and the government. In the end, nobody wins," added Mário Menel, president, Brazilian Association of Investors in Self-Energy (Abiape).

For industrial consumers, who were intended to be the main beneficiaries of the law, the outcome was not satisfactory. "We had very important conceptual gains, such as acknowledgement that energy is a competitiveness factor. But in the case of concessions for power generation, the changes did not reach the free market," Abrace's Pedrosa said. He pointed out that, for captive consumers, which consist of only a very small number of industries, electricity price reductions were 30%. But for most manufacturers, which operate in the free market, the reduction was much lower, between 9% and 18%. "A policy that should have made industry more competitive

Consumption of conventional thermal power has increased as drought has affected hydro power generation. (GWatt-hour)



Source: National System Operator (ONS).

ended up mostly reducing the rates of residential consumers, "said Christopher Vlavianos, president, independent power company COMERC.

In order to reduce electricity prices, the government issued a sequence of decrees and resolutions that caught companies by surprise and triggered a series of court challenges from which the energy industry now needs to recover if it is to return to normal.

Effects on investment

"We have a big challenge for the next 10 years: increase generation by 6GW to 7GW a year," said Altino Ventura Filho, secretary of energy planning and development, Ministry of Mines and Energy. Since the government announced that it would allow electricity concessions to expire several years early to reduce the rates charged to consumers, however, concessionaires have been pulling back on investing.

The apprehension triggered by Law 12,783 does not mean there is no financing for new energy projects. "So far, financing has been fantastic. In Brazil it is hard to see a project that does not have financing," said Gustavo Gattass, company analyst, BTG Pactual Bank. Felipe Guth, manager of renewable energy, National Bank for Economic and Social Development (BNDES), explained that part of this success comes from auction designs that allow long-term expansion of energy supply based on projected revenue. Most credit to the energy industry is in the hands of BNDES, which represents a significant portion of the capital structure of the market: 30% of the total, with the rest divided between other creditors (15%) and equity (55%). "In the last 10 years, the BNDES has financed about 220 projects in energy alone, and we do not see financing shortages in the short term because energy is a priority," Guth said. However, other sources of financing so far have helped to finance electricity projects. Marcio Prado, partner, Indie Capital, said that the energy sector is second most important in issuing bonds, over 10 years issuing approximately R$10 billion.

Capitalization is a good measure of the value the market assigns to companies. Since mid-2012, however, the outlook for electricity companies has not been favorable for both shareholders and future investment. Since mid-2012, the market capitalization of the electricity sector has declined by US$30 billion. Some companies have increased their leverage two to five times. This means that the capacity of the electricity sector to invest to



THE WAY THE WIND IS BLOWING

Holding great promise among alternative energy sources, wind power generation is also undergoing a transition. Questions about how intermittent generation might restrict wind power expansion and problems caused by lack of transmission lines have brought about some adjustments to the rules for the sector. Projects with no connection to the transmission grid have been barred from the energy auction scheduled for August, and the National Bank for Economic and Social Development has tightened lending conditions for new wind power projects.

Nevertheless, the August auction has attracted 665 projects, with an installed capacity of 16 GW in nine states. "Prospects are excellent," said Elbia Melo, chief executive, Abeeólica. The goal, she said, is to expand installed capacity from 2.5 GW in 2012 to 8.8 GW in 2017 and 20 GW in 2021, at which point wind would account for 12% of the total supply of energy. Enrique de Las Morenas, manager, Enel Green Power in Brazil, confirmed the attractiveness of wind power to Brazil. "A country that has wind power potential of over 250 GW will always offer a great opportunity," he said, adding that at US$2,500 per kW wind power is also cheap to install.

Melo noted, "We hope to have good demand to consolidate the supply chain that we brought to Brazil. Otherwise, when the world economy recovers and resumes investing, Brazil could lose these investors." Melo also pointed out the positive externalities of wind power, which generates 15 jobs throughout the production chain for each installed MW, and its complementarity with other economic activities, such as farming and livestock, bringing in additional income for small farmers.



expand supply is declining; it is not keeping up with growth in demand for energy.

Analysts are convinced that clearer regulation is vital to reverse this situation. "Managing expectations is crucial to reducing volatility, risk, and the cost of capital," Prado said. Fernando de Holanda Barbosa Filho, IBRE researcher, alerted participants to an additional risk: reactions to the public demonstrations that began in June may launch a wave of rate controls, as occurred in Paraná state. "We must ensure return on investment," he said. "It is not possible to invest in the long term without guarantees about the rules for price formation in the short term," Prado added. Changes in how the PLD is calculated have left the electricity market in a limbo..

Gas dilemma

Another concern is the heightened reliance on thermal generation to ensure energy security. Experts believe that Ministry of Mines and Energy efforts to expand hydro, biomass, and wind power will not be enough. "With the growing presence of dams with smaller reservoirs, and the increasing

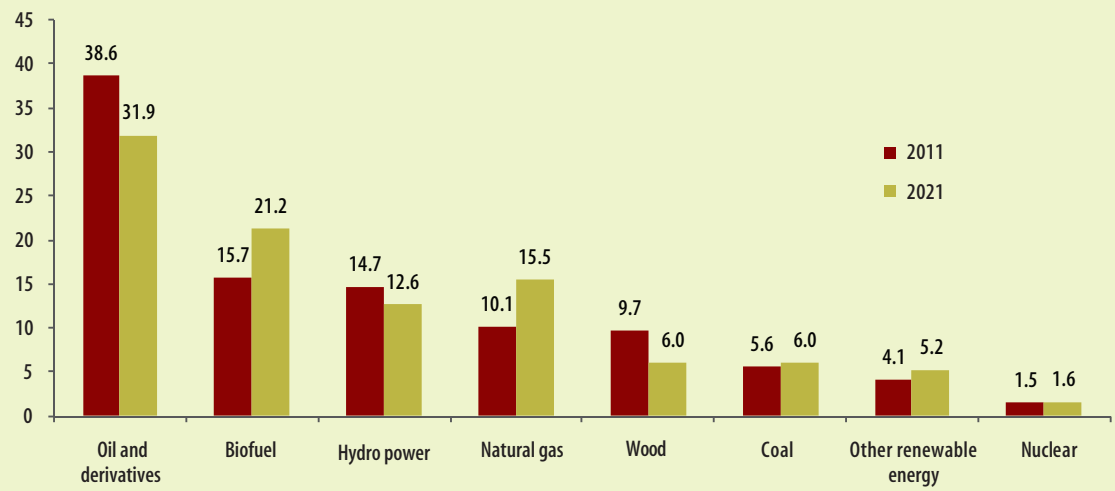
difficulty of environmental licensing for new large hydroelectric projects in the Amazon region, we have lost capacity to store energy," Hermes Chipp, director, National System Operator (ONS), said. "The increase in sources like wind power is good, but we need the thermal power plants," he said, calling for urgency especially in replacing less efficient power plants. This should rekindle demand for coal-fired power plants but not expensive nuclear power projects beyond the Angra 3 plant, scheduled for May 2018. "To generate power at competitive costs, it would be important to have coal plants but also nuclear plants to take advantage of the great potential of our uranium reserves," said Othon Luiz Pinheiro da Silva, president, Eletronuclear. Edvaldo Santana, director, National Electric Energy Agency (Aneel), underlined the importance of creating a favorable institutional environment for expansion. "When the rules of the game change," he said, "we must ensure balance in the distribution of both the benefits and the costs."

"A policy that should have made industry more competitive ended up mostly reducing the rates of residential consumers."

Christopher Vlavianos

Joisa Campanher Dutra, coordinator, FGV Center for Studies in Regulation and Infrastructure, reminded the audience that expanding thermal power is not problem-free: "Thermal plants have not materialized in the past, and gas still receives inadequate treatment, demanding improvement of its regulatory framework," she said. The

Brazil's current and projected energy supply structure
(% of total)



Fonte: MME.

Since mid-2012, market capitalization of the electricity sector has declined by US$30 billion.

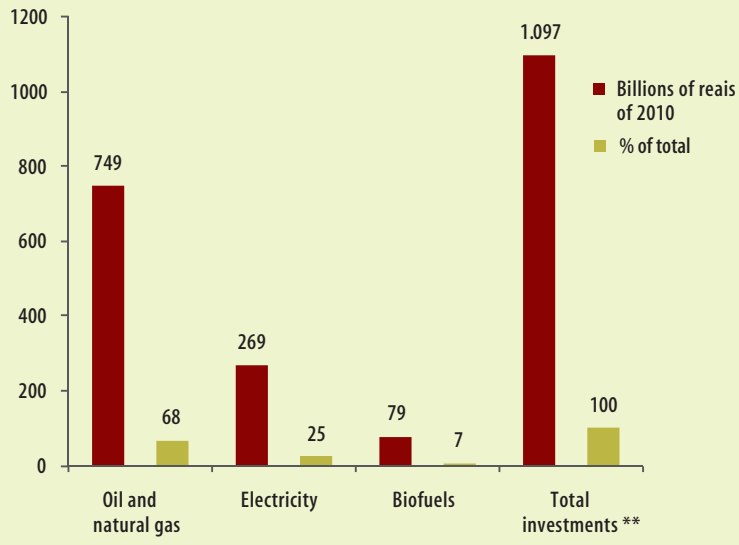
ministry's Ventura Filho acknowledged that the outlook for natural gas depends on a better outlook for volumes and prices but added, "Nevertheless, we are optimistic; thanks to the possibilities of deep sea oil and onshore gas . . . the supply of gas should increase by the end of this decade."

For industrial consumers, however, that time horizon sounds like an eternity compared with the speed of U.S. shale gas exploration. "U.S. gas prices are so low that they will have great influence, improving the competitiveness of U.S. industries like aluminum, ceramic, glass, steel, production of certain goods, not to mention fertilizers and petrochemicals," Sergio Quintella, FGV vice president, said. "We have to bear in mind that we need to produce energy at competitive prices; otherwise we risk a decline in industrial activity."

For Brazilian shale gas exploration, Mauricio Tolmasquim, president, Energy Research Company (EPE), recommended having more conservative expectations. "Until now, shale gas is a U.S. phenomenon. In Poland, which has one of the largest reserves of shale gas, exploitation is much more expensive, almost the price of our liquefied natural gas," he said.

Regardless of the results of shale gas exploration, experts pointed to the need to review how the natural gas industry currently operates. "Today we have an inhibited consumer market, high prices, and gas distributors working on a small scale," said Marcos Tavares, chairman, board of directors, Gas Energy. "Our gas law is a great agreement but the law was not enough to make the Brazilian gas market more competitive," he said, noting that although the law allows entry of new

Brazil's projected investment in energy, 2012-2021



**2.3% of GDP.

Source: Ministry of Mines and Energy.

natural gas producers, it has not eliminated the current monopoly. "The terms of the gas law are slow to give the answer that industry needs," he said.

Despite the numerous problems, there are encouraging examples in Brazil. São Paulo already has a structure for local utilities to buy gas in a competitive market and thus make room for new producers. "We regulated the market in 2011 and have conducted studies to carry out the first auction for utilities in São Paulo state to purchase gas," said Silvia Calou, chief executive, Regulatory Agency for Energy and Sanitation of São Paulo state (Arsesp).

With the entry of new producers and a clear development goal, Tavares insisted that industry could benefit from gas long before 2025: "We could have a boom in gas . . . What we need now is to anticipate the future, to ensure that Brazil has affordable, abundant, and reliable gas."

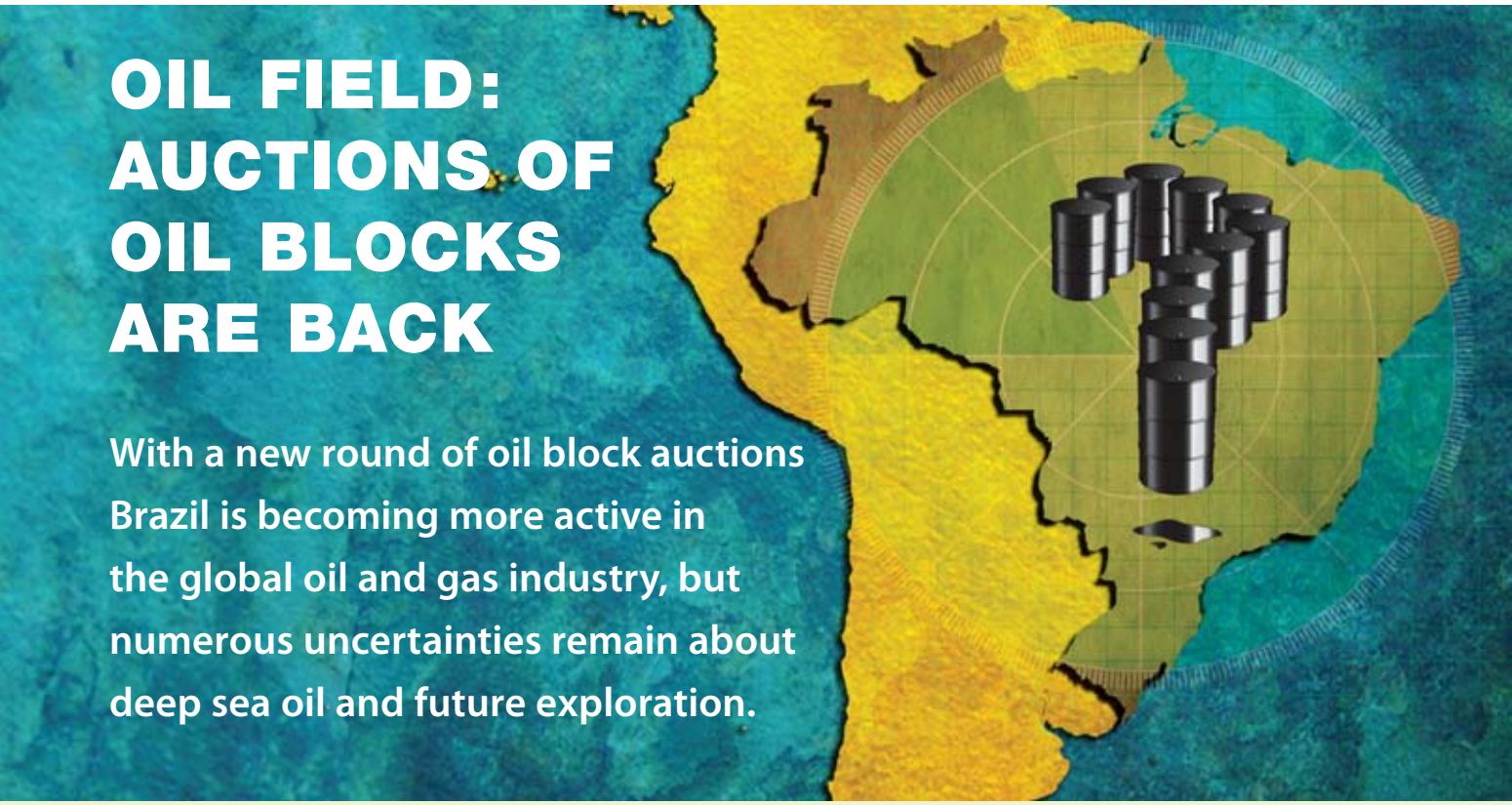
Diverse and efficient

For analysts, building up the Brazilian energy industry mainly depends on how each source of energy is regulated to ensure that it has its share of Brazil's energy matrix. One example is the great weight of sugar cane biomass. "Our biomass energy potential through 2011 was 4.2 GW, but we were able to tap only 1.4 GW by 2012," said Zilmar de Souza, bioelectricity manager, Sugar Cane Industry Union (UNICA). With problems like crop failure and reduced investment in ethanol production (which was discouraged by the fuel pricing policy), de Souza pointed out, the sector, which has the energy production capacity of four nuclear power plants of 1.1GW, needs a long-term policy to consolidate a sustainable market for bioelectricity, sugar, and ethanol.

"We are creatures with an unquenchable need for energy, and resolution of our energy supply problems will also necessitate changing social attitudes about energy consumption."

Cicero Bley Jr.

Leonardo Calabró, executive vice president of the Association of Energy Industry Cogeneration (Cogen) emphasized that energy expansion has to be planned in a more integrated way because each source of energy has a benefit to offer. He argued that Brazil should ensure both expansion of energy supply and stimulation of new technologies that promote savings in energy consumption, such as smart grids (see page 21). "We cannot think about increasing power generation alone but also about efficient consumption," echoed Cicero Bley, Jr., superintendent of renewable energy, Itaipu hydro power plant. "We are creatures with an unquenchable need for energy, and resolution of our energy supply problems will also necessitate changing social attitudes about energy consumption."



OIL FIELD: AUCTIONS OF OIL BLOCKS ARE BACK

With a new round of oil block auctions Brazil is becoming more active in the global oil and gas industry, but numerous uncertainties remain about deep sea oil and future exploration.

Solange Monteiro, *Rio de Janeiro*

THIS YEAR THE AUCTION OF oil blocks in May after four years of no activity brings Brazil back near the center of the global oil and gas industry. With 142 blocks purchased by 30 companies from 12 countries and record signature bonuses and investments, the auction suggests that oil exploration has excellent prospects in Brazil.

However, the expectations generated by the first auction of the deep sea oil blocks scheduled for October are stratospheric. Open for bidding will be the new jewel of the Brazilian oil industry, the Libra oil field—an area of 1,548 square kilometers (598 square miles) deep in the waters of the Santos Basin off the Rio de Janeiro coast. "Today Brazil's proven oil and gas reserves are 18.2 billion barrels of oil equivalent. In the Libra oil field alone the expectation is for another 8 to 12 billion barrels," says Clayton Pontes, general coordinator of oil and gas reserves, Ministry of Mines and Energy (MME). He notes that investment in oil exploration and production is expected to be US$162 billion for 2013–17, of which the state-owned Petrobras will be responsible for 81%.

Sharing doubts

These enormous projections are not enough to guarantee the success of the October auction because there are

PRODUCTION-SHARING CONTRACTS

Brazil has mandated production-sharing contracts (PSCs) for the deep sea oil and other strategic areas whereby oil companies (operators) are granted the rights to explore, develop, and produce oil at their own cost. The costs the operator incurs are later reimbursed by the government through an allowance referred to as "cost oil." The PSC stipulates a maximum percentage of total production that may be characterized as cost oil, although, if a development is successful, over the term of the contract the operator would expect to recover all of its costs. The oil remaining after deduction of cost oil is referred to as "profit oil." This is shared between the operator and the government in percentages stipulated in the PSC. For the deep sea Libra block, the government will receive a minimum of 40% of the oil revenues after oil costs. Moreover, the government may award PSCs to Petrobras as sole operator without holding a licensing round, and if it tenders blocks to other oil companies, Petrobras must be the operator, with a minimum 30% interest. Petrobras may bid alone or in a consortium to increase its participating interest beyond the minimum specified in the tender notice.

Bidders will specify a profit oil split, subject to the minimum percentage for the government specified in the tender notice. The operator or consortium that bids to give the biggest share to the government will be granted a PSC for that block. The tender notice may specify that this percentage will vary in relation to the economic efficiency, profitability, or volume of production or variations in the prices of oil and gas.

The operator will also be required to pay a signature bonus set by the government, royalties, and for onshore blocks, 1% of the value of production to landowners.

The attractiveness of this regime to independent oil companies will depend on a number of factors that are still unclear, such as maximum cost oil, minimum government share of profit oil and terms of the profit oil split, term of the PSCs (subject to a maximum of 35 years), the Petrobras share in the oil block, minimum exploration programs, and required signature bonuses and royalties.

The switch to PSCs was widely anticipated by the industry, but the preferential treatment of Petrobras came as a surprise, given that the current concessionary regime treats it like other companies. Its predominance may worry oilfield service companies and suppliers investing in the region, who would be increasingly dependent on a single major client. However, Petrobras already has a leading role in the Brazilian market because of its local knowledge and deepwater expertise, so many international oil companies may elect to work with it in any event.

serious doubts about the production-sharing contracts defined by law in 2010. "Starting this year, we will test the degree to which this type of production-sharing contract will attract private investors. Along the way, we will also test whether it will ensure good management of exploration and production activities," says Luiz Gustavo Kaercher Loureiro, law professor at the University of Brasilia

"[With high signature bonuses] companies that do not have cash now will be out of the game and we will have less competition; as a result, the production and government's share may also be lower."

Edmar de Almeida

(UNB). Loureiro highlights the centrality of Petrobras, which will hold at least 30% in all the production-sharing contracts besides being the sole operator in all contracts for deep sea oil. "The state deep sea oil company, PPSA, will also be quite powerful in terms of business decisions," Loureiro says.

MME's Pontes believes the production-sharing contracts ensure exploratory opportunities for a wide number of industries. But analysts and market participants argue that they increase insecurity, and the technical and economic parameters of the Libra block auction discourage competition. The signature bonus, set at US$7.5 billion, is considered too high. "The government has prioritized short-term tax revenues," says Edmar de Almeida, professor at the Economy Institute of the Federal University of Rio de Janeiro (UFRJ). He notes that unlike the concession agreement, in which the competition is focused on signature bonus offers, the production-sharing contract seeks the highest return, with the government's minimum share at 40%. However, with high signature bonuses, "companies that do not have cash now will be out of the game and we will have less competition; as a result, the production and government's share may also be lower," he says.

Surplus

Almeida also points out two constraints for companies: setting the price at US$105 per barrel of crude oil for calculating the minimum value of oil revenues transfers the risk of changes in oil prices to companies, and ceilings for recovery of costs are set at 50% of the gross value of production in the first two years and 30% thereafter. "We're talking about a large investment—the Libra field is the size of a country—and it is clear that fixing a ceiling for revenue will lengthen the time to recover investment," he says.

He also is concerned about the policy of hiring staff and buying parts locally, commenting that there is a need to be more realistic about the capacity of Brazilian industry. "We cannot turn an opportunity into a problem," says Almeida, noting that the local staff and parts policy has resulted in production delays on existing commitments. He argues that an appropriate policy must permit progressive specialization in products and services in which the country has a comparative advantage.



WANTED: ENERGY INNOVATION

Kalinka Iaquinto, *Rio de Janeiro*

HOW BRAZILIANS USE electric energy should soon change. Like other countries worldwide, Brazil has been investing in smart grids. These grids apply information technology to electric power systems, integrating them into communication systems and network infrastructure to allow more speed, efficiency, and transparency at all stages of energy production and consumption. Smart grids give consumers a larger role because they will become more aware of the use and consumption of electric energy. As the whole system changes, regulatory and technological capacity issues will arise.

"The smart grid has revolutionized the way electricity is distributed in homes. People will be much better able to control consumption because the system allows for different ways of charging for energy," said Maurício Canêdo, Brazilian Institute of Economics (IBRE) researcher. As examples, he notes that those who have wind or solar power at home may earn discounts or be able to sell excess energy.

Control

Knowing how much they are consuming and at what times, consumers are expected to better control their consumption, shifting their energy needs to periods

"The great challenge is to bring the same evolution we have seen in the power generation and transmission systems since the 1990s to the distribution system."

Pedro Jatobá

during the day when demand, and therefore rates, are lower. "[The smart grid] will start to be tested next year, with variable rates for electric energy during the day," says Máximo Luiz Pompermayer, superintendent of research and development, National Electric Energy Agency (Aneel). Today, the consumer of low voltage pays a single rate throughout the day, week, and month, even though these costs vary during each period. "When consumers can better manage their use of energy, this will improve energy efficiency generally," Pompermayer says.

The pursuit of energy efficiency will also change how companies deal with electric power network problems. Surveys by the Center for Management and Strategic Studies of the Ministry of Science, Technology and Innovation show that for every 100 kilowatts (kW) of electric energy produced in Brazil, 15 kW are lost between generation and consumption—more than double the world average of 7%. Experts believe that replacing current meters with smart meters that transmit data to companies through fiber-optic cables or by wireless will significantly reduce these losses.

The new networks, says Joisa Campanher Dutra, coordinator, Center for Infrastructure Regulation of the Getulio Vargas Foundation, should increase system responsiveness to stress, avoiding power interruptions as consumers react by changing their demand for energy.

The smart grid will also have a significant positive environmental impact. Luiz Maurer, World Bank energy specialist, points out that the International Energy Agency 2012 report indicates that by 2015 two-thirds of the total carbon dioxide emissions will come from the energy sector, particularly generation and consumption. "Therefore, adoption by electric power and distribution companies of alternative technologies that improve consumption efficiency is of great importance. Smart grids are one of those technologies," he says.

Innovation

Here technological upgrade is crucial. Brazil should invest more in research and technological development and innovation, Pompermayer says: "Undoubtedly it is important to invest more than we invest today in technological innovation, research and development. But above all, it is important that we direct resources to reducing our technological dependence in the power sector."

The recent federal Energy Innovation program (INOVA Energy), may be a move in the right direction. "We will not

immediately have 100% national solutions. What we want is the ability to solve the challenges of deploying the smart grid in Brazil. INOVA is going to accelerate that process," says Alexandre Veloso, head of the Department of Energy and Clean Technologies of the Brazilian Innovation Agency (FINEP). INOVA Energy has US$1.5 billion in funding from FINEP, the Brazilian Development Bank (BNDES), and Aneel to finance projects in the area, especially smart grids.

Changes

The success of the smart grid depends on cultural, structural, and legal changes. "The great challenge is to bring the same evolution we have seen in the power generation and transmission systems since 1990s to the distribution system," says Pedro Jatobá, president, Association of Enterprises Property Infrastructure and Private Telecommunication Systems (Aptel). He points out two solutions: smart metering, a response to the findings by power distribution companies that electric energy losses are the main problem, and automation, where the focus is the quality of energy. "Companies will make their choices according to their needs," says Jatobá, who believes that one of the biggest barriers to advances is how these changes are regulated.

Jatobá stressed that the deadlock in modernizing of electric power distribution is the lack adequate regulation; in contrast, generation and transmission are well-regulated. "Concessionaires fear change because they do not know how the regulator will react," he says. Jatobá believes it is necessary to incorporate the issue of technological revolution into the regulations themselves, as has been done in other countries. He suggests that "We need to make room for power companies to propose modernization and negotiate with the regulator their return on these investments."

"It is important that we direct resources to reducing our technological dependence in the power sector."

Máximo Luiz Pompermayer

"Adoption by electric power and distribution companies of alternative technologies that improve consumption efficiency is of great [environmental] importance. Smart grids are one of those technologies,"

Luiz Maurer

How can Brazil compete globally?



Kalinka Iaquinto, *Rio de Janeiro*

BRAZIL'S INDUSTRY IS GROWING only marginally, domestic savings are low, GDP projections have been steadily revised downward, inflation and the tax burden remain high, and the qualifications of skilled labor fall short of international standards. Yet unemployment is low and real wages have been rising over the years. This scenario raises questions about how well Brazil can compete in global markets and also meet domestic needs.

These issues were discussed by participants in the seminar on "The Challenges of Competitiveness" sponsored by the Brazilian Institute of Economics of the Getulio Vargas Foundation (IBRE) on June 28, which identified many factors that need to be addressed so that Brazil can be competitive with other countries in terms of productivity, tax burden, and industrial policies.

"In Brazil, we have a policy mix similar to European countries, where countries spend a lot on social programs. We want to be like the Europeans, but we do not have the productivity they have, so in order to spend we tax more," said Mansueto Almeida, economist, Institute of Applied Economic Research (IPEA). This means

that any Brazilian industry that is open to international competition is less competitive. "To support these industries, [the federal government] increases protection," he said. Unfortunately, protecting industry from international competition is a barrier to competitiveness. "We are on the path of failed policies," said IBRE's Maurício Canêdo. "This kind of industrial policy proved inadequate when production chains were contained in countries. If it was inadequate in the 1960s, imagine what will happen with today's global production chains," Almeida said.

> "In Brazil, we have a policy mix similar to European countries, where countries spend a lot on social programs. We want to be like the Europeans, but we do not have the productivity they have, so in order to spend we tax more."
>
> *Mansueto Almeida*

Otaviano Canuto, World Bank senior advisor, pointed out that on one hand global production chains benefit small and low-income countries because they can be inserted into unskilled labor-intensive segments of industry and on the other a country can only make progress in the global production chain by adding value to products, a process that does not happen easily, even in countries with more solid economies like Brazil's. "There must be appropriate infrastructure and regulatory frameworks," he said.

Another hurdle Canuto pointed out is the slow pace at which labor productivity evolves in Brazil. "This is a result of the combination of real wages rising above productivity and soaring industrial labor costs," Canuto said.

In contrast, Samuel Pessôa, IBRE associate researcher, argued that Brazil could look to the Australian model, which combines low domestic savings and high consumption. In an unfavorable industrial setting, the alternative is to bring in foreign savings to pay for imported goods and services. To do this, he explained, the country needs institutions that allow it to live with high current account deficits: sound fiscal policy, a floating exchange rate, free movement of foreign capital, and rules that encourage borrowing from abroad in local currency. Is this possible? Pessôa believes so, but it would require more rigorous institutional discipline. "In this respect in the last five years, we've been going backward," he said.

Slow running

"The economy is working far below its production potential in terms of best practices," said Edmar Bacha, director, Institute for Economic Policy Studies (IEPE); he pointed out that by the end of the 1990s, Brazil was working at only 50% of its capacity in terms of international best productivity practices. "The question is: why are we not there yet?" he asked, and

suggested a way to get there: the focus should be on why Brazil is so much less productive given its factor endowments, stock capital, education, and infrastructure: "For me, the key is competition. We should talk more about the challenges to make this country more competitive."

> "[Legal and regulatory uncertainty] leads to increased transaction costs, barriers to investment, legal uncertainty, and the risk of unexpected liabilities."
>
> *José Augusto Fernandes*

In fact, Brazil does not fare well compared to countries with similar incomes and economies. Renato da Fonseca, executive manager of research, National Confederation of Industry (CNI), presented results of a CNI survey that compared 14 countries on eight categories—supply and cost of labor, supply and cost of capital, infrastructure, the tax burden, the economic environment, education, technology, and innovation—and Brazil ended up in 13th position, just ahead of Argentina but below Mexico, Colombia, Russia and South Africa. Da Fonseca noted that macroeconomic stability is not sufficient for growth but it is highly important to bringing in more investment. "Without investment in fixed capital and innovation," he said, "there are no productivity gains."

Another hurdle to investment in Brazil is legal and regulatory uncertainty. José Augusto Fernandes, CNI executive director, said that an excessive number of rules in effect leads to a system without laws. "It leads to increased transaction costs, barriers to investment, legal uncertainty, and the risk of unexpected liabilities," he said. He added that it is necessary to address jurisdictional conflicts between various government spheres, dilatory judicial decisions, the growing role of the judiciary as legislator, the way Brazilian legislation disregards corporate entities, and the excessive power of regulators.

Here, the new ports law is a step in the right direction, according to Eduardo Augusto Guimarães, former Treasury secretary and former IBGE president, because it eliminates some legal uncertainties and will contribute to the resumption of investment in ports. But aside from such specific improvements, the general assessment is that the outlook for Brazil's competitiveness is not bright. "The situation is bad, and the outlook is not good either," summed up Regis Bonelli, organizer of the IBRE seminar.

Urgent need for change

Although viewpoints differed, there was unanimous agreement that reforms need to be carried out quickly, with the government moving promptly to solve problems already identified. "At the end of 2012 concerns about competitiveness and productivity rose—but not enough to impact the [government's] strategy," said Sandra Polónia Rios, director, Center for Integrative

and Development Studies (CINDES).

"There are so many challenges that it is difficult to pinpoint one. We need an institutional apparatus that generates discussion on reforms that are really relevant," said Fernando Veloso, IBRE researcher, illustrating that reforms in the bankruptcy law, personal payroll loans, and the liens law have facilitated and expanded access to credit but have not significantly affected the business environment. "That's the problem," he said. "At some point we have to face the fact that the problem is systemic."

> **"Without investment in fixed capital and innovation, there are no productivity gains."**
>
> *Renato da Fonseca*

In fact, since 2003 the country has been experiencing a credit boom. The credit-to-GDP ratio increased from about 25% to 55%. However, since 2009 there has been a very significant increase in the share of state-owned banks in total credit. "In 2005, private banks provided about 60% of Brazil's credit . . . . In 2007, this changed and the Treasury has issued public debt to cap-

IN SEARCH OF INNOVATION

THE CONSENSUS IS THAT POLICIES that encourage innovation bring about gains in productivity and competitiveness. Fernanda De Negri, IPEA director of sector studies, believes innovation is a determining factor for the expansion of Brazil's presence in global markets. IPEA data show that innovative firms are 16% more likely to export, generate better jobs, and pay salaries 23% higher than the industry average. Nevertheless, companies still invest too little in innovation. Research and business development expenditure as a share of GDP increased from 0.49% in 2005 to 0.53% in 2008. This negligible increase is just one ten-thousandth of what countries of the Organization for Economic Cooperation and Development (OECD) have invested in the same period.

"If you look at the rest of the world, Brazil is still at the same distance from other countries. Brazil has improved compared to its own past but not in relation to other countries," De Negri said, highlighting the role of the federal Inova Company program that will bring more resources to public policy. However, there is a catch: "Our technology policy is pointing in the right direction, but it will not be effective if other systemic factors are not helping and industrial policy is pointing to less competition and more protection."

A similar scenario can be seen in academic circles. Although Brazil is investing more resources in education, for scientific and technological research it is necessary to take bolder steps. Cláudio Frischtack, president, International Business Consulting (Inter.B), argues for taking academic researchers to companies and reassessing the amount of resources devoted to research. "We have advanced in terms of science, but moved very little in terms of innovation over the years. What is the productivity of resources spent on innovation and science? Our productivity is very low," he said.

italize and strengthen state-owned banks," said IPEA's Almeida. He warned that "Brazil has returned to using state-owned banks as a source of funding." This has not brought about higher growth or increased productivity because to provide funds for state-owned banks to expand their credit operations, there has been a considerable expansion of public debt, which will reduce the government's ability to reduce its interest payments. "Nevertheless, investment remains low and in the short to medium term there is no alternative but to attract foreign savings to grow," he said.

"We managed to worsen what was already a very bad situation, adding new problems", said José Roberto Afonso, IBRE researcher. He believes old distortions need to be changed. For instance, "tax exemptions granted haphazardly resulted in increasing tax spending [through loss of revenues]." What can be done to change this situation? Afonso concluded, "First, we need to update our assessment. Abandon the idea of piecemeal reform without strategic vision and adopt gradual changes more consistently. We must build an entirely new tax system—the current tax system is so bad that it is not worth trying to reform it. New problems arise from the side effects of well-intentioned measures to reform the tax system."

> "We must build an entirely new tax system —the current tax system is so bad that it is not worth trying to reform it."
>
> *José Roberto Afonso*



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Back to basics



Antonio Delfim Netto

Former Minister of Finance, Agriculture and Planning

Solange Monteiro, *São Paulo*

Antonio Delfim Netto has had a long, distinguished, and demanding career: Minister of Finance during the economic miracle (1967–74); Ambassador to France (1975–79); Minister of Planning during the second oil crisis and the Latin American debt crisis (1979–85), which brought about inflation and recession; and member of the Constituent Assembly and Congressman (1987–2006). His 50 years of experience in the Brazilian political and economic scene gives him a calming perspective on the deteriorating fiscal situation and rising inflation. "Let's reject this idea that the apocalypse is around the corner," he says, but he adds that fiscal policy should abandon "alchemy" and return to the basics. He believes that for the next three to five years, financing the external current balance deficit will be the main problem, and that eventually the exchange rate will have to depreciate.

The Brazilian Economy—What can we make of the current discontent?

Delfim Netto—The transformations and dislocations of the world economy have brought about this [popular] movement that we are living with. . . . The [people] want to show that government priorities are not the priorities that society wanted, but society's priorities do not fit within Brazil's GDP.

It has never been so important to show society that there are physical limitations. Concrete and steel can be used for building either a soccer stadium or metro transportation, but not both, because production factors are limited . . . Economic growth can only be attained by raising labor productivity. And that depends not only on the education and health of workers but also the amount of capital that each worker has. Productivity can only grow with investment. As Brazil's total production is growing very little, investment must be done either by replacing private or government consumption, or by increasing the external current account deficit. . . . Any attempt to violate this limit will produce more inflation, more confusion, and a larger current account deficit.

To address popular demands would require unpopular policy adjustments to change the current growth model. Will this prove costly to the government?

First, let's reject this idea that the apocalypse is around the corner. True, the government fiscal position is not comfortable, but the nominal budget deficit is only 3% of GDP, and

interest payments on public debt are 5%. Could be a little less, a little better, but there is no great fiscal disorder. The nominal budget deficit has been declining since the Real Plan [stabilized inflation in 1994]. However, [the government] has done a lot of accounting alchemy. In fiscal matters, we have to forget all the sophistications and go back to basics—understand, for instance, that deficits and public debt are closely connected. … Gross Brazilian public debt is much higher than what is recorded, and net public debt [used by the government as a fiscal indicator] no longer makes sense. [Large gross public debt] has significantly reduced the room for fiscal policy. This is not a disgrace; it does not mean that we will explode soon. It just means that we cannot regard debt as current revenue.

Analysts point out that the budget primary surplus is falling and inflation is rising because the government has exhausted its options for stimulating growth. Do you agree?

Of course we have nasty inflation of 6%, but … it has never been much smaller than it is today. Ten years ago inflation was high—but the real interest rate then was 10% per year and today it is 1.5%. Earning an honest living today is much harder.

Among the factors that used to help mitigate inflation were the large export revenues from commodities that pay for imports of consumer goods. However, commodities prices are falling. Does this concern you?

Rising prices for commodities exports definitely helped to contain inflation . . . .

Agribusiness will suffer greatly. Its income will fall and the infrastructure inefficiencies will show up … it will take years to resolve the issues that affect agribusiness logistics.

We are in a predicament, but by no means a tragedy. The more complicated situation, despite Brazil's high international reserves, relates to the external trade balance: With commodities prices falling, we are heading for a trade balance deficit. Although currently that deficit is only 3.5% of GDP, that amounts to a projected deficit of US$75 billion for this year that will have to be financed. … It is apparent that the exchange rate will depreciate, but the exchange rate is not a continuous variable . . . . It may overshoot . . . making the government richer because it has international reserves, destroying part of the private sector . . . . Bank customers that borrowed in dollars but do not export will find it difficult to pay their debts . . . . This, in my opinion, is the most delicate aspect for the future.

[Exchange rate appreciation] is the product of economic policy. Since 2009, [the government] has both stimulated a fantastic increase in nominal wages far above labor productivity and kept domestic interest rates high, bringing about a sharp appreciation of the exchange rate. This has weakened industry.

What are your expectations for exports?

Agribusiness will suffer greatly. Its income will fall and the infrastructure inefficien-

The government fiscal position is not comfortable, but the nominal budget deficit is only 3% of GDP, and interest payments on public debt are 5%. Could be a little less, a little better, but there is no great fiscal disarray.

cies will show up. Rates of return will be lower because it will take years to resolve the issues that affect agribusiness logistics. Not only will commodities prices fall, but agribusiness income will grow less than GDP. Thus profits will decline. At the same time, we have destroyed the industrial export sector. I believe that in the next four to five years the critical problem for Brazil will be financing the external current account deficit.

Bank customers that borrowed in dollars but do not export will find it difficult to pay their debts . . . . This, in my opinion, is the most delicate aspect for the future.

Will exchange rate depreciation help the export sector?

[Exchange rate depreciation] will not stimulate exports much because external demand is weak . . . . But it should have an important role in import substitution. It is not conceivable that Brazil does not produce more electric irons and blenders. It has nothing to do with low Brazilian productivity. It has been demonstrated that the Brazilian factory worker is as productive as the Chinese worker. The differences are outside the factory. This idea that Chinese is very efficient is true, but at the expense of huge subsidies and other types of social organization of labor relations . . . . Brazil was the only country in the world that believed China was a market economy, and our industry has paid a dear price for it.

How will the Brazilian economy be affected by the positive signs of economic recovery in the United States and China's slowdown?

The consequences are all negative. The U.S. is still the place to which we export our industrial products. China's slowing down will certainly bring down prices for Brazil's commodities. Rising U.S. interest rates will redirect capital flows back to the U.S., which will worsen Brazil's external current account deficit and reduce external financing. We will have to use our international reserves. Brazil's exchange rate will eventually adjust—depreciation is inevitable. This adjustment would take about two and a half years . . . Exchange rate depreciation has much less effect on inflation than you might think . . . . Our problem is that we cannot continue borrowing to support the exchange rate. The freedom of the Brazilian economy has decreased markedly.

The port concessions are absolutely correct, but how they are being done is producing too much friction.

Would you say the government has been hyperactive?

Hyperactivity in the right direction is very good. In this case, what happened was a wrong answer. Everything was fine in the streets. It was going in a civilizing direction . . . The answer of government and Congress, in my opinion, was schizophrenic. Congress voted on 10 things that had been pending for 14 years — and all wrong. The government itself has not really tried to understand what was happening. There is no use advertising US$25 billion for urban transportation without knowing how it will be financed. The problem for education and health in Brazil is not lack of resources, but . . . it is a matter of administration. No use saying that [the government] will allocate 10% for health, 10% for education, subsidize fuel . . . All this

brings about only confusion. Brazil needs to go back to basics.

Is the same logic being used for allocating funds from deep sea oil?

If we cannot manage these resources, it will be a tragedy. I think for deep sea oil it would be best to use the old law. It worked beautifully for the previous oil concessions . . . [With the new sharing regime] companies will win oil blocks for exploration, but it will take another three years of discussion to ascertain the production costs [to carry out the profit-sharing agreements established by the new law]. I look to Australia and die of envy. Australia discovered shale gas in 2011, and in this first half of 2013 delivered gas to China and Japan. We have known about the deep sea oil since 2003, and in 2012 we were still discussing how to explore it. Probably production will only start between 2017 and 2020. We need to improve administration. Capping the rates of return for concessions, for example, is useless, because the risks are changing every day. They are now much larger than two weeks ago . . . We need to focus on carrying out good projects . . . conduct auctions, and let the market determine the rate of return.

In the next four to five years the critical problem for Brazil will be financing the external current account deficit . . . exchange rate depreciation is inevitable.

Even with the need for so many adjustments, do you think the government is moving in the right direction?

Yes. The renewal of electric power concessions, for example, was correct. It did not violate the contract, though it could have been done in a different way. [The government] could have waited for current contracts to expire, and energy prices would have declined much more . . . . The port concessions are also absolutely correct, but how they are being done is producing too much friction . . . Policies are in the right direction and will produce results in two to four years, but in the short term the friction they are producing is enormous .

The discrediting of the government economic team is being reflected in the popularity ratings of the president.

Those in the government know that everything is more difficult than those on the outside think . . . . Since 2009 there has indeed been fiscal laxity . . . We have to calculate the public deficit and debt correctly. The numbers will be depressing, but knowing the actual numbers is the first step to correcting them. I insist: we can no longer turn loans into income; loans are not the same as revenues.

With commodities prices falling, we are heading for a trade balance deficit. Although currently that deficit is only 3.5% of GDP, that amounts to a projected deficit of US$75 billion for this year that will have to be financed.

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The recent deterioration in Brazil's economic indicators has significantly exacerbated the risk of lower GDP growth in 2013, for which IBRE lowered its forecast to 2.3% last month. It also casts doubts about the performance of the economy in 2014.

THE MAIN FEATURE OF THE RECENT economic situation is how quickly both economic indicators and expectations have deteriorated. Except for agriculture, economic activity, inflation, and external accounts have all deteriorated, leading to the most difficult situation in the last 10 years.

It is difficult to pinpoint a single cause for the deterioration. The change in the external outlook is undoubtedly a central factor. The slowing Chinese economy has pushed down prices for some of our commodity exports and will discourage investment. Since the U.S. Federal Reserve Bank announcement that it was considering tapering off the exceptional monetary easing in the United States, financial assets in Brazil have in any case fallen sharply. The increased cost of financing is also limiting corporate fixed investment.

Moreover, the external shocks are hitting Brazil when its economic policy is already overstretched. In particular, monetary and fiscal policies and lending by state-owned banks have been overly expansionary, seeking without success to accelerate growth despite higher inflation. The economic fundamentals are no longer positive, which means government has less room to react to further changes in the external outlook.

Finally, the impact of the external outlook was magnified by increased economic openness. For almost 10 years economic expansion was dependent on an external context that brought in higher prices for Brazil's commodities and higher inflows of foreign capital. This helped to finance the domestic consumption-led growth, but that is showing signs of exhaustion because the labor market is at full employment, households are deeply in debt, external current account deficits are substantial, and inflation is rising.

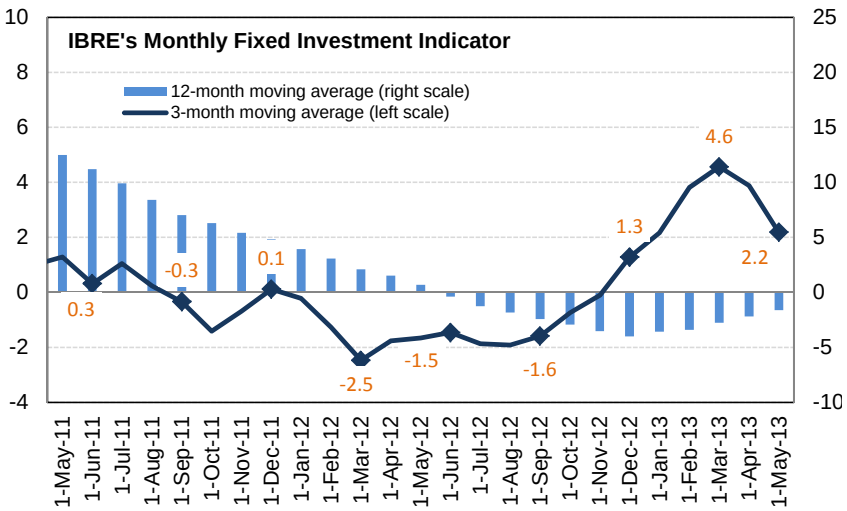
More important, however, was the plunge in potential growth despite numerous tax breaks and government stimulus. The frustration with this year's economic performance casts doubts on how the economy will perform in 2014.

In fact, our forecast for GDP growth for the second quarter is 0.6% (quarter-on-quarter), which matches actual GDP growth for the first quarter. We believe fixed investment will increase in the second quarter but possibly less than had been projected. IBRE's Monthly Investment Indicator slowed from 4.6% last March to 2.2% in May.

The current dire economic situation is pushing down our projections for GDP growth in 2013, currently at 2.3% (IBRE Economic Outlook, June 2013). The risk that growth will be even less in the second half of the year has risen significantly.

Growth in fixed investment has been slowing since March 2012.

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



Sources: IBGE, Funcex, and IBRE staff.

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