THE BRAZILIAN ECONOMY

FGV
Economy, politics and policy issues • AUGUST 2013 • vol. 5 • nº 8
A publication of the Getulio Vargas Foundation



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Surfing the new wave of trade agreements.

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The BRAZILIAN ECONOMY

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Economy, politics, and policy issues

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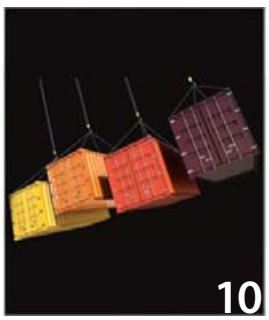
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THE BRAZILIAN ECONOMY









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IBRE Economic Outlook

36 In the short term, the negative effects of the U.S. recovery on the Brazilian economy will likely outweigh any gains it might have. Brazilian inflation and economic activity are expected to be quite volatile for the rest of the year, keeping GDP growth at about 2% for 2013.

ECONOMY

Job vacancies falling

According to data from the Ministry of Labor and Employment, in the first half of 2013 there were 826,168 job vacancies, down 21% compared to the same period in 2012. (July 23)

Consumer and business confidence both down

The consumer confidence decline of 4.1% is linked to high inflation, a rise in interest rates, and concern about employment, as well as the effect of popular demonstrations, according to the FGV Consumer Confidence Survey. The proportion of consumers who see the current state of the economy as good also decreased. (July 23)

The July FGV Industry Confidence Index indicates that the confidence of Brazilian industry also fell 4.0% from June, hitting its lowest point, 99.6, since July 2009. Confidence about current business conditions and expectations for the following months have both deteriorated. (July 31)

June jobless rate highest in more than a year

Brazil's unemployment rate rose in June to 6.0 percent in June, the highest level since April 2012, according to government statistics agency IBGE. This suggests the labor market may be easing slightly. Average wages discounted for inflation fell 0.2% to R$1,869.20 (US$841.98) in June. (July 24)

Less credit, fewer delinquencies

Loan delinquencies in Brazil's banking system fell in June for the first time since March, a sign that the efforts of private banks to slow lending were finally producing results. Loans in arrears for 90 days or more fell from 5.5% of outstanding loans in May to 5.2%. (July 26)

Industrial production up, but automotives down

Brazilian industrial production as a whole rose 1.9% in June, according to IBGE. Compared with June 2012, the increase was 3.1%. For the first half of 2013, it also was up 1.9% compared to the same period in 2012. (August 1) However, in July vehicle production fell by 2.7%, to 312.300 units, according to the National Association of Vehicle Manufacturers. In the first seven months of 2013, vehicle production was 2.2 million, 15.8% above the amount for the same period last year. (August 6)

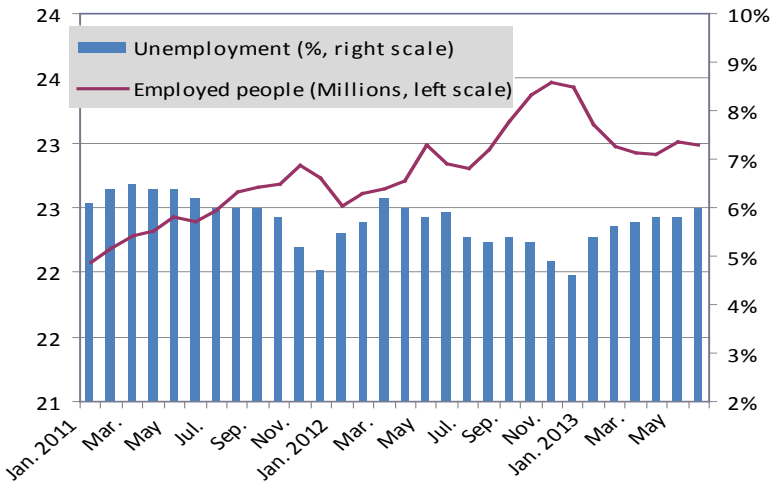
Inflation slows on lower bus fares

Inflation in Brazil braked abruptly in July after authorities in several cities and states rolled back public transport fare increases to quell the largest street protests in decades. The official price index edged up just 0.03 percent last month, the lowest monthly increase since July 2010, IBGE said. Inflation also eased with the fading of the impact of last year's drought in U.S. grain-producing areas. Food prices were 0.33 percent lower in July than in June. (August 7)

Price controls hit Petrobras hard

With the *real* devalued against the U.S. dollar by almost 10% in the first six months of 2013, government-controlled oil company Petrobras has lost an estimated US$1.3 billion because of the difference between prices of petrol and diesel in Brazil and international prices, according to the Brazilian Center for Infrastructure. (August 9)

Brazil's labor market may be easing.



Source: IBGE.

POLITICS

No real responses to popular protests yet

Two months after the national wave of protests triggered by increases in transportation fares, promises of improved public services and greater efficiency in public spending are tied up in red tape, congress went on vacation in July, and proposals for direct popular consultation were ignored as protests subsided in July. Historian Marco Villa says, "Everything is back to normal." He points out that surveys show that the popularity of President Dilma Rousseff is still low, and numerous respondents have no preferences for presidential candidates in the 2014 elections, adding, "Voters are looking for a candidate not from the Workers' Party." (August 11)



Photo: Jose Cruz/Agencia Brasil.

Former Senator Marina Silva

Rousseff popularity up, but the election is not a shoo-in

A Datafolha survey on the 2014 presidential election shows President Dilma Rousseff regaining some voter popularity, but probably not enough for her to win in the first round. Although the survey showed that former Senator Marina Silva, who has since resigned from the Green Party, has benefited most, Silva has struggled to create her own party. The ratings found were Rousseff (Workers Party, PT) 35% of the vote, Silva 26% , Aécio Neves (PSDB) 13%, and Eduardo Campos (PSB) 8%. (August 10)

ECONOMIC POLICY

Can spending cuts boost fiscal credibility?

The federal government has cut another R$10 billion (US$4.5 billion) in budgeted spending for 2013, officials said recently, in an effort to bolster investor confidence in the government's commitment to fiscal austerity. The government had also announced a cut of R$28 billion in May, bringing total cuts for the year to R$38 billion. After two years of aggressive spending President Dilma Rousseff is now trying to convince investors her administration will stick to tough fiscal rules, but spending pressures are building ahead of next year's presidential election, in which she is expected to run, and after the recent nationwide demonstrations in which Brazilians demanded more investment in health and education. (July 22)



Photo: Jose Cruz/Agencia Brasil.

Finance Minister Guido Mantega and Planning Minister Miriam Belchior announce cuts in the 2013 budget.

Transfers to government-owned banks raise federal debt

Federal debt increased in June by R$50.4 billion (US$23 billion), which brought the total to R$1,985 billion (US$902 billion), the National Treasury reported. Contributing to the increase was the issuance of bonds to finance Treasury's cash transfers to the National Bank for Economic and Social Development (R$15 billion) and the federal savings bank Caixa (R$8 billion). (July 24)

Brazil seeks change in how the IMF calculates its debt

Brazil has asked the International Monetary Fund to change how it calculates the government's debt, a move that would cause Brazil to look less indebted. In a letter to IMF Managing Director Christine Lagarde, Finance Minister Guido Mantega said the fund's calculation is "distorted." According to IMF calculations, Brazil's gross government debt is the equivalent of about 68% of gross domestic product. The requested change would reduce that ratio to 58.7%, in line with Brazil's official figures. (July 28)

Import tariff reduction for 100 products

Finance Minister Guido Mantega announced that the government will cut import tariffs on 100 products on which tariffs were increased in September 2012. (August 1)

FGV Brazil

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A delicate balancing act for Brazil

THE GOVERNMENT CLEARLY NEEDS to do something about the radical deterioration in Brazil's current accounts—between April 2007 and April 2013, the balance moved from a surplus of more than 1% to a deficit of 3%—mainly because of the worsened trade balance. But whatever it does has to be done carefully to avoid unbalancing other areas of the economy.

With commodity prices and China's economy (and therefore demand) both going backwards, Brazil's trade balance deteriorated, and as it did, it has exposed structural vulnerabilities in Brazil's current accounts. For the next few years, then, Brazil's main problem will be financing the deficit in external current accounts. To adjust the balance of payments Brazil will have to let the exchange rate float to encourage exports by promoting the competitiveness of our products on world markets. Ultimately, that will be the only way to pull the economy out of its current, and ever more evident, stagnation.

That means we're looking at further depreciation of the *real*. Unfortunately, that will undoubtedly lead to inflation. That calls for a careful rebalancing of monetary policy to hedge against depreciation spillover effects on wages and other prices, using those comfortable international reserves to smooth out volatility of the exchange rate.

There's also an important role for fiscal policy in this scenario. A tighter fiscal policy would allow the central bank to raise interest rates less than otherwise needed to cushion domestic prices against the exchange rate depreciation.

With monetary and fiscal policy working in tandem, the inevitable devaluation will shrink domestic demand by reducing incomes and curbing imports by making them more expensive. But monetary and fiscal policies by themselves will not be enough—even if major devaluation to relieve the external account deficit is politically feasible—and it may well not be.

Part of the balance adjustment has to be a push for higher productivity. That's the only way our exports will be able to compete. That means Brazil needs to invest more in innovation and technology, but starting at the bottom with better quality basic education and initiatives for more vocational education, so that young Brazilians learn how to think innovatively early on.

Brazil also has to rethink its trade policy. Barring the entry of products from other countries, protectionism, has never worked.

Brazil also has to rethink its trade policy. Barring the products of other countries, protectionism, has never worked. The local content policies are killing companies that can't find components they need because they're not made here; visa restrictions for foreign workers are killing the possibilities for technology transfer because experts can't stay long enough to train Brazilians effectively.

Brazil should also pursue more vigorously bilateral trade agreements, including with traditional trading partners like the U.S., as other Latin American countries did. We may have overestimated, and overreacted to, the relative loss of US power and also overestimated the convergence of our interests with those of China. In the last decade, the lack of major trade deals signed by Brazil was overshadowed by high commodity prices and booming demand from China. Now with lower commodity prices and lower demand from China, Brazil needs more than ever to diversify its export markets and address its structural problems.

Waiting for Lula

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

PRESIDENT DILMA ROUSSEFF'S APPROVAL ratings have plunged after massive demonstrations in the streets of major Brazilian cities. In less than one month, according to national polls, support for her dropped from over 70% to under 50%. It is true that much of the president's popularity may still depend on the economy, but Rousseff is not likely to rebound to her previous levels of popular support before next year's presidential election.

Until then, speculation about her reelection chances will mount, and calls for former President Lula to return and replace Rousseff on the ballot will become more frequent. According to recent polls, support for Lula has not been significantly affected by recent events, and if he were to run for office, his chances of victory are particularly high. Consequently, if the president's standing stays weak or continues to deteriorate in the coming months, pressure will mount within Rousseff's own Workers Party (PT), not to mention other parties within the ruling coalition, to replace her with Lula.

While Rousseff has lost political support in vote simulations, those of opposition candidates did not advance proportionately. If circumstances remain somewhat stable, Lula is not likely to replace Rousseff on the ballot.

The probability of Lula running for office again, however, is very low. Age and health concerns weigh against his return, but the decision will boil down to more structural factors. While Rousseff is not likely to rebound to her previous levels of popular support any time soon, she is still favored to win reelection in 2014. For starters, any poll taken in the midst of massive protests should be taken with a grain of salt. Rousseff's positive numbers are still higher than her negatives, and she continues to lead the pack in a hypothetical presidential election. So far, the numbers also show that while Rousseff has lost political support in vote simulations, those of opposition candidates did not advance proportionately. If circumstances remain somewhat stable, Lula is not likely to replace Rousseff on the ballot.

An equally important consideration is the fact that while Lula's popularity may be

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high, his competitiveness is not immune to the economic cycle. Though Lula is aware that, if he were to run now, he would have a good chance of winning, making that decision would not come easily. He would most likely only decide to run if he were persuaded that Rousseff is no longer favored to win next year.

Rousseff's main vulnerability is, of course, the economy. If economic growth rebounds modestly this year and next, she will be in good standing for 2014. But if the interaction between a very tense political environment and a crisis of confidence in financial markets pushes the economy close to recession, her electoral prospects would certainly be more worrisome. For Rousseff to lose her favored position, unemployment would most assuredly have to rise more, which would mean that economic discontent would intensify well beyond today's levels. Such a scenario would give the opposition more room to respond with a bold move, such as having well-known presidential hopefuls join forces in next year's election.

While Lula may still be highly competitive in this scenario, that would not make his choice much easier. Lula's popularity derived from his ability to steer Brazil through a more favorable global economy, especially during his second term in office (2007–10). In other words, Lula accrued most of his political capital during a period of economic abundance. If the prospects for the global economy are much less favorable, Lula's political instinct to preserve his legacy might drive him farther away from electoral politics. That would probably make him exceptionally risk-averse with regard to announcing his candidacy and risking the possibility of losing the election.

For Rousseff to lose her favored position, unemployment would most assuredly have to rise more, which would mean that economic discontent would intensify well beyond today's levels.

Ultimately, this scenario suggests that the economy would have to deteriorate to a point where Rousseff is no longer favored but not so far that Lula would evaluate his own chances of winning as not very high. While his return cannot be ruled out, these factors will certainly put Lula's personal ambitions on hold. And any confirmation of his candidacy would most likely come only at the last minute: Parties do not have to confirm presidential bids until late June to early July of 2014, three months before the election..

If the prospects for the global economy are much less favorable, Lula's political instinct to preserve his legacy might drive him farther away from electoral politics.



Brazil's rising trade imbalance

Brazil's trade deficit has not been this high for 20 years. Does yet another policy need to be rethought?

Solange Monteiro, *Rio de Janeiro*

THE BRAZILIAN TRADE BALANCE DEFICIT in the first seven months of 2013 was US$5 billion, the highest recorded since 1993. It has deeply disappointed the expectations of analysts, who hoped for a recovery last July. The trade deficit will push up the external current account deficit, turning the spotlight on the less bright side of the Brazilian growth model in recent years—dependence on external financing to boost domestic consumption and on favorable prices for our exports at the expense of increasing competitiveness.

In addition to international reserves of over US$370 billion and a favorable external debt profile, today Brazil has solid fundamentals and is in a good position to adjust the balance of payments, which in June recorded a deficit of US$72 billion. However, any adjustment will directly impact incomes and credit. "In the situation we're in, either we produce more, more efficiently, or we consume less.

Clearly this will affect people directly," says Silvia Matos, coordinator of the IBRE Economic Outlook. "When the external outlook is favorable, we can have higher domestic absorption, because the world is financing us. But now the external outlook is deteriorating in a domestic context in which Brazil has many problems, among them high inflation, rising interest rates, low growth in investment, and no growth in the economy," Matos says.

Lia Valls Pereira, IBRE coordinator of external sector studies, emphasizes the importance of the trade balance in this context, commenting, "The prospect of a future without the trade surpluses of US$40 billion that financed deficits in services and income has made Brazil dependent on more volatile portfolio investments, which increases our external vulnerability."

Tatiana Prazeres, former Secretary of Foreign Trade of the Ministry of Development, Industry and Trade (MDIC), maintains that "The government holds to its original estimate: 2013 will be difficult, but we will continue to export at a high level, close to the levels of 2011 and 2012"—which would be the very optimistic range of US$10–19 billion. Prazeres noted that the trade balance deficit in the first half of 2013 reflected the delayed recording of various import operations made by the oil company Petrobras in 2012 and the drop in Petrobras production caused by scheduled shutdowns for oil rig maintenance. "We had a significant reduction in exports in the first six months, 48%, and a significant increase in import costs," she said. From January to July, the oil account deficit alone was US$15.4 billion.

Brazil has solid fundamentals and is in a good position to adjust the balance of payments, which in June recorded a deficit of US$72 billion. However, any adjustment will directly impact incomes and credit.

For Bráulio Borges, an economist with LCA Consulting, recovery of oil production will have a positive effect on the trade balance in 2014."Oil rigs will be working again with a larger production capacity. And six new oil rigs will start operating in the second half of the year," he says. But Pereira points out that there is a risk of lower U.S. demand for oil because of the increased supply of U.S. shale gas.

Though clearly relevant, oil has not been the only variable affecting trade. Expectations for exports of minerals and agricultural products depend on China, where the economy is slowing and domestic demand is rebalancing from infrastructure to consumption. Borges notes that "One would expect a change in the prices of commodities. Prices of metals will weaken . . . because Chinese investment in fixed capital will no longer be growing at 40% to 50% a year. On the other hand, Chinese consumption will

> **"In the situation we're in, either we produce more, more efficiently, or we consume less. Clearly this will affect people directly."**
>
> *Silvia Matos*

grow faster, and that will benefit most agricultural commodities."

Lower Chinese demand is the main channel for the contagion of slower global growth to reach Brazil. According to the International Monetary Fund, in the last three years global GDP grew only 3.1%. That lower global growth has helped bring about the worsening of Brazil's trade balance. Last year, internationally exports increased by less than 2% in volume and this year should approach just 3%. The historical average is about 7% a year.

If growth of the U.S. economy is confirmed at close to 3% in 2014, and global growth is close to 4%, how much would Brazil be able to benefit from the recovery?

INDUSTRY

Brazilian exporters of manufactured goods have hopes of maintaining an undervalued currency to guarantee gains in competitiveness. "The important thing here," Pereira says, "is that there is exchange rate stability. As long as the new

Warning sign: Brazil's trade balance has deteriorated significantly in the last 3 years.



* January-June for current account balance and January-July for trade balance.
Sources: Ministry of Development, Industry and Commerce, and central Bank of Brazil.

exchange rate level is unclear, exporters will feel insecure about the best time to sell, afraid to make losses."

"Many factors led to a worsening of the trade deficit in manufactures . . . and the exchange rate issue is one of them," Borges says. He explains that there was continuous appreciation starting in 2003 that reached R$1.60 to the U.S. dollar early in 2011. Only in mid-2012 did this scenario begin to change slightly. Stronger growth of the U.S. economy growth, he notes, will cause the dollar to appreciate. "This means that the trade deficit in manufactures should decline in coming years, or at least not continue deepening," Borges says, pointing out that a depreciated exchange rate will also reduce imports.

For a sector where competitiveness is a chronic problem, however, an exchange rate of R$2.25 to the dollar may not be enough to offset the Brazil cost. "It's a relief; it somewhat improves the trade balance," says José Augusto de Castro, chairman of the Brazilian Foreign Trade Association (AEB). "If we had decent infrastructure, a civilized tax system, normal interest rates, and less bureaucracy, an exchange rate of R$1.80 per dollar would be acceptable. But today we have to depend on [a much depreciated exchange rate], and ideally it should reach R$2.50."

For Castro, a lower exchange rate will not be enough to stimulate exports, or discourage imports, which are growing. A survey by the National Confederation of Industries (CNI) shows significant growth in the use of imported inputs in manufacturing—21% in the first half of 2013. Among sectors where there have been major increases are computers, electronic and optical goods, pharmaceutical chemicals and pharmaceuticals, textiles and clothing, and metal products. "It seems that R$2.25 is still not enough to cause a reversal of this situation," says Marcelo Azevedo, CNI economist.

"What generates economic development is trade flows, and we need to stimulate those by adding more value to exports."

José Augusto de Castro

For manufacturing exporters it will be crucial to rebuild market share in Europe as well as recover the dynamics in markets like Argentina, Brazil's third largest trading partner.

THE CURRENT ACCOUNT

Castro thinks, however, that increased sales of manufactures because of a depreciated exchange rate will only keep Brazil's exports around their historical 10% of GDP. With the outlook for the trade balance less auspicious, the government will be forced to check the uncontrolled growth of the current account deficit. According to IBRE staff, Brazil has sound fundamentals and an economic policy that make it possible to adjust the external balance without plunging the country into crisis. But this will require addressing the consumption-led growth that has been a government target in recent years.

CONTINUED UNCERTAINTIES IN BRAZIL-ARGENTINA TRADE

Solange Monteiro

FOR THE THIRD BIGGEST MARKET for Brazilian exports, Argentina, the medium-term economic outlook for foreign trade is unfavorable. "This year we still anticipate a dynamic second half, but next year the scenario promises to be more mixed, with some difficulty in finding foreign currency for foreign trade," says Enrique Dentice, coordinator of the Center for Economic Research at the University of San Martín, Buenos Aires.

The fiscal and currency crisis that has affected the Argentina since 2011 has significantly reduced the international reserves that support foreign trade. "Our economy is more open than Brazil, and production of both commodities and manufactures depends on imported inputs," Dentice says. He calculates that "for Argentina, a 30% growth in imports results in 1% GDP growth."

Because of the shortage of foreign currency, the government is releasing imported products and materials slowly, which is slowing down economic activity in Argentina. "This situation benefits some sectors like automotive or steel industries that have advantages in negotiating the purchase of foreign currency. However, it has a different effect on industries like textiles, which mainly supply the domestic market, which is protected by the government, and must pay high prices for foreign currency. That was the reason that Brazilian mining company Vale was forced to exit Argentina," Dentice points out, referring to the Rio Colorado potassium mining project that Vale abandoned last March. It was the largest foreign direct investment in Argentina—about US$6 billion, creating 2,700 jobs.

"Argentina's economy is not dependent just on Brazilian industrial goods . . . Today Brazil is also our major direct investor," Dentice says. The insecure business environment, however, has reduced the appetite of Brazilian corporations for investing in Argentina. In January, the Brazilian oil company Petrobras sold its stake in EDESUR, which distributes electricity. EDESUR has been running losses because of government controls on electricity rates. In April, Duratex closed its hydraulic products factory; and in June, Argentina President Cristina Kirchner canceled a rail contract with ALL Logistics.

The best hope for reversing Argentina's current situation is investment in the exploitation of its shale gas, ranked among the top five reserves in the world. The state-owned oil company YPF has an agreement with Chevron that provides for it spending US$1.2 billion in Vaca Muerta in the province of Neuquén. The government also intends to stimulate public investment in shale gas by issuing a Treasury bond with an interest rate of 4% a year and a tax amnesty for dollars reinvested in the country. "We will see what the response of economic agents is," says Dentice. He has pointed out that a similar instrument was launched in early July without much success. The Certificate of Deposit for Investment (Cedin) offers a 90-day tax amnesty, and the same rate of 4%.

By attracting dollars that are outside the formal foreign currency market, the government hopes to maintain its current level of international reserves and set a ceiling on the price of the dollar in the informal market, where this year the difference with the official exchange rate has been more than 100%. "In the first month, the new financial instrument had little effect," says Dentice. "Purchases have not yet reached US$8 million, and the initial expectation was at least US$4 billion." The government estimates that Argentines have US$200 billion deposited in offshore accounts or under their mattresses. "There is no lack of financial instruments to stimulate investment, but uncertainties abound," Dentice concludes.

In the short term, the alternative is to reduce consumption and investment. "Between the two, it is best to adjust consumption," Silvia Matos says. Depreciation of the exchange rate should reduce income, she notes, inhibiting domestic demand.

Sandra Manuelito, economic affairs officer of the UN Economic Commission for Latin America and the Caribbean (ECLAC), points out that for some years Brazil has stood out in the region for attracting foreign direct investment (FDI). "In the early 2000s FDI represented about 16% of GDP and is now closer to 20%," she says. However, a recent ECLAC study warns that in recent years FDI in Brazil and other Latin American countries has compromised the quality of economic growth. "The large FDI flows were concentrated in two sectors, domestic commerce and services, which cater to domestic consumption but contribute little to exports, and the production of commodities, which works against diversification of exports, generating vulnerability," Manuelito says. She argues that a solid exporting industrial base can generate export revenues to balance FDI-related external obligations, such as remittance of profits.

"Prices of metals will weaken . . . because Chinese investment in fixed capital will no longer be growing at 40 to 50% a year. On the other hand, Chinese consumption will grow faster, and that will benefit most agricultural commodities."

Bráulio Borges

"The prospect of a future without the trade surpluses of US$40 billion that financed deficits in services and income has made Brazil dependent on more volatile portfolio investments, which increases our external vulnerability."

Lia Valls Pereira

AEB's Castro warns that much of the FDI coming into the country relates to mergers and acquisitions, not new business: "Currently FDI in Brazil purchases a company that is already established; there are no new investments." Luis Afonso Lima, president of the Brazilian Society for the Study of Transnational Corporations and Economic Globalization (SOBEET), confirms that "Today, less than 50% of FDI coming into the country is [invested in new industries]." SOBEET estimates that Brazil will be by 2015 the

If growth of the U.S. economy is confirmed at close to 3% in 2014, and global growth is close to 4%, how much would Brazil be able to benefit from the recovery?

fifth preferred destination for FDI, even if some conditions—reduced purchasing power and tighter credit—suggest the possibility that the investments will be less profitable. "However, FDI will not completely bankroll the current account deficit as it did in the recent past. The deficit has grown because of structural and external factors, and investment is declining. Now, it's up to us to do our homework," he says.

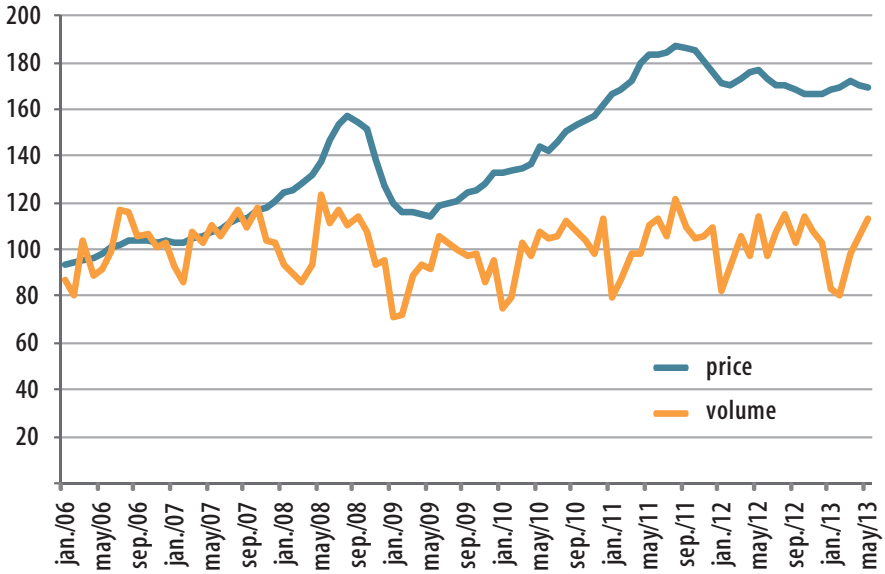
With little domestic savings to invest and no more large trade surpluses, Brazil will have to adjust. "Having a current account deficit is not necessarily bad," Matos says. She cites as an example Australia, which has had a deficit in its balance of payments of more than 4% of GDP since the 1980s. But its macroeconomic framework has enabled Australia to survive major international crises without major damage. "Australia has opted for a low level of industrialization and focused its activities in commodities and services, where it is competitive," says Matos. To do the same, Brazil would have to ensure a sound fiscal balance as well as opt for less industry. For Matos, a key step toward an external adjustment is the end of remedial policies to maintain a large industrial sector.

In contrast, AEB's Castro calls for major reforms that will ensure that Brazil's industry



Since mid-2011 prices of Brazilian exports have declined slashing significantly the trade surplus.

(price and volume indexes)



Sources: Funcex and MDCI.

is competitive. "The measures that we see, the temporary relief programs, are all cyclical, not structural. As long as Brazil does not make the necessary labor and tax reforms, there will be no gain in competitiveness," he says. "A trade balance surplus is always a consequence, not a cause. What generates economic development is trade flows, and we need to stimulate those by adding more value to exports," he adds.

"FDI will not completely bankroll the current account deficit as it did in the recent past. The deficit has grown because of structural and external factors, and investment is declining. Now, it's up to us to do our homework."

Luis Afonso Lima

Surfing the new wave of trade agreements

Lia Valls Pereira

ACCORDING TO THE WORLD TRADE ORGANIZATION (WTO), the number of free trade agreements has surged from 25 in 1958–1990 to 88 in 1991–2000 to 158 in 2001–2012. The proliferation of these agreements in the first years of the 21st century is being interpreted as a "new wave of regionalism."

What is new about the recent agreements is that Asian countries, notably China, are now actively securing trade agreements. In South America, China has already signed agreements with Chile, Peru, and Colombia. The new free trade agreements are not limited to liberalization of interregional trade. They now also cover intellectual property rights, investment, trade in services, and aspects of labor and the environment.

The U.S. was already relying on an extensive network of agreements in Latin America, but as the context is changing, it has launched two new initiatives: the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP).

How might the new American partnership affect Brazilian trade? And what are the prospects of a bilateral trade agreement between Brazil and the U.S.?

China's ascension

Throughout the first decade of the 2000s, the major change in Brazilian foreign trade was the rise of China and the decline of the U.S. as Brazilian trade partners. The U.S. share in Brazilian exports declined from 25.4% in 2002 to 10% in 2013; meanwhile, even as the European Union's share was also receding, from 25.8% to 19.0%, China's share was increasing from 4.2% to 20%. Rather than new initiatives, however, the recessive situation in the EU explains its market share decline.

What explains the declining U.S. share in Brazilian exports? The share of Brazilian products in total U.S. imports has actually held steady. After declining to 1.2% in 2010, Brazil's share in U.S. imports

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returned to 1.4% in 2012, exactly where it had been in 2008. Brazil thus maintained its share in the U.S. market and its exports expanded. Most of the narrowing in the U.S. share in Brazilian exports can be explained by the run-up in commodity prices and Brazil's commodities exports to China. As Brazilian exports to the U.S. are mostly manufactured goods, they did not grow faster because they did not benefit from the same generalized price increases as commodities.

Agreements

The U.S. already has free trade agreements with Australia, Bahrain, Canada, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Israel, Jordan, Korea, Mexico, Morocco, Nicaragua, Oman, Panama, Peru, and Singapore.

The new free trade agreements are not limited to liberalization of interregional trade. They now also cover intellectual property rights, investment, trade in services, and aspects of labor and the environment.



Photo: Ricardo Andre Frantz/Wikimedia Commons.

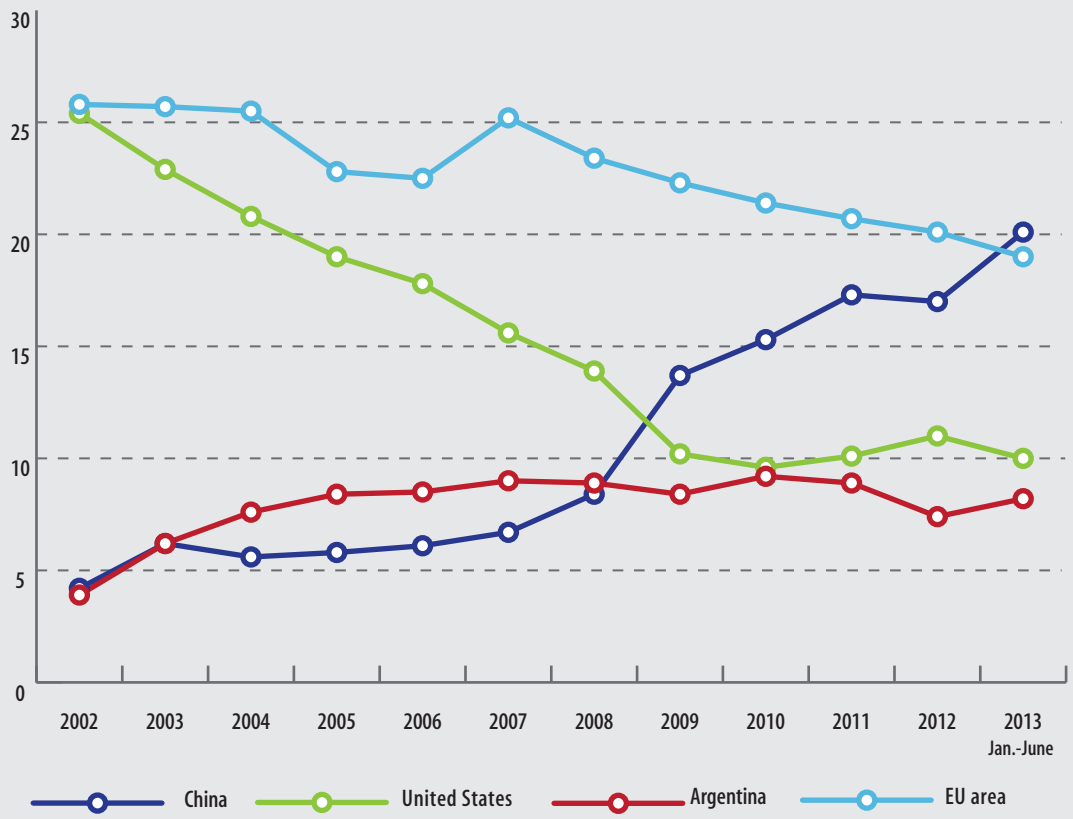
The prospect of China's slowdown suggests that Brazilian exports to China are not likely to repeat their dramatic performance in 2008–12, when they shot up by 55%.

These countries comprise 46% of total U.S. exports and 35% of total imports.

Members of the TPP, which has not yet been signed, are currently Australia, Brunei Darussalam, Chile, Japan, Malaysia, New Zealand, Peru, Singapore, Vietnam, and the United States. The TPP free trade area will comprise 45% of U.S. imports and 58% of its exports.

How might these agreements affect Brazil? The TPP market accounts for 20% of Brazilian exports, of which, according to

Main trading partners shares in Brazilian exports.



Source: Secretary of External Trade of the Ministry of Development, Industry and Commerce.

2012 data, 11% goes to the United States. Chile and Peru already have free trade agreements with Brazil and the other countries account for only 5.7% of Brazil's exports. Brazilian exports do not compete with Japan's. The TPP risk for Brazil is a possible loss of markets in small Asian and Oceania countries.

As for the TTIP, the greatest potential trade loss may result from negotiations to facilitate the entry of European agricultural products into the U.S. market, but such a scenario is as yet far from being realized. In the area of phytosanitary standards, Europeans and Americans have many differences.

In current trade agreements, however, the regulatory aspects are the main issues, as underscored in a recent book.[1] Also, the proliferation of trade agreements with the U.S. could further weaken the search for negotiated solutions in the multilateral trade system.

To avoid being drowned by the new wave, Brazil needs to formulate its preferred strategies for trade agreements—which should not be confused with the realization of agreements as a way to advance the liberalization of Brazilian trade. For instance, what type of regulation of investment, intellectual property, and environment compromises, among others, is Brazil willing to negotiate with the U.S.? What benchmarks would Brazil like to set for multilateral trade negotiations and the deepening of South American trade integration?

To avoid being drowned by the new wave, Brazil needs to formulate its preferred strategies for trade agreements.

Since a free trade agreement with the U.S. is not part of Brazil's current trade policy, we will have to improve our export performance in the U.S. market. A trade agreement by itself will not ensure that Brazilian manufacturers will be more productive or otherwise become more competitive in the U.S. To increase productivity, Brazil will have to address, among other problems, its cumbersome tax system, poor infrastructure and logistics, and high import tariffs for intermediate goods.

Considering that in 2012 crude oil constituted 27% of Brazilian exports to the U.S., the increased supply of shale gas in the United States may undermine Brazil's performance in that market. For Brazil, enhancing the export potential of ethanol will thus be important.

Finally, China will not replace the U.S. market in importance. The U.S. is not only still the largest economy in the world, it also recovering. Also, the prospect of China's slowdown suggests that Brazilian exports to China are not likely to repeat their dramatic performance in 2008–12, when they shot up by 55%.

[1] Ivan Tiago Machado Oliveira and Michelle Ratton Sanchez Badin (editors), *Tendências regulatórias nos acordos preferenciais de comércio no século XXI: os casos de Estados Unidos, União Europeia, China e Índia*. Brasília, 2013. Instituto de Pesquisa Econômica Aplicada.

The demonstrations are a wake-up call for Brazil's political leaders



Riordan Roett

Dr. Riordan Roett is the Sarita and Don Johnson Professor of Political Science and Director of Western Hemisphere Studies at The Johns Hopkins Paul H. Nitze School of Advanced International Studies (SAIS) in Washington, DC.

Anne Grant, *Washington D.C.*

In an interview here two years ago, Dr. Roett warned of pitfalls ahead for the Brazilian economy. A former national president of the Latin American Studies Association who is fluent in both Portuguese and Spanish, he is a recognized expert on the region and published *The New Brazil in 2010, two years after he edited China's Expansion into the Western Hemisphere*. Earlier, for his work on Brazil he was awarded the Order of Rio Branco with the rank of Commander. In the wide-ranging interview recorded here, he touches not only on Brazil's current economic difficulties but also on its evolving relationships with other emerging nations—and with its own people. He underlines the need to consolidate democratic governance, and raise competitiveness through investment in education and health to create the human capital required for a global economy.

***The Brazilian Economy*—You're very knowledgeable about the entire region and well beyond. What might Brazil learn from neighbors like Mexico or Chile?**

Roett—Mexico has recently undertaken important reforms in the areas of education and telecommunications. The Congress is about to consider changes in energy policy. Under President Enrique Peña Nieto of the PRI, the Mexican Congress has become a positive force for change. In Chile, careful and prudential fiscal management and the creation of Pension Reserve and Social and Economic Stabilization Funds from copper earnings to deal with downturns in the economy have added stability to the economy. These sorts of initiatives are important and might be useful examples for Brazilian policymakers to consider.

Since Brazil doesn't save much, its economic growth depends desperately on foreign investment. Yet a former finance minister recently told us that "the government has frightened off entrepreneurs." Would you agree?

Investors, who are by nature risk-averse, have moved away from Brazil. Inflation is

a worry. Growth is disappointing. Labor laws are overly rigid. The tax code is incomprehensible. Local content requirements [for companies to hire and buy parts locally] are counter-productive. The education system does not produce the talent a modern economy needs but it is very difficult for foreign talent to enter Brazil because of the bias against granting work visas. All these problems should be of high priority in Brasilia.

The education system does not produce the talent a modern economy needs but it is very difficult for foreign talent to enter Brazil because of the bias against granting work visas.

How well and how effectively do you think the BRICs can work together now that each of them has economic troubles of its own?

The BRICS concept is a symbol of the future of the global economy. The developing economies over time will have an increasingly important role but all the BRICS need to carry out significant structural reforms before they can challenge the industrial countries. Brazilian growth is anemic. The Indian economy is in free fall. Russia relies on energy exports alone and is increasingly authoritarian. China remains an enigma. While growth in China is reasonable, the debate, annually, is whether or not the regime can deal with the expectations of a rapidly growing middle class. South Africa, a political addition to the concept, is probably not best suited to join the other four given the relative size of its economy and its internal social divisions. No one would argue that the BRICS will replace the U.S. and the EU in the immediate future. But the natural resource base, large populations and territory, will give them an expanding role in the global economy over time.

What does U.S. exploitation of its shale gas imply for the Brazilian oil industry?

Just a few years ago there was an expectation that Brazilian oil reserves might become important for the U.S. market. President Obama in his visit to Brazil in 2011 commented that the two countries should become energy partners. The scenario has now changed dramatically with the shale gas revolution in the U.S. The dependence of the U.S. on foreign oil supplies is dropping rapidly. Geopolitically, Washington sees this as a very welcome development that over time should allow the U.S. to reduce its dependence on a volatile Venezuela and countries like Saudi Arabia. Mexico may become a major player if the proposed energy reforms are approved by the Mexican Congress. Canada continues

The BRICS need to carry out significant structural reforms before they can challenge the industrial countries.

to be a key supplier to the U.S. market. The slow pace of exploitation of the deep sea oil fields in Brazil probably means that an energy partnership between Brazil and the U.S. is a fairly distant prospect.

When the government allows entrepreneurship in the public sector to flourish, Brazil is as competitive as any developing country.

In *The New Brazil*, you said that Brazil needed, among other things, a restructured tax system, a more flexible labor market, and more—and more effective—education spending, especially in math and science. Do you see any signs of any political will in Brasilia to actually slash the Brazil cost?

Not really. The Brazilian Congress appears immune to any reasonable argument that Brazil will only become truly competitive and productive if it approves major structural reforms. The World Economic Forum's annual *Global Competitiveness Report* ranks Brazil near the bottom in terms of public education, competence in math and science, etc. In the latest report, which ranked 144 countries, Brazil was 132 in the quality of math and science education. The problem in part is that legislators in Brasilia send their children to private primary and secondary schools; that prepare them to pass the entrance examination for public universities—the vestibular. The public universities are very good and they are generally free of charge. Poorer children must attend mediocre public schools and are unable to pass the entrance exams of public universities. If they go to a university, it is an inferior private institution that is expensive.

The protests and demonstrations are a wake-up call for Brazil's political leaders.

Brazil does not have a comprehensive technical and vocational education program. Those who graduate from the public universities are highly competent but there are too few for the size of the economy—and public university graduates are not going to run machines or perform the manual jobs the economy needs day to day. A year or so ago the *Financial Times* reported on a frustrated engineer on one of the oil rigs in the southeast who could not find welders. He turned one day to the woman serving coffee and asked her if she would like to become a welder. She asked if it paid more than her current job. It did indeed. She is now a welder. Companies are desperate for the trained technical staff that the education system is incapable of providing for industry.

The Brazil Cost is well known. The cost of doing business in Brazil is very high. In the World Economic Forum's latest report the most problematic factors for doing business in Brazil were listed as tax regulations; inadequate infrastructure (only 16 percent of Brazilian roads are paved); tax rates; inefficient government bureaucracy;

corruption; an inadequately educated work force; and restrictive labor regulations. All these issues have been on the agenda for decades but politicians in Brasilia seem unable to find the political will to address the country's vital developmental challenges.

The new lower middle class is now beginning to demand the kind of services that the traditional middle class has not received.

Despite much talk, nothing substantive has yet changed as a result of the street demonstrations in June. How effective do you think they'll be?

The protests and demonstrations are a wake-up call for Brazil's political leaders. The average citizen is frustrated with miserable public health care, impossible public transportation bottlenecks, high taxes that bring them little in return. The situation is more complicated because the new lower middle class is now beginning to demand the kind of services that the traditional middle class has not received. Both groups are tired of corruption in Brasilia. When individuals are tried and convicted, why do they not go to jail? The high cost of the infrastructure for the soccer finals in 2014 and the Olympics in 2016 is being questioned—if there is money for those projects, why are hospitals and schools inferior? Civil society has been energized by social media. Information spreads quickly. Brazil has an impressive record of investigative journalism. It will be impossible for the political elite to play politics as usual in the future.

What Brazilian government programs do you think have been effective? Which ones have not?

Clearly *Bolsa Familia* (the Family Grant program) has been very successful in reducing poverty and bringing tens of millions of Brazilian into the national economy. What the politicians did not consider was the heightened expectations for social services of newly empowered Brazilians. There now needs to be a balancing of the positive consequences of the program and the need to address those expectations. EMBRAPA (The Brazilian Agricultural Research Corporation) has been extraordinarily important to Brazil's agricultural revolution that has allowed the country to be a very efficient producer of a wide variety of commodities for export. EMBRAPA has a network of 37 research centers, 3 service centers, and 11 central divisions across the country. Over the years, it has generated and recommended more than 9,000 technologies for Brazilian agriculture. EMBRAER, the Brazilian aerospace conglomerate, is a world-class producer of commercial, military and executive aircraft—a global player in the industry. When the government allows entrepreneurship in the public sector to flourish, Brazil is as competitive as any developing country. When it interferes through overregulation, high taxes, and poor public services, it is difficult to be competitive. These exam-

ples demonstrate that the talent and the will to change are alive and well in Brazil as long as the public sector supports, rather than hinders, innovation.

How do you view the political situation in Brazil?

It's very uncertain. Clearly the average Brazilian rejects the current political class. Polls now demonstrate that the public is very frustrated with the inability of the politicians in Brasilia to govern effectively in the public interests. Constant corruption scandals magnify the problem. Impunity reigns among the politicians. They confuse their public duties with their private interests. It is well known that the political party system, one of the most confusing in the world, needs to be changed. But, of course, that means the Congress would need to do something. There is little possibility of meaningful reform since the interests of the legislature will be compromised. It is widely recognized that the judicial system is unwieldy, inefficient, and incoherent, but there is little political will for reform.

If the economic issues are seen as serious problems in 2014, it is not impossible to imagine the various "oppositions" being able to challenge President Rousseff, particularly if the election goes to a second round.

The president's popularity sank during the demonstrations. Do you see any possible challengers emerging for the elections next year?

The conventional wisdom, in spite of the recent demonstrations, is that President Rousseff will win a second term, probably in a second round run-off in 2014. But there are other scenarios. Former President Lula may sense that President Rousseff is not electable and choose to stand as the PT candidate. Senator Marina Silva is organizing a new political party and current polls indicate she is in second place and closing in on President Rousseff. Other contenders so far seem to be far behind the two women. If the economic issues—unemployment, low growth and inflation in particular—are seen as serious problems in 2014, it is not impossible to imagine the various "oppositions" being able to challenge President Rousseff, particularly if the election goes to a second round. ■

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Troubling portents for growth prospects

Fernando Dantas, *Rio de Janeiro*

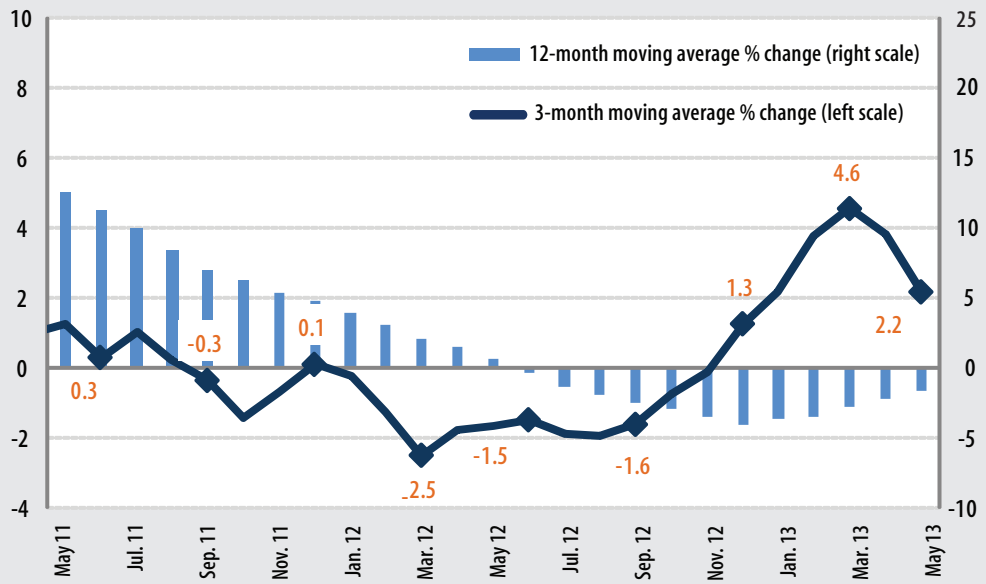
THE RECOVERY OF INDUSTRY may have already passed its peak in the second quarter, capping a tentative recovery of the Brazilian economy that started in late 2012. Silvia Matos, coordinator of the IBRE Economic Outlook, sees considerable risk that in the second half of 2013 the economy will return to the semi-stagnation it saw in 2011 and 2012.

Industry registered growth of 1.1% seasonally adjusted in the second quarter compared to the first. But doubts have been raised about whether even that much recovery is sustainable. Vinicius de Oliveira Botelho, IBRE researcher, points to the increase in the volatility of industrial production as a concern.

The fixed investment conundrum

Capital goods performed well, rising by 3.9%, seasonally adjusted, in the second quarter compared with the first quarter, followed by construction at 1.6%. This

After increasing 4.6% in the first quarter, the IBRE fixed investment index fell 2.2% in the three months ending in May.



Sources: IBGE and IBRE.

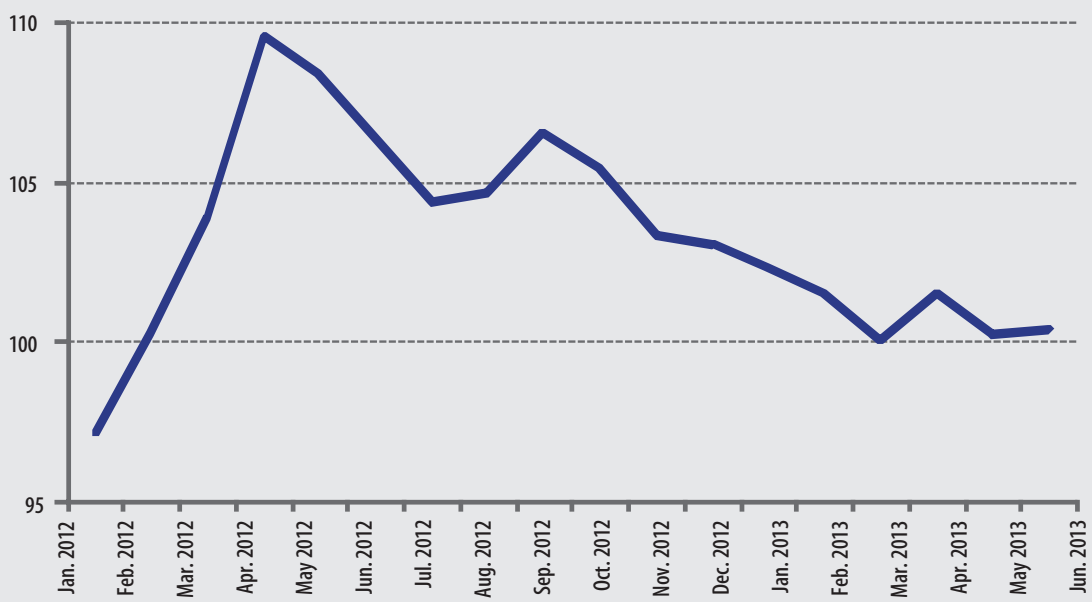
might suggest an apparently promising outlook for fixed investment.

However, intermediate goods grew by only 0.1% in the second quarter. This sector can be considered the heart of industry because it accounts for 53% of the industrial production index. Intermediate goods, in fact, have been close to stagnation for the last three quarters, recording 0.1% in the first quarter of 2013 and less than 0.2% in the last quarter of 2012. Consumer goods grew 1.3% in the second quarter, with a push from durable goods, which expanded by 3.1%, mostly driven by automobiles.

Intermediate goods have been close to stagnation for the last three quarters, recording 0.1% in the first quarter of 2013 and less than 0.2% in the last quarter of 2012.

There are several points of concern with this pattern of industry rebound in terms of the sustainability of the recovery. For

Consumer expectations have declined since April 2012.



Source: IBRE.

After a brief period of recovery, it seems fixed investment is already showing signs of exhaustion.

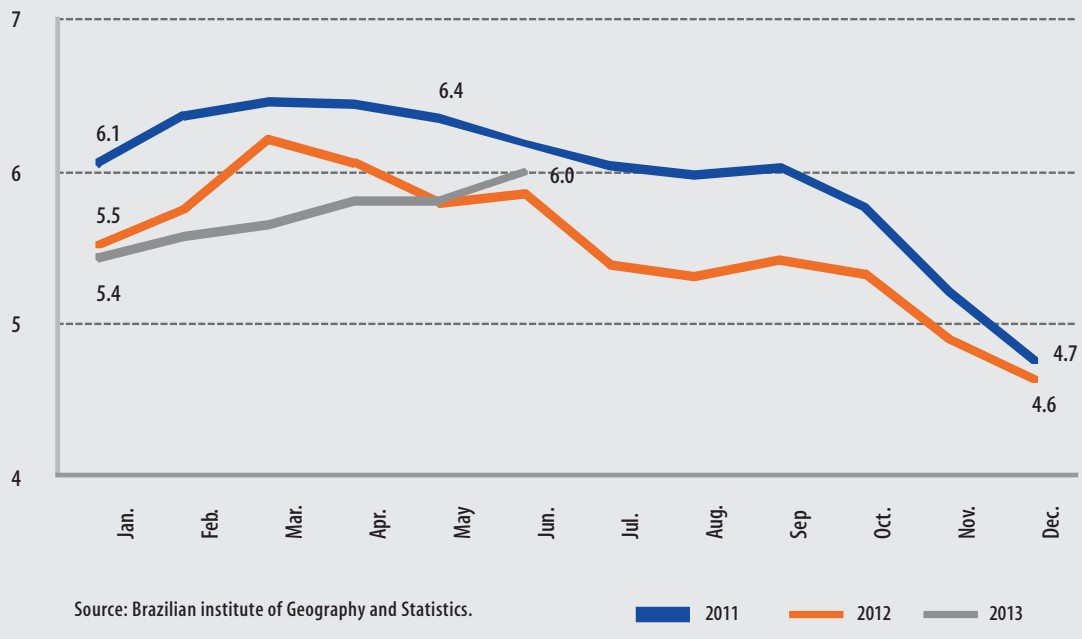
instance, it is difficult to believe that the good performance of capital goods—the main engine of industrial growth in the second quarter—will last considering that intermediate goods production seems to have stagnated.

The IBRE monthly fixed investment indicator (IMI) maintained an upward growth trend from last November through April. However, after increasing 4.6% in the first quarter, the IMI fell 2.2% for the three months ending in May. After a brief period of recovery, it seems fixed investment is already showing signs of exhaustion.

The problem of confidence

Business and consumer confidence surveys were also not so positive in the second half. After improving between August

Increasing unemployment is one more factor weighing on growth in 2013.
(Percent)



Source: Brazilian institute of Geography and Statistics.

and December 2012, the FGV business expectations index has been declining ever since; in July it fell by 4.1%. The fall in business confidence discourages investment. After increasing between January and April 2012, the FGV consumer expectations index has also declined, falling by 1.6% in July. Economic insecurity discourages household consumption, which barely increased in the first quarter.

Labor market

Since 2011 an unusual corollary to slow economic growth in Brazil has been the strength of the labor market, which remained buoyant, with unemployment falling: The average unemployment rate for the first five months was 7.4% in 2010, 6.3% in 2011, 5.9% in 2012, and 5.7% this year.

A weakening labor market is one more factor weighing against growth in 2013—household consumption is closely linked to the performance of employment and income.

Economic insecurity discourages household consumption, which barely increased in the first quarter.

However, there are signs that labor market conditions are becoming less favorable. Ministry of Labor data show a significant downturn in the number of new job vacancies, and the IBRE labor market survey also signals a cooling labor market. Unemployment was 6% in June compared to 5.8% in June 2012, and is likely to head further upward in the second half of 2013.

A weakening labor market is one more factor weighing against growth in 2013—household consumption is closely linked to the performance of employment and income.

Brazil-LEI: Getting the bad news more quickly?

In July the Conference Board partnered with The Brazilian Institute of Economics of Getulio Vargas Foundation to launch a new indicator to track Brazil's economic ups and downs.

Thais Thimoteo, *Rio de Janeiro*

EARLIER THIS YEAR, MOST ANALYSTS bet that the Brazilian economy would grow about 3.5% for the year. Today, with industrial production down, households too heavily indebted to contemplate consumption, and inflation rising, the reality is that in 2013 growth is likely to be more modest: between 2% and 2.5%. The new Conference Board (TCB) Leading Economic Indicator for Brazil (Brazil-LEI) aims to better anticipate Brazilian business cycles.

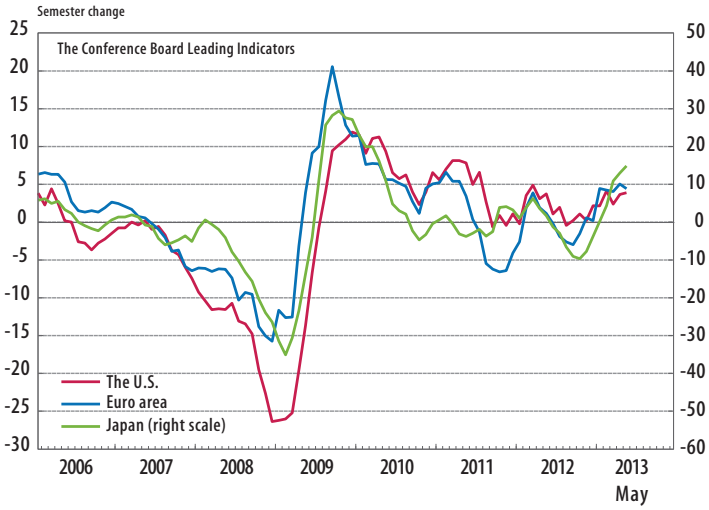
There was no change in April, but in May the Brazil-LEI fell 1.2% and in June it fell 0.6%. According to Paulo Picchetti, IBRE economist, it is still too soon to say that the country will soon be facing an "unequivocal contraction" of the economy, but the index results are sufficient to raise concerns. "There is no rule of thumb for telling whether a downward trend will become a downturn over time—economic cycles are exceptionally difficult to predict; however, we do not see any factor suggesting that growth will resume," he says.

Ataman Ozyildirim, TCB economist, says Brazil's LEI has been moving sideways compared to last year, but both the financial markets and consumer expectations are pushing it down. "The weakening of the Brazil-LEI is in line with the weakening of the main indicators in China and India," he says. He points out that before it was introduced the Brazil-LEI series was calculated retroactively to 1996 based on findings of the IBRE Dating Economic Cycles Committee.

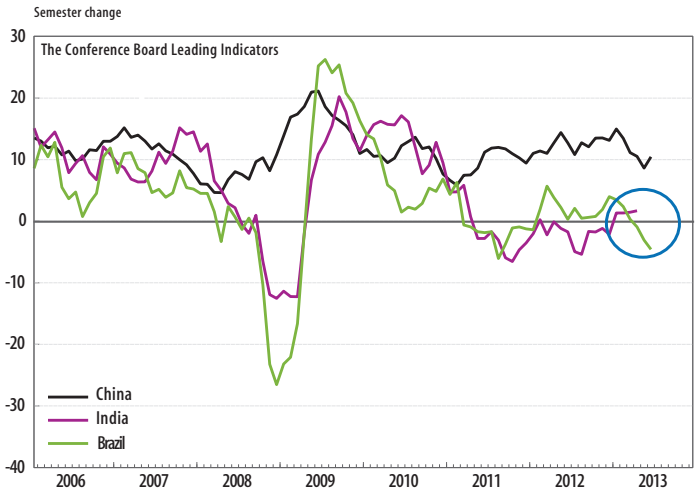
Expectations

For Bart Van Ark, TCB vice president and chief economist, Brazil will be able to achieve higher growth in the next few years only if it can increase its public and private investment and carry out structural reforms to make markets more flexible so that it can become more competitive internationally. Also, the country urgently needs to simplify its tax legislation, which hinders Brazilian development. "These are undoubtedly the main problems that Brazil needs to address if it wants to grow above 2% in coming years," he says, emphasizing that if Brazil follows these recommendations it might grow 3.2% a year between 2014

As the developed economies recover ...



... the emerging economies slow down.



Sources: IBRE and The Conference Board.

and 2018—and even contemplate long-term growth of up to 4.5%.

Van Ark cautions against comparing Brazil's economy to China's—they are quite distinct: "Brazil and other South American countries have a per capita income that is much higher than the Asian population. To grow at sustainable levels, it is not enough to add fixed capital to the economy, as China does; it is also necessary to invest in intangible capital, such as innovation and education. If Brazil can attain growth rates of 4.5%, it would have a significant possibility of catching up with mature economies."

> "There is no rule of thumb for telling whether a downward trend will become a downturn over time—economic cycles are exceptionally difficult to predict; however, we do not see any factor suggesting that growth will resume."
>
> *Paulo Picchetti*

Aloisio Campelo, IBRE deputy director of business cycles, also foresees no major changes in the Brazilian economy if the government fails to do its job. "If there are no changes in economic fundamentals, Brazil will never reach potential growth of 4.5% . . . We have the policy tools to make adjustments but we need to change the sources of the economy's growth from encouraging consumption to increasing investment," he says.

Nevertheless, it is true that economic success does not depend entirely on the domestic market. The uncertain global outlook, resulting partly from expectations of poor performance in emerging countries and only modest recovery in developed countries, is also contributing to Brazil's slowdown. According to TCB projections, economies in developing countries are

"If Brazil can attain growth rates of 4.5%, it would have a significant possibility of catching up with mature economies."

Bart Van Ark

expected to grow on average about 4% in 2013 and 5% annually between 2014 and 2018. Advanced economies should grow 2%, bringing the global average to about 3%. "World economic growth of 3% is not a disaster. And it will come to a large extent from emerging economies, including countries in South America that have significant potential. But we still have to deal with uncertainty," Van Ark says.

Components

In the domestic market, one of the main factors that has held back Brazilian economic growth is the performance of industry. The FGV Industry Confidence Index (CCI) fell by 4% in July, the lowest level since July 2009 during the global recession. "The wave of demonstrations in the country, low GDP growth in the first quarter, and a change in U.S. monetary policy [the Fed, the U.S. central bank, has signaled withdrawal of monetary stimulus] may have contributed to business expectations worsening and a decline in the Brazil-LEI," Campelo explains.

According to Picchetti, leading indicators are an attempt to measure economic trends more quickly than other

ABOUT THE CONFERENCE BOARD LEADING ECONOMIC INDEX FOR BRAZIL

The Brazil LEI was launched July 17, 2013. It aggregates eight indicators of economic activity in Brazil. Each of the LEI components has been proven accurate elsewhere. The eight components of Brazil-LEI are:

- The 1-year swap rate (source: central Bank of Brazil)
- Stock prices on the Bovespa Index (São Paulo Stock Exchange)
- The Industry Expectations Index (IBRE/FGV)
- The Services Expectations Index (IBRE/FGV)
- The Consumer Expectations Index (IBRE/FGV)
- Production of durable consumer goods (Brazilian Institute of Geography and Statistics [IBGE])
- The Terms of Trade Index (Foundation Center for Foreign Trade Studies [FUNCEX])
- The Exports Volume Index (FUNCEX)

https://www.conference-board.org/data/bcicountry.cfm?cid=12
http://www.conference-board.org/

economic activity indicators, such as quarterly GDP, using a simpler statistical model. "There are several advantages to its simplicity: the first is transparency, since the leading indicator is easy to calculate; second is the comparability of indicators across countries; and third is its stability," he explains. With Brazil, there are now 12 regions or countries for which TCB calculates indicators of economic activity monthly: Australia, China, the Euro area, France, Germany, japan, Korea, Mexico, Spain, the United Kingdom, and the United States. In September, the TCB will release India's LEI, which will help to complete the global indicator of the world's major economies.

Brazil will be able to achieve higher growth in the next few years only if it can increase its public and private investment and carry out structural reforms to make markets more flexible so that it can become more competitive internationally.

IBRE ECONOMIC OUTLOOK

The Brazilian economy and macroeconomic scenarios

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In the short term, the negative effects of the U.S. recovery will likely outweigh any gains to the Brazilian economy. We expect Brazilian inflation and economic activity to be quite volatile, keeping GDP growth at about 2% in 2013.

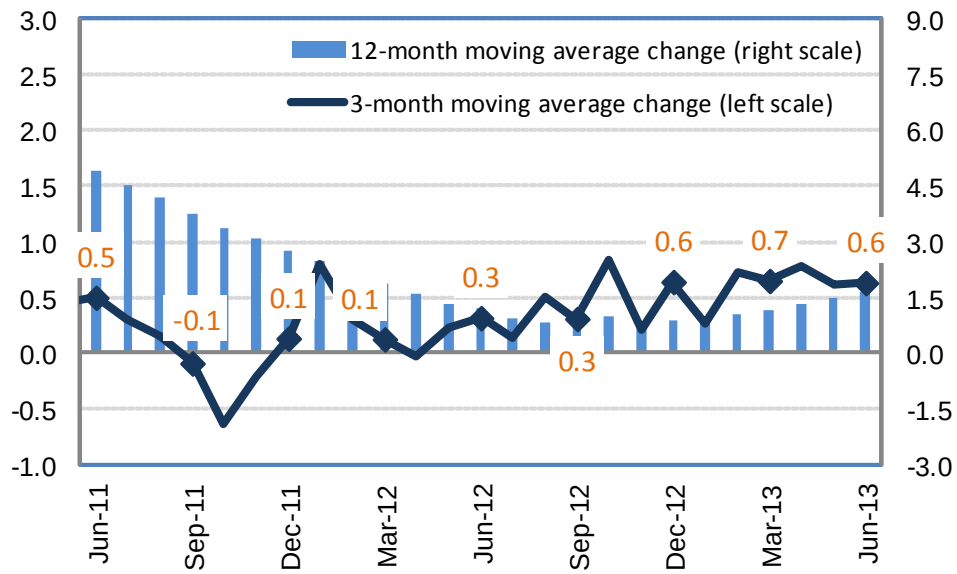
THERE ARE MOUNTING SIGNS THAT THE U.S. ECONOMY is finally emerging from the deep recession into which it plunged in 2008. Although this is good news, its implications for the Brazilian economy are far from clear. One theory is that the U.S. recovery could presage a global economic recovery. A dynamic U.S. economy would stimulate European and Japanese growth, helping to resolve the serious problems these countries have faced for years. U.S. growth would then have a positive spillover for Asian, Latin American, and African economies. But how much and how soon the U.S. recovery would boost the rest of the world, especially China, is a matter for speculation.

There are also concerns about whether the Brazilian economy can sail smoothly through the transition to a more normal world economy as developed countries wind down their recent extraordinarily expansive monetary policies. A particular concern is the flows of international capital and financing for developing economies as the U.S. Fed tapers off its monetary easing and raises interest rates. The plunge in the cost of funding the Brazilian government and corporations in the last five years has been due more to Fed policy and ample monetary liquidity than to Brazil's domestic policies. The prospect of that changing has already increased the yield on U.S. Treasuries and pushed up interest rates in emerging countries like Brazil. It also prompted a steep devaluation of the Brazilian *real* against the dollar.

These changes will affect the Brazilian economy in several ways. Some consequences will be positive: the devaluation of the *real* should make Brazilian industry more competitive globally, leading to more balanced economic growth. Other inevitable consequences will not be so good, among them the resulting fall in real wages. Still others will require government responses, such as the impact of devaluation on inflation and the rising cost of borrowing to finance the government. On the whole, in the short term, for Brazil the negative effects of the U.S. recovery will likely outweigh the gains. We expect inflation and economic activity to be quite volatile.

IBRE estimates that Brazil's GDP grew in the second quarter of 2013 at about the same 0.6% rate as in the first quarter. For the rest of the year, growth will likely be slower, so the GDP growth projection for the full year is now about 2.0%. As industry still struggles to recover, annual growth will depend ever more on the good performance of agriculture and the statistical carryover of 1.8% from 2012.

The 12-month IBRE indicator of economic activity rose 1.5% in May to 1.6% in June
(Percent change, seasonally adjusted)



Sources: IBGE, Funcex, and IBRE staff.