THE BRAZILIAN ECONOMY

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Address
Rua Barão de Itambi, 60
Botafogo – CEP 22231-000
Rio de Janeiro – RJ – Brazil
Phone: 55(21)3799-6840
Email: ibre@fgv.br
Web site: http://portalibre.fgv.br/

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ECONOMY

Industry growth lukewarm

Industrial output increased 0.7% in September, said statistics agency IBGE; the market had been expecting output of 1–1.5%. Though the September result is positive, it is not enough to make up for previous losses, notably the July drop in production of 2.4%. (November 1)

Brazilian roads worsening

According to a study by the National Confederation of Transport (CNT), 64% of Brazil's highways have signaling, paving, and other deficiencies, up from 63% last year; at least US$155 billion is needed to rehabilitate them. Privately managed roads did better than public roads: 84.4% are excellent or good, and only 15.6% were fair to very poor; of roads under public management, only 26.7% are excellent or good and 73.3% are unsatisfactory. CNT estimates that poor road conditions raise transport operating costs on average by 25%. (November 1)

Industry confidence flat, consumer confidence down

The Industry Confidence Index by the Getulio Vargas Foundation (FGV) remained virtually unchanged, down by 0.2% in October; now at 97.8 points, the index was at the lowest level since July 2009 (95.7 points) The FGV Consumer Confidence Index dropped 2.5%, from 114.2 to 111.7 points. That index has been below the historical average of 114.9 points for eight consecutive months. (October 23)

Retail sales slow, economic activity stagnant

Retail sales seasonally adjusted grew 0.5% in September, compared with 0.9% in August and 2% in July, according to IBGE. The setback is attributed to higher inflation and slower growth in incomes. Meanwhile, the central bank economic activity index declined 0.01% in seasonally adjusted terms, suggesting that economic activity was off by 0.12% in the third quarter. (November 13 and 14)

POLITICS



Photo: Marcello Casal Jr./Agencia Brasil.

President Dilma Rousseff recovers popular approval.

President's approval strong, administration not so much

Five months after massive street protests, 59% of Brazilians again approve of President Dilma Rousseff but only 39% approve of her administration, according to a survey of the National Confederation of Transport. In preparation for the 2014 presidential elections, the president has stepped up domestic travel and announced allocation of resources in ceremonies across the country. (November 7)

Campos attacks growth under Rousseff

The governor of Pernambuco state, Eduardo Campos, has again criticized the Rousseff administration's economic policy, calling growth rates of 2% a year "mediocre." In Teresina city, Campos said that in advance of the 2014 presidential elections he and former Senator Marina Silva "will travel around Brazil and show that there are ways for the country to renew politics. Brazil will not improve if we do not improve policies." (October 22)

BUSINESS

Eletrobras posts US$393 million loss

State-run electricity utility Eletrobras posted a net loss of US$393.34 million for the third quarter, mainly because of government-mandated price reduction—third quarter 2012 had produced a net profit of US$430 million. Eletrobras agreed in December to a government plan to renew expiring hydroelectric dam concessions in exchange for electricity rate cuts of 18–32%. The company is struggling to cut costs and reorganize its management to counteract the rate mandate. (November 14)

FOREIGN POLICY

Departing U.S. Ambassador insulted in Brasilia

Foreign Affairs Minister Luiz Alberto Figueiredo did not attend the farewell lunch on September 5, as would have been customary, for departing U.S. Ambassador Thomas Shannon, who has since been named special adviser to U.S. Secretary of State John Kerry. At the lunch, Carlos Antônio Paranhos, undersecretary for political affairs, gave an aggressively hostile speech.

Shannon wrote a letter of protest to Figueiredo, who chose not to respond. The Brazilian authorities admitted that the message might have been unduly harsh, but said that given the president's indignation over the espionage, it was justified.

The relationship between the two countries has been tense since the revelation that the U.S. National Security Agency spied on President Rousseff, which led to her cancelling a state visit to Washington in October. Ambassador Shannon left his post earlier when the NSA spying scandal exploded.

Although there is no justification for the behavior of the NSA, that did not justify the Foreign Affairs Ministry mistreating the ambassador in a way that has been described as "humiliating." Ambassador Shannon has been a good friend of Brazil and has been working since the George Bush administration to improve U.S.–Brazil relations. (November 11)

JUDICIARY

Supreme Court orders convicted officials to begin prison time

Brazil's Supreme Court ordered former leaders of the ruling Workers' Party to begin serving their sentences following landmark convictions related to a congressional vote-buying scheme. José Dirceu, a party founder and former chief of staff to former President Luiz Inácio Lula da Silva, turned himself in to federal police to begin serving his 10-year sentence. Despite the delays, not uncommon given a notoriously slow judicial system, many Brazilians see the convictions as a sign of at least partial progress in a culture long tolerant of corruption. The Supreme Court will continue to review the appeals of the convicted officials. (November 14)

ECONOMIC POLICY

Protests fail to stop oil blocks auction

Amid street protests, Brazil's first auction of rights to drill for oil in the country's biggest deepwater field awarded the rights to the only consortium to bid. The Libra oilfield is estimated to hold 8–12 billion barrels of oil equivalent. In the winning group are state-owned oil company Petrobras, European giants Royal Dutch Shell SA and Total SA, and two Chinese firms, Cnooc Ltd. and China National Petroleum Corp. (October 22)



Photo: Tania Rego/Agencia Brasil.

Activists protest against auction of rights to explore deepwater oil field in Rio de Janeiro.

Record high for the primary fiscal deficit

Brazil's primary fiscal deficit rose in September to R$9 billion (US$4 billion), the highest in more than 10 years, the Central Bank reported. In the first nine months of the year, the primary surplus was 68% lower than for the same period last year. The main problem is that spending on social programs and public administration has gone up 16%. (October 31)

National Development Bank (BNDES) to lend less

BNDES, the state development bank, will reduce lending by about 20% next year, according to Finance Minister Guido Mantega; it will provide about US$67 billion in new loans in 2014, rather than this year's US$85 billion. To shore up public finances BNDES lending to states and municipalities will be frozen and tax breaks on consumer goods will be unwound. Brazil's debt-to-GDP ratio, according to rating agencies, is at 59%; the median for other nations with similar ratings is 45%. (November 5)

FGV Brazil

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Brazil's looming fiscal risks

INTERNATIONAL FINANCIAL MARKETS seem more concerned about Brazil's fiscal problems than the administration appears to be. Already this year Moody's has lowered its outlook on Brazil's credit rating from positive to stable, though its Baa2 rating for Brazil is still considered investment grade, and Standard & Poor's cut its outlook on Brazil from stable to negative. An outright downgrade of Brazil's rating early next year has become a real possibility; that would make it more expensive for Brazil to borrow money from international markets. Since mid-October, international investors have also been asked to pay more interest on credit default swaps (CDSs), the insurance again Brazil defaulting on its sovereign bonds. Between October 16 and November 15, interest paid on five-year Brazil bonds went up by 0.47 percentage points, compared to 0.05 for Chile; Mexico CDSs actually went down by 0.01.

The rapid deterioration of public finances was brought about by a variety of tax breaks to stimulate a sluggish economy, and steep increases in public expenditures. Now, as former finance minister Antonio Delfim Netto said in a November 15 interview with *Agência Estado*, to recover credibility, the government needs to report transparently the actual position of its accounts, without any of last year's accounting gimmicks. Brazil will have to meet a budget primary surplus goal of 2% of GDP in 2014 if it is to avoid a lower credit rating from international agencies. Improvement in public accounts is also necessary to regain the harmony between fiscal and monetary policies that existed in 2011. Rescuing the credibility of the administration, Delfim says, could help bring inflation down to 4.5% in two years.

One persistent problem has been the government's lack of consistent medium-term fiscal goals and a strategy to achieve fiscal sustainability. Two recent events were particularly disturbing. First, a large majority in the House of Representatives approved renegotiation of state and municipality debt, which violates the Fiscal Responsibility Law. Proposals for greater borrowing autonomy for state and local governments are also certain to weaken fiscal discipline. Second, the Senate approved the Mandatory Budget, which compels the government to carry out representatives' spending amendments for public works and projects approved by Congress. The government needs to regulate both measures properly to prevent a substantial weakening of fiscal discipline.

One persistent problem has been the government's lack of consistent medium-term fiscal goals and a strategy to achieve fiscal sustainability.

Unfortunately, there's not much hope for any major changes in economic policy before next year's presidential elections. Government officials believe a rollback in some tax cuts, a stronger economic recovery, and fewer capital transfers to state banks will improve the government's accounts in coming months. They may be correct—but it's a huge gamble. Current pessimism may jeopardize recovery and make the economy more vulnerable to external shocks. It is certainly not possible to rule out further appreciation of the dollar and heavier inflationary pressure. Many expect that whatever administration takes office in 2015 will have to tighten fiscal policy to regain credibility. However, the longer fiscal adjustment takes, the more it will cost the economy.

And the election cycle begins . . .

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

WITH GENERAL ELECTIONS LESS THAN a year away, political dynamics in Brazil will be increasingly shaped by polling numbers and suppositions about potential candidates. For starters, an interesting aspect of next year's race is the "second-best" nature of the three main contenders. A glance at the polls confirms that in each party more prominent political figures currently overshadow each of the three major presidential hopefuls.

In the Workers' Party (PT), will former president Lula replace Dilma Rousseff in the ballot? Will José Serra supersede Aécio Neves as the Social Democratic Party's (PSDB) candidate? In the Socialist Party (PSB), will Marina Silva lead the ticket with Eduardo Campos as her VP? Definitive answers to each of these questions are unlikely to materialize before the party conventions in June.

Speculation aside, it's safe to say that next year's presidential election will be the most interesting in over a decade. Underscoring this appraisal is the fact that the well-known polarization that has dominated the country's political landscape for nearly two decades will be splintered by a third party. A recent defector from the current governing coalition, the PSB will seriously shake up the established feud between the "old-timers," the PT and the PSDB.

At this juncture, with the major political forces coalescing into three distinct camps, it is possible to speculate about what the next government's policies will look like. The issues raised by protesters earlier this year will be central to all the candidate's platforms. It is important to note, though, that this is a response not only to the recent demonstrations but also to the expansion of the middle class in the past decade. The emergence of these consumers has changed Brazil's economy. The growth of this segment of the population is also changing the demands on politicians.

A decade ago, according to public opinion surveys voters were primarily concerned with such economic issues as jobs, salaries, and inflation — quality of life issues, such as health, security, and education, were of secondary concern. Since then, however, preoccupation with economic issues has steadily declined while the quality of life agenda has expanded in importance and recently surpassed the economy as voters' primary concern. To succeed politically, politicians will have to work harder to deliver tangible improvements to services. Unfortunately for them, this challenge is occurring at a time when resources are less abundant than five years ago.

joao@castroneves.net

So how would the three main contenders respond to these challenges?

Dilma Rousseff's critics argue that her government's decision to intervene often in currency markets, its tolerance for above-target inflation, and the deterioration of government fiscal accounts represent an erosion of macroeconomic management. While these critiques are not without substance, they go too far when they suggest that Rousseff's economic policy has broken with the policies of the past two decades. A more nuanced interpretation takes into account the effects of the economic supercycle — the commodity and consumption booms from 2004 to 2010 — on policymakers, and their incentives.

With the end of the supercycle, the Rousseff administration is slowly turning to a more constructive economic agenda. Signs of this shift can be found in the central bank's recent cycle of rate hikes intended to fight inflation, signals from Rousseff that the government will reduce the subsidized lending of public banks to nonstrategic sectors, and the government's aggressive turn to the private sector for transportation infrastructure. If Rousseff wins, the gradual shift to more constructive policies—although consistently behind the curve—can be expected to continue.

If Aécio Neves wins, the shift to more market-friendly policies would be wholesale. Not only would he restore the orthodox premises of macroeconomic management, he would also unwind some of the excessive interventionism of the state in key sectors of the economy, such as energy. Neves would probably improve and deepen the government's engagement with the private sector and launch an agenda of economic reforms to boost competitiveness. His challenge would be essentially political in that he would have to form a coalition of center and center-right parties to endorse these changes.

> To succeed politically, politicians will have to work harder to deliver tangible improvements to services. Unfortunately for them, this challenge is occurring at a time when resources are less abundant than five years ago.

An Eduardo Campos—Marina Silva government could be more of a wildcard in terms of social issues, especially because of Silva's conservative ideological bent. Furthermore, her track record as an environmentalist casts doubts on the future of energy policies. On macroeconomic topics, however, the signs from both suggest a more positive trajectory, similar to the changes that Neves would implement. But here too the main challenge would be political: Campos and Silva would have to carve a new coalition, breaking the balance of power that has structured Brazil's politics for the past two decades. ■

> Preoccupation with economic issues has steadily declined while the quality of life agenda has expanded in importance and recently surpassed the economy as voters' primary concern.

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Brazil and China

Challenges to development

Luiz Guilherme Schymura
Director of IBRE

BRAZIL AND CHINA AS EMERGING COUNTRIES have drawn attention both for what they have in common—not much—and for their outstanding differences. The main similarity is the fact that they are both major economies. They have also become more active and relevant in global geopolitics, something that cannot be ignored by companies, governments, and international institutions planning their global strategies.



The differences between Brazil and China, on the other hand, are numerous. On one side, Brazil is a Latin American country that has European, African, and Amerindian roots; five centuries of history; and today a functioning and vibrant democracy with all the freedoms, noise, and difficulties typical of a country where power can only be exercised with many limitations and balances. On the other, China is an ancient oriental civilization that has been immersed in socialism and has a centrally planned economy but whose single-party government has now introduced market mechanisms that have led to the most impressive economic growth spurt in human history.

The partnership between the Brazilian Institute of Economics of the Getulio Vargas Foundation (IBRE-FGV) and the Institute of Latin American Studies at the Academy of Social Sciences of China (ILAS-CASS) believes that new thinking can arise from an exchange of the experiences of each country in order to help find solutions to challenges that both countries face. Clearly this does not mean mechanical application of each other's solutions, since the socioeconomic and political models of China and Brazil are very different. But precisely because they are located at opposite poles, the two nations can look to each other to assess the extent to which they can correct the excesses of their own development models.

Brazil can learn in particular how China has managed to create a diversified export platform. Clearly, many aspects of the Chinese model are distinctive, starting with China's high savings and investment. Nevertheless, it would be interesting to understand how China carries out its export-oriented industrial policy, which necessarily involves the choice of sectors to be benefited.

This is a sensitive issue in Brazil. Although past policies to promote import substitution helped to industrialize the country, they also were among the causes of economic imbalances that led to a long period of low growth after the 1980s. It is true that China's political system favors centralized decision making, but given the success of its industrial and export diversification, it is reasonable to assume that there is an active and well-organized bureaucracy to carry out industrial policy, and that sectors to be favored are chosen for serious technical reasons. Brazil, which has returned to a policy of promoting specific sectors, could learn a lot from the Chinese experience.

Another area of interest is China's success in carrying out infrastructure projects. China has astonished the world with the fantastic speed with which it has built roads, railways, ports, dams, telecommunication networks, homes, and even entirely new cities. In contrast, Brazil finds it very difficult to carry out infrastructure projects, as is clear from the lethargic implementation of the Growth Acceleration Plan (PAC) and the vacillations in designing infrastructure concessions to attract the private sector.

As with industrial policy, it would be naive to imagine that the Chinese experience can be automatically transplanted to the Brazilian context, where environmental protection, the vested interests of various groups, and the rights of less well-off Brazilians are highly sensitive issues, though there is as yet no institutional framework that rationally takes them into consideration. Thus, rights and interests are often accommodated at the cost of delaying or even preventing realization of major infrastructure projects. Nevertheless, it is likely that China has much to suggest to Brazil in this area, particularly in terms of building bureaucratic capacity to formulate and execute massive long-term investments.

Clearly Brazil and China have much to gain from closer relations, in terms not only of trade and investment but also of the exchange of knowledge and experience.

But the Chinese also have much to gain by examining the Brazilian model of social inclusion. The success of the Brazilian model is reflected in the popular approval of recent governments. When the economic instability that had long consumed all the authorities' energy was at last ended, they were able to carry out income distribution policies that have begun to repair the complex injustices that had accumulated throughout Brazilian history.

China is currently experiencing a critical moment of its institutional development as it works to set up a comprehensive social welfare safety net that will make sense both politically and economically.

Thus, especially in terms of social security and transfer programs, ours should be a very interesting case for the Chinese authorities. Brazil certainly has one of the most extensive

and generous social security systems in the emerging world; and its Family Grant program of conditional cash transfers is a world-class example in terms of efficiency and service to the poor. On the other hand, the Brazilian experience can illustrate for the Chinese the trade-off necessary between inclusion and growth, which though certainly much smaller than we believed is by no means nonexistent.

In general, the broad movement of social inclusion and acknowledgment of the rights of the poor in the Brazilian Constitution of 1988 provides for China an example of how, in addition to economic growth, political stability also relies on the ability of authorities to respond to the demands for justice for the majority of population. In this sense, the democratization of Brazil since 1988 is a road map of the interaction of inclusion, economics, and politics.

Clearly Brazil and China have much to gain from closer relations, in terms not only of trade and investment but also of the exchange of knowledge and experience. The two volume book The *Middle Income Trap: Visions of Brazil and China* published by Getulio Vargas Foundation Press will have fulfilled its mission if it proves to be the first of many other initiatives on the part not only of IBRE-FGV and ILAS-CASS but also of all who see the rich potential in Sino-Brazilian partnership. The book will be presented at a joint IBRE and ILAS-CASS seminar on "The Middle Income Trap" on November 22, at the FGV headquarters in Rio de Janeiro.

As the title makes clear, the unifying theme of all the articles in the book is the "middle income trap," characterized by the fact that there are many transitions countries must make in moving from poverty to the middle stage of development and on to the higher income level of the most advanced nations. Even the idea of there being a "middle income trap" is disputed by some authors. But China and Brazil are middle-income countries that aspire to ascend to the level of the developed world as a definitive statement of their role on the global stage, and for both the assumption that there is a trap is a great starting point for discussion and analysis.

The first volume of the book, edited by Fernando Veloso and Lia Valls Pereira, presents the views of IBRE researchers on the environment, inequality, welfare, innovation, savings, and financial systems. The objective is to show how Brazil is addressing each of these vital areas and formulate policy recommendations to make its efforts more effective. The second volume of the book, edited by Prof. Zheng Bingwen, presents the views of ILAS-CASS researchers on the same issues for China. They look into China's economic growth experience and the challenges to overcome the middle income trap. The 8 articles that follow are a summary of the books' various contributions presented by their respective authors.

Avoiding the middle-income trap

Kalinka Iaquinto, Solange Monteiro, and Thais Thimoteo

A FEW YEARS AGO, when China looked at Brazil with great interest, it was not only to estimate its potential as a supplier of food and basic supplies for expanding its infrastructure. Nor was it only to investigate possibilities for investing China's large surplus savings. The strategy of the experts of the Asian giant had another aim: to analyze how the Brazilian economy had evolved since it recorded so much growth between the 1950s and 1980s, when per capita income quadrupled, and to identify what characteristics had kept Brazil from sustaining a similar pace of expansion to become a rich country.



The risk of stagnation that China feared is known as the middle-income trap, which holds back a large number of economies. Of 101countries that the World Bank considered middle-income in 1960, only 13 had become high-income economies by 2008. Otaviano Canuto, World Bank senior advisor, has commented that "If we extend this analysis to 2012, we will not see significant changes." In general, initially underdeveloped countries all had high productivity gains as workers transferred from less productive activities, such as traditional agriculture, to more productive ones, such as industry. In the process, the countries imported standard technologies and were able to compete internationally, exporting labor-intensive products. But, explained Fernando Veloso, IBRE economist, "When underdeveloped countries approach average income, factors responsible for growth to that point begin to run out, and economic expansion becomes dependent on productivity gains in industries that require more training and technology development."

As the challenges change, countries cannot always adjust accordingly. "History reveals that many economies can achieve middle-income status quickly, but few manage to get out of it because the political and institutional changes necessary are complex," said Zheng Bingwen, director of the Institute of Latin American Studies at the Academy of Social Sciences of China (ILAS-CASS). Canuto added, "This process occurred in Latin America in 1950 to 1970; successful countries like Japan also passed through it; and it is the reason that China has been able to achieve high growth rates in recent decades."

Recently, the Brazilian Institute of Economics (IBRE) and ILAS-CASS have been studying the topic. The results have been consolidated into a book, "*The Middle Income Trap: Visions of Brazil and China*," published by Getulio Vargas Foundation Press.

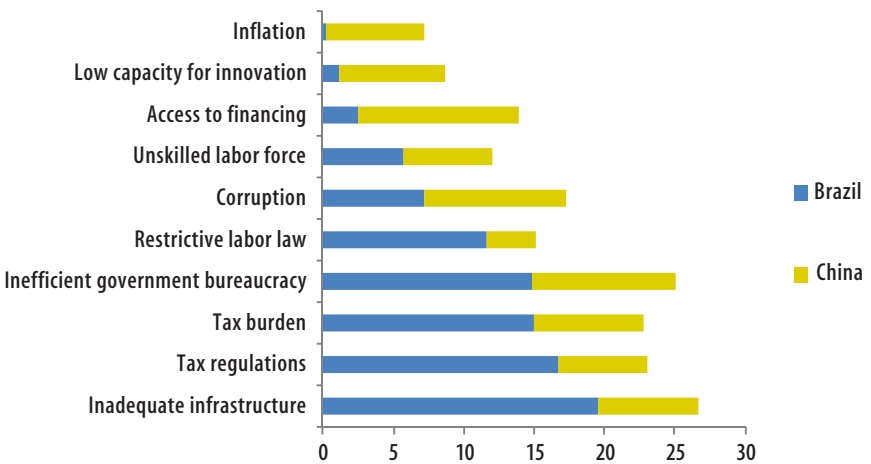
Veloso, one of the organizers of the program, believes that the middle-income trap is not inevitable. He assesses the drawbacks that caused the slowdown in Brazil's growth as due to an incomplete transition: "Our period of expansion occurred with strong state intervention in the economy, with an import substitution policy, a closed economy, and large subsidies to public and private companies. We changed policies

to allow more space for the private sector and a more open economy, but progress has been insufficient." Canuto pointed out that, similarly, in China the private sector will have to have more space to flourish independently. "This will require changes in the financial system, a different focus on property rights in private investment," he explained. "During this change, China runs the risk of making the same mistakes Brazil did. In principle, however, the Chinese have shown themselves to be more pragmatic than Brazilian leaders."

A successful transition to a high-income economy requires numerous changes, from educational development to improvements in the business environment, which will be analyzed in the following pages. Canuto noted that countries that have transitioned successfully to high-income status have a growing share of the population associated with innovation activities, a more skilled workforce, and sound infrastructure to support fluidity of ideas and synergies. He believes that an economy cannot move from middle- to high-income if it does not have a good business climate, low transaction costs, and a well-developed financial system to provide funding for innovative activities, adding, "When it comes to innovation, we speak of a process of learning that permeates the entire production system, including organizational adaptations, processes, products, and features of the local market."

International indicators of national business climate make clear the weaknesses of each country, showing where to focus reform efforts. The important thing, according to experts, is not to try to continue with policies that are ineffective for growth. Canuto explained that "Since 2008, countries like China, Brazil, India, and Indonesia were tempted to extend their older policies using the fiscal and monetary policy space rather than shifting to new policies. … In China, this was expressed in the fever of real estate investments through shadow banking." Canuto also sees a regression in Brazil's reform agenda.

Brazil and China: Factors clouding the business climate.



Source: *The Global Competitiveness Report 2013-2014*, World Economic Forum.

Innovation



Barriers to innovation in Brazil

Kalinka Iaquinto, *Rio de Janeiro*

ECONOMIC PROGRESS has over the centuries always gone hand in hand with innovation. What is different today is that with globalization, understanding innovation means reaching out beyond the boundaries of universities, companies, and countries. The nature of the innovative process has become much more collaborative and global. Countries are seeking ways to differentiate themselves by means of heavy investments in research and development (R&D) in order to raise their productivity.

Brazil and China are no exception, and despite having somewhat similar levels of investment in R&D as a share of GDP—Brazil invests up to 1.2% and China 1.7%—they differ significantly in terms of effective use of research by the market. While China has invested to assimilate technology produced internationally so as to enhance and create its own technological base and innovate, Brazil pays more attention to scientific research and is more protectionist, even though most experts agree that innovation grows out of exchange rather than isolation.

"Innovation policy should not be restrained by other public policies," said Maurício Canêdo, IBRE researcher, pointing out that Brazilian industrial policy has a strong protectionist bias. "One of the biggest levers to encourage innovation is pressure from competitors. That is why isolating the Brazilian economy from the rest of the world is not a good idea if the intention is to encourage domestic firms to invest in innovation."

Protection

Claudio Frischtak, president of Inter B Consulting, agreed. "Brazil remains a very much closed economy; there is little exchange with the world. As a consequence, the innovation process is also protected, and this is a way to shoot yourself in the foot," he warned. Frischtak pointed out that currently any country's economic growth is associated with its integration into global value chains, which calls for innovation without boundaries: "Industry and innovation will only become more weighty when they are effectively integrated into their own global value chains."

Brazil's history of innovation—with occasional exceptions such as the Brazilian Aerospace Company (Embraer), the Brazilian Agricultural Research Corporation (Embrapa), newer programs like Criatec Fund and advances in biotechnology and nanotechnology—has not been linear or constant; and compared to similar economies, its progress has been negligible. In general, the generation of knowledge by research universities and institutes has not usually been transformed into innovation by companies. UNESCO data show that, while Brazilian companies invest as little as 0.5% of GDP in innovation, Chinese companies invest 1.2%. "In Brazil, private business investments in innovation are not effective in terms of generating patents," said Canêdo. The Chinese, however, promote a constant exchange of knowledge between companies and research universities. In

2010, the Chinese private sector was responsible for 73% of R&D investment compared to 17% by government institutes and 9% by universities.

"In Brazil, South Africa, Russia, and India, the public sector is doing the innovating. In China, the private sector invests a lot in patents and innovation. But we cannot explain how this is encouraged," said Ana Saggioro Garcia, a researcher at the BRICS Policy Center, adding that little is known about the Chinese policy for attracting investments. "We do not know whether innovation is promoted by multinationals operating there or by Chinese companies."

Obstacles

Data from the 2008 Technological Innovation Survey of the Brazilian Institute of Geography and Statistics (IBGE) show that the share of Brazilian companies that are innovative—companies that are able to turn an idea or invention into a good or service that creates value—grew from 32% in 2000 to 38% in 2008. Nevertheless, the number is relatively low compared to China or smaller economies like South Korea. "We have been running, but we are still in the same place relative to the rest of the world. Our investment in R&D is done half by companies and half by the government. Investment carried out by companies, despite having grown, grew more slowly than in the rest of the world," said Fernanda De Negri, director of studies of production and innovation of the Institute of Applied Economic Research (IPEA). "Since 2008, the situation has been even more worrying," she warned, "because during crises investment R&D declines."

In China, the situation is quite different. Over the past 50 years the country has adopted a policy of importing technologies, assimilating and improving knowledge, and investing in R&D centers and training researchers. Li Guangsi, associate professor at the Nanjing University of Finance and Economics, believes that "copied innovation can promote innovation capacity in basic research, resulting in rapid growth in the number of inventions and innovations." The result of this policy is reflected in the numbers: Between 2000 and 2010 China's ranking for obtaining international patents rose from 13th to 4th place and for obtaining domestic patents from 8th to 3rd. "In Brazil there is an effort by the National Institute of Industrial Patents (INPI) to speed up the patent process, but the problem is that other countries make twice the effort . . . and as a result we are falling behind," Frischtak commented.

"The interaction between research universities and industry is severely constrained by bureaucratic procedures. Innovation does not work well with bureaucracy."

Fernanda De Negri

Frischtak advocates a revision of legislation and standards in order to reduce the red tape and encourage innovation in Brazil. IPEA's De Negri agrees. She believes the key is simplification: "We need to simplify procedures. The interaction between research universities and industry is severely constrained by bureaucratic procedures. Innovation does not work well with bureaucracy. There is an institutional and regulatory bottleneck that needs to be reconsidered."

Education



Education for growth

Thais Thimoteo, *Rio de Janeiro*

SOUTH KOREA DEMONSTRATES clearly that investing in education and improving the skills of its people are the foundation for making a country rich. Since the 1970s it has given the highest priority to education, making large investments especially in secondary and higher education. As its education system rose in rank in international comparisons, its economy has become highly competitive, exporting annually billions of dollars in high-value-added goods such as cars and machinery. Having begun by copying technology from developed countries, it is now producing its own technology.

Brazil has made some advances in education, introducing universal fundamental education (up to 9th grade) in the 2000s; creating the Fund for the Maintenance and Development of Fundamental Education and Valorization of Teachers (Fundef); and defining educational indicators, such as the Brazil Test for Fundamental Education and the National Secondary Education Examination (Enem), which serve as benchmarks for formulating public policies. However, Brazil still has to cover a lot of ground to catch up since the "lost decades" between the 1970s and early 1990s, when average years of schooling country stagnated at 2.8 years, while Korea recorded 8.3 years and China 5.6.

Prescription

Rodrigo Leandro de Moura and Fernando de Holanda Barbosa Filho, researchers at IBRE, are convinced that Brazil still has a long way to go in education if it wants to escape the middle-income trap. It has to address three major issues: improving the quality of education at all levels; pushing up enrollment in secondary schools (grades 10–12), which is currently at only 51%; and raising the share of resources for fundamental and secondary education to reach parity with higher education.

Barbosa explained that "Brazil's average years of schooling were very low in the 1980s, when other emerging countries had begun to reduce their educational deficiencies. As a result, unlike the Asian Tigers, we are not able to create new technologies and have no ability to copy existing ones. If nothing is done, we will continue to have minimal human capital, and hence low productivity."

The farther a country is from the technological frontier, the more important is investment in basic education (grades 1–12) to support economic growth, Moura and Barbosa explained, since basic education is what qualifies students for copying technologies. Although basic education was not a priority in Brazil in past decades, gradually the situation is changing. According to the National Institute for Educational Studies Anísio Teixeira (INEP), while in 2000 public spending per student in higher education was 11 times greater than in basic education, it is now only 5 times greater, gradually reducing a major distortion in the Brazilian educational system.

Improving the quality of education is another challenge for Brazil. "It is one thing to put children in school, and quite another to keep them studying and raising the quality of teaching. It is possible, but it is much more difficult," Barbosa said.

China has been doing its homework more diligently than Brazil. *The Global Competitiveness Report 2013–2014* of the World Economic Forum shows that tough both countries are far from the top in the list of most competitive countries in terms of education, their situations are very different in terms of the qual-

ity of primary and higher education. Of 148 countries surveyed, Brazil ranked 129th in the quality of primary education and 121st in the quality of higher education; China's rankings were 56th in primary education and 54th in higher.

In China, though the education situation is less critical, it still requires attention. Since reform of the Chinese educational system in 1978, which was linked to a strong investment policy and the opening of the economy, the number of students who completed higher education rose from 165,000 to 5.7 million in 2010, according to the *2011 China Statistical Yearbook*, while graduates of secondary and technical schools jumped from 6.8 million to 10.3 million, though the number that completed primary education recorded a slight drop, from 2.2 million to 1.7 million.

However, Chinese education still has considerable shortcomings, such as the difference between urban and rural areas in quality of and access to education, especially in the secondary and higher levels. Liang Jun, associate professor of the Faculty of Economics, of Qufu University in Shandog Province, has noted that the education gap between urban and rural areas is explained by the imbalance of economic growth, the movement of people from the country to cities, and differences in regional educational policies.

Change

"Even with the enormous advances made to avoid the middle-income trap, it is essential to change our economic development model. It needs to rely less on increased gross investment, and more on increased efficiency. And education is the basis of development driven by innovation," Liang commented. For this it is necessary to invest more in education so that the country can achieve the scientific and technological innovation needed to become more competitive globally.

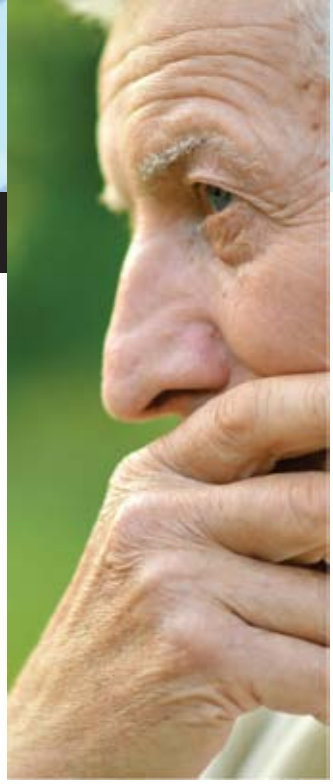
Liang's research shows that in China every rise by 1 percentage point in the level of educational development increases GDP on average by 0.48 percentage point. The lack of resources is considered the most vulnerable point in education. According to *Education at a Glance 2012* of the Organization for Economic Cooperation and Development (OECD), Chinese per capita spending on education was US$1,593 in 2008, below that recorded in Brazil, US$2,416, and Russia, US$4,878.

According to Liang, in 2012 even though almost one-sixth of Chinese government revenues were allocated to education (US$350 billion), the share of educational spending in GDP is only 4%. This fact is due in part to a lack of understanding of the importance of education for a country's development. "Although [the Chinese government] frequently publicizes the importance of education and prioritizes educational strategy, when it comes to allocating resources, education is neglected," he said, commenting that the government needs to prioritize education more forcefully by investing more in it.

Andrew Kipnis, an anthropologist specializing in Asia at the Australian National University, believes that China should not follow in the footsteps of Korea, which sends a much larger number of young people to college than any other developed nation. However, the desire for education is already becoming an obsession that transcends borders in China. Costs of overseas education have put pressure on Chinese family budgets. A recent survey by Mintel consultants found that 87% of parents surveyed are willing to finance the education of their children out of the country because they believe it is a shortcut to professional success.

Kipnis believes it is more important that China focus on increasing investments in vocational and technical schools—something that some provinces are already doing. While recognizing the danger of the middle-income trap to China, the researcher believes that it is too early to say if China will be stuck in it because the Chinese economy is still growing at high levels—the Central Bank of China is projecting 7.5% GDP growth in 2013. In the opinion of Kipnis, "I believe that pollution, corruption and the aging of population are greater dangers to continued economic growth in China than the problems with education."

Social Security



The uncertain future of social security

Kalinka Iaquinto, *Rio de Janeiro*

WHEN IT COMES TO SOCIAL SECURITY, Brazil and China have something serious in common: they need to find ways to ensure the financial survival of their people in old age that is financially sustainable and at the same time takes into account social and budget realities. In Brazil, despite some problems, social security covers virtually everyone with few exceptions, such as people who have never contributed to the welfare system. In China, despite progress in the last 60 years, there is a wide gap between beneficiaries in urban and in rural areas. Regardless of the problems, in both countries there is consensus that resolving social security questions is a key to maintaining sustainable growth.

"Social security in Brazil will affect future growth because of its increasing burden on the public budget. The country has committed an increasing share of its resources to pay social security benefits, which drains resources that could be used to invest and create conditions for future growth," Fabio Giambiagi, head of the Department of Market Risk Management of the National Bank for Economic and Social Development (BNDES), stated.

Brazilian demographic fear

The Brazilian demographic bonus—as a result of lower fertility rates and the extension in average life expectancy, which increase the working age population—will be over soon, and the elderly population will grow much faster than those of working age. Census data from the Brazilian Institute of Economics and Statistics (IBGE) shows that in 1991 only 4.8% of the population was over 65; in 2010 the proportion was 7.4%; and this progression will continue.

"In future, there will be a growing proportion of workers with less purchasing power. Together [with growing numbers of old people], these trends will act as a brake on consumer spending, limiting the potential growth of the economy in the long run," Rodrigo Dora, deputy-head of the Chamber of Economic Development and Promotion of the BRICS, said. He recognizes that adjusting social security by reducing pensions and benefits is not easy, as well as being politically unpopular, but it is necessary to balance social security accounts and make government budgets sustainable.

Brazil's social security spending (11% of GDP) is already comparable to that of countries with higher proportions of the elderly. "In the last 25 years, social security spending has tripled as a share of GDP. There is no more eloquent indicator of the deterioration of social security," Giambiagi warned, adding that "as the number of elderly increases 4% per year and the economy grows less than this, social security spending will increase as a share of GDP. In addition the government is pushing benefits above inflation for two-thirds of the beneficiaries."

Giambiagi advocates such changes as stricter rules for workers entering the labor market in the future, reduction of the difference in retirement age between genders, stricter standards for granting pension, and adjusting pensions to the National Consumer Price Index.

"In future, there will be a growing proportion of workers with less purchasing power. Together [with growing numbers of old people], these trends will act as a brake on consumer spending, limiting the potential growth of the economy in the long run."

Rodrigo Dora

Savings

China has also a large and growing aging population: 185 million elderly, many of whom live in poverty. According to Zheng Bingwen, head of the ILA-CASS World Center of Social Security Studies, Gao Qingbo, ILA-CASS researcher, and Yu Huan, a researcher and PhD from the School of Labor and Human Resources of the People's University of China, several factors have contributed to China's current social security problems: in the 1990s, social security reform served to expand the economy. The Chinese government reduced its role in the social security system and expanded individual responsibility for future pensions—individuals could no longer rely on government protection but needed to save for old-age needs. As a result, China's domestic savings has increased steadily, helping to finance investment and sustain growth.

The authors also highlight what they call "system fragmentation": Since the 1980s, the social security system has been divided into three parts: public institutions, workers in urban enterprises, and workers in rural areas. The differences between them in terms of benefits are huge. Rural social security exists in name only: because of shortcomings in the design of the new system, retirement benefits offered in rural areas are very low and cover only a limited number of people.

Financial Development

The state and the financial system



Solange Monteiro, *Rio de Janeiro*

THE VERY DIFFERENT FINANCIAL SYSTEMS of Brazil and China have one thing in common: inadequate development, which is a drag on their economies. In general, access to stronger and more diversified financing instruments is directly related to increased productivity, as they help in efficient allocation of resources and support technological development, making possible higher-risk projects that have longer maturities. Armando Castelar, IBRE researcher, and Zhang Yu, Dagong School of Credit Management of the University of Finance and Economics in Tianjin, believe that for both countries enhancing the diversification of financing tools depends largely upon reducing the role of the state in the financial sector.

Nevertheless, both countries have made progress in building up their financial systems. In Brazil, the last decade has been marked by a significant improvement in the size and quality of the capital market and an explosion in credit from banks, which doubled between 2004 and 2011 as a proportion of GDP. Credit expansion was helped by lower interest rates and bank spreads, and institutional reforms have improved collateral and established mechanisms such as payroll loans and liens on real estate.

Financial systems and GDP

The share of the financial system in GDP, however, remains low compared to fully developed economies. "Financial intermediation is still concentrated in state-owned banks, which account for more than half of bank credit," Castelar said. He indicated that this result is a legacy of practices in the 1960s, which focused on earmarked credit, when the financial system was less developed and still needed government support. He noted that "Another feature we bring from the period of high inflation is that debt maturities are relatively short, [though] today, there have been efforts to develop long-term private debt." After state banks were privatized and other federal banks were restructured after going bankrupt when inflation was brought down in the mid-1990s, Castelar believes that Brazil missed the opportunity to do something more responsible, noting that in the last decade the share of state-owned banks has again gone up.

The National Bank for Economic and Social Development (BNDES) has greatly expanded its lending. Castelar is of the view that the BNDES mission to stimulate job creation and technology-intensive sectors is not reflected in how it allocates subsidized resources; instead, it favors large companies with low credit risk that could obtain financing in the market, which would help reinforce it. Other negative consequences of the predominance of the public sector in the financial system are a capital market that is relatively small for the size of the Brazilian economy, particularly the fixed income market, such as debentures.

In China, the share of the financial system in GDP is much larger than in Brazil, but the state is even more predominant, focused on financing large state-owned companies. Although between 1979 and

1993 the four main institutions—Agricultural Bank of China, Bank of China, Construction Bank of China, and Industrial and Commercial Bank of China—were restructured, they continued to fund state-owned companies. In 1997, the Asian crisis revealed the weaknesses of the financial sector in terms of poor quality of assets and bad loans. In response, the government injected large amounts of capital into its financial institutions to clean bad loans from their balance sheets. Since 2003, the financial restructuring has been followed by, e.g., allowing in as shareholders foreign investors, who introduced not only new capital but also technology. Even with these advances, Zhang observes that in addition to the financial sector preference for lending to state-owned companies, it also discriminates against lending to small and medium companies, explaining that "The distortions in China's financial system cause resource allocation decisions to be based more on political than economic interests."

"The distortions in China's financial system cause resource allocation decisions to be based more on political than economic interests."

Zhang Yu

Roberto Dumas, professor, Institute of Education and Research (Insper), who holds a Master's degree in the Chinese economy from Fudan University (China), has pointed out that the choice of banks to concentrate on investing in large projects is also reflected in the interest rates on deposits, which are below inflation; this is known as financial repression. Dumas noted that this feature is mostly negative for an economy that wants to redirect its focus to domestic growth: "It is more difficult to stimulate consumption if banks do not pay interest rates above inflation, penalizing savers to subsidize businesses, even more in the context in which rising workers wages still fall short of productivity and GDP and the exchange rate does not favor income gains."

Credit restrictions and financial repression have stimulated the growth of shadow banking, offering wealth management products (WMP), lending for high-risk projects, and paying higher rates but without legal guarantees. "Today it is estimated that the shadow banks move RMB33 trillion. Added to RMB67 trillion from the official banking system, this represents leverage of about 200% of GDP," Dumas says. "This does not imply a risk that would break the banking system—the country has sufficient reserves and there are controls on movement of private capital [in and out of the country]—but certainly it will have a cost," he says.

Even with a large number of companies listed on the Chinese stock exchanges, about 3,400 in 2010, analysts see a need to improve their operations. Zhang has suggested, for example, that the preference of companies for issuing shares in Shanghai is often motivated by factors unrelated to expansion and productivity, such as fewer restrictions, a weak evaluation system which allows for prioritization of shareholder profits, and greater influence of government action on market fluctuations.

"In Brazil, we had major advances in the early 2000s in the stock exchange, with new regulations for listing in the Stock Exchange of São Paulo (New Market) and the entry of foreign investors," Castelar noted. Although these changes improved the transparency and governance of the stock exchange, the number of companies listed is considered low compared to fully developed economies. "The BNDES competes with the capital market unfairly because it takes money from the Treasury to lend to the best companies, which would be natural candidates to seek resources in the capital market. And the cost of capital is high in Brazil," Castelar added, arguing that an increase in the number of listed companies could help reduce concentration and boost the entry of smaller companies.

Foreign Trade

World of opportunities



Solange Monteiro, *Rio de Janeiro*

THE BRIGHT SPOT in the economies of Brazil and China in recent years has been trade. The two countries recorded healthy export growth—in the case of Brazil, thanks mainly to Chinese demand—and are among the top recipients globally of foreign direct investment (FDI). The challenges for trade as a driver of economic expansion in the future, however, are different for each country: while Brazil needs to increase the share of exports in the economy, diversifying export goods and markets, China needs to reduce the share of exports in its economy, focusing more on improving the quality of FDI and innovation.

In China, the remarkable expansion of trade and FDI is the result of reforms that in recent decades have promoted economic liberalization, changing the reality of a country that until the early 1970s was a closed economy with trade in goods limited by the centrally planned economy. Among the elements that were part of the change was the establishment of four special economic zones in 1980, investment in infrastructure, and devaluation of the Chinese currency, the renminbi, since 1994.

The changes accelerated after China's entry into the World Trade Organization (WTO) in 2001. From 2002 to 2010, China's exports rose an average of 22% a year, and imports by 20%. Hu Zhaoxia, professor, the Faculty of Economics and International Trade of Xiamen University, has pointed out that after China's entry into the WTO, the average tariff on imports fell to 15% in 2001, about half the 1982 level, and was reduced further to 10% in 2005. "The volume of goods that needed import licenses fell from 46% of total imports in the early 1980s to less than 4% by the time China joined the WTO," she said.

Another important feature was the diversification of exports from agricultural products and crude oil in 1980 to labor-intensive manufactures, and gradual improvement of those products. "Currently, we see that China is becoming less competitive in producing goods that have a lower aggregation of technological factors and is making efforts to increase the competitiveness of its higher-value-added goods," noted Roberto Milani, director of the Brazil-China Business Council.

Boosted by strong Chinese demand for agricultural commodities and iron ore, Brazil also recorded significant growth in its exports in the last decade. It has become China's ninth largest trading partner, surpassing the United States in 2009. The value of trade between Brazil and

China has grown almost 25 times in a decade; in that time the Chinese trade deficit with Brazil increased nearly 20 times, to about US$20 billion.

However, behind these glowing results Brazil's trade has a darker side: problems of the competitiveness of domestic industry led to a steep decline in the share of manufactures in total exports, from 60% in 2000 to just 13% in 2012. This is partly explained by the persistent protectionist bias of Brazilian trade policy, making the country one of the least open of the BRICs—Brazil's total trade-to-GDP ratio is 23%, compared to 53% for China—and limiting its share in total world exports to 1.3%, higher only than that of South Africa (0.6%). Lia Valls, IBRE researcher, has identified a major issue: "Brazil has often used higher tariffs on imports as an instrument of industrial policy. Today's situation calls for a tariff policy that allows cheaper imports of capital goods to improve the economy's competitiveness . . . . We should not protect whole chains of production; instead we should encourage production chains that have a comparative advantage in being integrated with other regional or global chains."

Valls noted, however, that in Brazil the protectionist bias does not apply to attracting foreign investment, explaining, "Brazil has always lived with an external current account deficit and has needed to attract foreign investment to finance it. Today, the big challenge for Brazil is to improve competitiveness. Trade will always be important. Brazil will never have to depend on exports because of the size of its domestic market, but we are not immune to external crises, and assuring diversified and high-quality exports is necessary to reduce external vulnerability."

"Brazil has often used higher tariffs on imports as an instrument of industrial policy. Today's situation calls for a tariff policy that allows cheaper imports of capital goods to improve the economy's competitiveness."

Lia Valls

In contrast, the main challenge for China is to reduce its dependence on export-led growth, especially when, as now, international demand is low. Hu emphasizes that "while trade liberalization has contributed to raising China's GDP, it is not a sufficient condition for ensuring sustained long-term growth."

To avoid the risks of over-dependence on export-led growth, Hu emphasizes the importance of the current government's strategy of boosting the domestic market. She believes that in China the beneficial effects of bringing in foreign capital to promote technology transfer and productivity are not yet clear. There is a need to focus more on the quality of foreign capital. In addition, Hu advocates replacing the current policy of granting foreign capital access to the domestic market in exchange for technology transfer with a policy of incentives to scientific and technological development with an emphasis on innovation.

Environment



Protecting the environment from consumption pressures

Thais Thimoteo, *Rio de Janeiro*

ECONOMIC GROWTH usually raises per capita income and expands consumption. Although consumption is good in that it helps to improve the quality of life of the population at large, it can also be bad for the environment in that it stimulates greater energy consumption and environmental devastation. Accompanying economic development are such problems as deforestation, greenhouse gas emissions, and more waste.

When there are more people having access to more goods, especially cars and electronics, pressures to exploit natural resources rise. Ronaldo Seroa, professor of environmental economics, State University of Rio de Janeiro, believes the pressures could be mitigated if pollution were priced to reflect the loss of the quality of the environment and the welfare of the population: "With shortages of natural resources, use of the environment becomes more expensive, and people and the productive sector will be interested in finding a way to reduce their costs."

Emilio La Rovere is coordinator of the Center for Studies on Climate Change and the Environment at the Institute of Graduate Studies and Research in Engineering (COPPE) of the Federal University of Rio de Janeiro; COPPE has a partnership with Tsinghua University in Beijing, where pollution has from time to time made international headlines. Most of the local and global impact on the environment is caused by how societies produce and consume energy, La Rovere explained. "There is no free lunch. The more energy is consumed, the greater the impact on the environment. First, we need more energy efficiency, for example, cars running at 40km per liter (94 miles per gallon). Second, we should learn to use [alternative sources of energy]. We will not solve the problem using fossil fuels on a large scale, such as coal that generates pollution, acid rain, and global warming."

On the use and sources of energy, the difference in natural resources endowment between Brazil and China is striking. Brazil has plenty of sources of renewable energy—80% of the energy it generates comes from hydropower, and it has huge potential to expand wind power generation, solar power, biodiesel (oilseed), and ethanol (sugarcane) production. In China energy is mainly produced from polluting sources, predominantly coal.

To get an idea of the severity of the problem, coal accounts for 67% of domestic consumption of energy—well above the international average of 24%. In 2012 China also imported 285 million metric tons of crude oil, about 60% of domestic consumption of oil. "Energy security has become a major challenge for rapid Chinese economic growth. China's energy consumption per unit of GDP is 2.2 times higher than the global average, 2.8 times higher than the American, and 4.3 times higher than the Japanese. There is a lot of room to improve energy efficiency," said Yang

Wanping, professor of economics and finance, Jiaotong University of Xi Na province. Yang believes that increased government control, technological advances, increased efficiency, and market-determined energy prices should force companies to improve their energy efficiency. Demand for energy is projected to be 2.9 to 3.9 billion tons of coal equivalent energy (TCE) by 2020.

Recognizing this barrier to future sustainable economic development, China, the biggest polluter on the planet, has been investigating methods of environmental control. The State Council, the country's highest administrative authority, has decreed that by 2017 industries operating in China will have to reduce their emissions of greenhouse gases by 30%. However, the central government stance on pollution control also needs to be extended to local governments, Yang said. "Although the central government has established laws, regulations, and policies, often local governments apply environment policies only mildly, for political reasons." He believes that "intensifying supervision and increasing penalties against environmental crimes are the main measures that can make pollution control by local administrations more efficient."

"Energy security has become a major challenge for rapid Chinese economic growth. China's energy consumption per unit of GDP is 2.2 times higher than the global average, 2.8 times higher than the American, and 4.3 times higher than the Japanese."

Yang Wanping

In Brazil, there has been significant progress in efforts to reduce deforestation, mainly because of tighter laws, such as the new Forest Code, and public policies since 2004 to improve satellite monitoring and law enforcement by the Brazilian Institute of Environment and Renewable Resources. According to the National Institute for Space Research, deforestation area fell from 19,014 square kilometers a year in 2005 to 4,656 in 2012.

Currently, the biggest problem, which can keep the country in the middle-income trap, according to José Gustavo Feres, economist, Institute of Applied Economic Research (IPEA), is unequal access to basic sanitation, especially sewage treatment. Today, treated water reaches almost 95% of urban areas and 28% of rural areas, but although it has grown in the last decade, sewage treatment reaches only 64% of urban areas and is nonexistent in rural areas. "This has severe social repercussions," Feres said, "because the low-income population suffers most from deficient sanitation. We must mobilize more investments. If I had to rank Brazilian environmental problems, I would certainly place sanitation first."

Seroa and Yang believe that innovative technologies will promote sustainable consumption of energy and goods that generate less solid waste. But to reach that point, Seroa emphasized, "We have to have proactive policies that encourage the creation of new clean technologies, granting subsidies to innovative producers and raising the cost of products that pollute more."

Social Inequality



Problems but possible solutions

Kalinka Iaquinto

BRAZIL AND CHINA have similar social problems. They have high poverty rates and large income differences between rich and poor. Nevertheless, these problems have different dimensions for each because the Brazilian and Chinese realities are quite different. Despite significant advances in the last decade, such as the Family Grant program and job creation, Brazil is still a very socially and economically unequal country. However, although China has been introducing policies to improve income distribution, including adopting a minimum wage, income inequality there continues to widen.

In 2008, according to World Bank data, of the 620 million people throughout the world who were living in extreme poverty (earning under US$1.25 per day), 510 million were Chinese. Brazil has managed to reduce extreme poverty from 24.6 million to 6.12 million.

"Of all the countries that compose the G-20, only Brazil has made progress in reducing income inequality. But Brazil, along with South Africa, is still among the most unequal societies for historical and structural reasons," Carlos Aguilar, coordinator of the Oxfam Global and Regional Programs in Brazil, said. "In the Brazilian case, a deliberate policy of income transfer, including the Family Grant and a higher minimum wage, and employment growth helped to improve the situation. But that does not mean that these measures have succeeded in changing structural factors that sustain conditions of inequality, such as gender and race."

IBRE researcher Fernando de Holanda Barbosa Filho agreed. He noted that Brazil has been dealing with social issues since the Constitution of 1988 and today the state protects both elderly (through pensions and retirement) and children (through cash transfer programs) at relatively low cost. "Spending in the Family Grant program, for example, is very small, only 0.5% of GDP," he says.

Reform

Further reforms are necessary if poverty is to continue to be reduced. Aguilar highlighted the importance of fiscal reform: "The Brazilian government has developed policies targeting the poverty problem, but we still need to address the issue of very high concentrated wealth. The quickest way to do that is through fiscal policies."

Rodrigo Dora, deputy head of the Chamber of Economic Development and Promotion of the BRICS (BRICS -PED), predicted that by 2015 the BRICS should account for 22% of global GDP. This fact, he believes, underscores the need to invest in the quality of education. "Education is a fundamental tool for social mobility," he said. "The ability to read, understand, write, and access information are intimately

linked to equality of opportunity. Professional qualification is made possible to the extent that more skilled workers have more stable jobs, better wages, and better conditions for career advancement."

Brazilians have on average fewer years of schooling (7.2 years in 2011) than the Chinese (7.5 years). The critical issue is the quality of that education. "We made the education system accessible; now the next step is a systematic improvement of quality in order to reverse this process and allow everyone the same opportunity to go to college and get good jobs," Barbosa Filho said.

Challenges

China is also challenged by social inequality. Li Shi, director of the Institute of Income Distribution of Beijing Normal University, and Luo Chuliang, professor of Economics and Management, at Beijing Normal University, have pointed out that the most immediate problem is the huge difference between the incomes of urban and rural residents. Their research shows that the main obstacle to reducing inequalities is not just the existence of multiple sources and forms of income but also the ambiguity of the distribution rules and a lack of transparency that makes policy measures arbitrary and based on questionable criteria. They concluded that it will be difficult to improve the situation in a fundamental way in the short term.

"The ability to read, understand, write, and access information are intimately linked to equality of opportunity."

Rodrigo Dora

Li and Luo also cited corruption and the lack of democratic institutions as problems to be overcome. They stated that what is important is "not just a profound reform of economic and social management, but also speeding up political reform, including the process of democratization."

Reform of political institutions is, in fact, important for the success of all social development polices. Although the Family Grant program has been widely publicized and recognized internationally as a benchmark, simply adopting it would not guarantee its success in other countries. Oxfam's Aguilar points out that "the program could not have had the success it had in Brazil without parallel work by civil society that was very well organized and very well coordinated with public policy. In most of the BRICS, the program could not be carried out because there is no conception of civil society or because the country's authorities see civil society as an obstacle to the work of governments. Brazil has matured in that sense, but China still has not."

Dora agreed: "If the BRICS countries do not promote immediate deep social changes parallel to economic development, there is room for emerging social crisis, because we foresee rich global powers with large poor populations that have no opportunities for social mobility."

How to manage the public budget better

Kalinka Iaquinto, *Rio de Janeiro*

MANAGING A COMPANY WELL IS closely related to managing its cash flow and requires knowledge not only of the actual position of its accounts but also of possible future scenarios. That lesson is so basic, it seems obvious, but apparently not to governments. A budget —federal, state, or municipal—is both fundamental for planning actions and policies and a way to communicate government spending priorities to society. But that is barely raised when budgets are being prepared. The problem was discussed recently at two seminars, "Evaluation of the Credit Risk of State and Local Governments" at the Brazilian Institute of Economic (IBRE) and "Budget Reform and Public Management: Beyond the Fiscal Adjustment," at the Brazilian School of Business and Public Administration of Getulio Vargas Foundation (EBAPE).

Since the fiscal adjustment at the end of the 1990s, government budget management has been criticized for its rigidity in the allocation of funds and for imbalances in the various demands for funds. These aspects of financial management hinder investment and make it impossible to make necessary changes to the budget, which increases risks. Advocates of budget reform argue for more transparency and less stringent regulations to give states and municipalities more freedom, especially with regard to borrowing.

"We made the fiscal adjustment in 1998, but like any medication taken for a long time, it ends up generating side effects," said Fernando Rezende, lecturer at EBAPE. He pointed out that the idea was to allow more flexibility in order to get out of the low-growth trap set by the current budget: almost 90% of resources are allocated according to constitutional rules for spending on health and education. Resources allocated but not spent in the previous year's budget ("unpaid spending") have become part of a parallel budget, playing havoc with current-year budget execution and making public spending unpredictable. As a result, policy makers and public sector managers have less than perfect knowledge of their cash flow.

Competing demands

According to Rezende, the budget is constructed in response to three distinct demands: health and education social needs; parliamentarians' political demands for government appropriations for local projects; and macroeconomic requirements related to government's need to generate primary budget surpluses to pay debts. These three demands have been balanced in a sort of arrangement of convenience that works very well when the economy grows above 3%. However, when economic growth falls below 3%, the informal budget agreement becomes unworkable.

"Street protests have created an additional demand on the budget: improvement of public services. This demand hits the core: how to improve management of public funds," said Gabriel Leal de Barros, an IBRE researcher, who pointed out that so much spending is earmarked that the budget has been immobilized.

For the federal government, for example, 18% of tax revenues should be invested in education, which is a substantial amount considering that Brazil has one of the highest tax burdens in the world (as of September, annual tax revenues exceeded US$520 billion). Barros said as an example, "When the federal government reduces the tax on industrial products and on financial transactions to boost the economy, it affects tax revenue and can reduce the amount that should be invested in education."

In this regard, current discussions in Congress that can lead to more spending rigidities are worrying. A constitutional amendment currently proposed would require the government to carry out the individual amendments of legislators. The proposal is unrealistic, Barros contended, because it will reduce to only 15% the federal budget spending that will not be earmarked: "There is no more budget space to meet all the various demands; on the contrary, we must revisit and reconsider the demands in the face of budget constraints." The discussions of most concern relate to oil royalties, changes in the VAT rules, a new federative pact, and the National Education Plan. Congress often uses political debates to pressure the executive, and that affects every aspect of public administration.

A budget—federal, state, or municipal—is both fundamental for planning actions and policies and a way to communicate government spending priorities to society.

"We live in a time of uncertainty, especially in terms of revenue, as some states are losing resources from the state tax on goods and service. So we live with national ceilings that further tighten public finance because we do not have resources to meet all demands. What we do is put out fires," complained Célia

Since the fiscal adjustment at the end of the 1990s, government budget management has been criticized for its rigidity.

Maria Silva Carvalho, president of the State Finance Managers Group (GEFIN). She added: "We cannot plan or think long-term. . . . To have better public financial management, we need greater certainty from the federal legislature about public cash flow. "

State and municipal borrowing

The budget rigidities affecting state and municipal governments are the result of measures adopted in the late 1990s, when the federal government had to bail out many local administrations because they had contracted so much debt. State and municipal budgets were further tightened in the early 2000s with passage of the Fiscal Responsibility Law (LRF) and Treasury monitoring of local borrowing. The result was budget management that to pay debt service prioritizes the generation of a primary surplus at the expense of public investment.

However, in recent years this scenario has been changing since states and some cities have sought financing from national and international public banks. With the endorsement of the federal government, the volume of their foreign loans in the first half of 2013 increased almost 50% compared to 2012. State and municipal debt has increased since April 2012 from US$12 billion to US$19 billion.

"The federal government acknowledged its own difficulties in carrying out investments and has used the fiscal space that the LRF allows to increase the debt limit of states so they can invest in infrastructure," said IBRE's Leal de Barros.

"Before, borrowing abroad was discreditable; it would mean you could not manage your finances well. This changed with the unprecedented event in recent history of a Brazilian municipal bond issue placed on the international market without a federal government guarantee—supported only by the balance of the municipality and best practices," Renato Villela, finance secretary, Rio de Janeiro State, said, pointing out that Rio has not just borrowed abroad, but rating agencies have also assessed its state and municipal finances. Villela's analysis throws light on states and municipalities that have potential for dealing with transactions like these." It does not make sense for a country like Brazil," he said, "with its sophisticated production structure and financial services, not to have a responsibly developed market for state and local government bonds."

Other experts also argue for greater borrowing autonomy for state and local governments. Rating agencies and assessment by banks like the Inter-

American Development Bank and the World Bank have greatly improved government financial management.

Lindbergh Farias, president of the Senate Economic Affairs Committee, believes that the time has come to shift funding today, which is concentrated in the hands of the Federal Government; since 2008 the National Bank for Economic and Social Development (BNDES) has become a major lender. To do so, he argues for changing the law to allow state and local administration to contract debt so they have capacity to carry out investments in major public works.

Confidence

One way to strengthen state and local governments and create a market for their bonds in Brazil is to submit government accounts to the scrutiny of international banks and rating agencies. This could bring about more transparency and better management of state and local administrations

For Maria Rita Gonçalves, senior director at Fitch Ratings, there is currently a transition and the Brazilian profile is evolving: "We are clearly in a moment of an improved credit profile of state and local governments, and credit expansion for infrastructure, "she said. Daniela Brandazza, Standard & Poor's director of public finances, agreed: "We are optimistic about the possibility that if Brazilian local governments have an opportunity to explore the rating process, they can improve long-term financial planning."

Even in a scenario where state and local governments continue to have relatively high debt service and low capital expenditures, the assessment of the volume of their own revenues is positive. "When we look at capital expenditures and infrastructure needs, what we can say is that state governments show a good level of own revenues and stable financial performance, especially when we look at operational results and cash flow requirements," said Alejandro Olivo, analyst for Moody's Latin America and Canada.

Policy makers and public sector managers have less than perfect knowledge of their cash flow.

Nevertheless, rating agencies and lenders have concerns. The transparency of Brazilian public accounts is neither ideal nor standardized. In addition, measures being discussed in Congress could alter the cash flow of local governments, such as long-term social security liabilities that need more balanced management.

"The Brazilian population is aging while the yield on collateral assets that will cope with these obligations is no longer the same, so this challenge will become more important as Brazil moves to an environment of lower interest rates," Gonçalves said.

"The transparency of public accounts is essential. Credit starts with confidence,

"Street protests have created an additional demand for the budget: improvement of public services. This demand hits the core: how to improve management of public funds."

Gabriel Leal de Barros

for both sides," Adriano Mendes, BNDES, pointed out, adding "Transparency has to do with data." There is strong advocacy for standardizing the way data are reported in Brazil. Another factor that prevents transparent analysis of public accounts is the fact that some local administrations follow the LRF while others are guided by the Treasury's decisions. "We need to standardize, correct, and put forward at least some [organizing] concepts," Mendes says.

José Roberto Afonso, an IBRE expert in public finance, advocates standardizing and disseminating fiscal data in a system that covers states, municipalities, banks, lenders, and rating agencies. "What we see is that everyone involved complains about the time it takes to evaluate the data," he said, noting that it is essential that local governments become better able to manage public debt.

The moment appears to be ideal for Brazil to rethink its budget and tax issues. "We have a very interventionist government," said Zeina Latif, a partner at Gibraltar Consulting, "and it has taken a long time for us to realize that the formula did not work." She believes the next government will have to make a change in economic policy: "We have to leave ideology aside and take the path that must be taken . . . . We have room and stronger institutions to make that course correction."



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Investment will drive the economy



Nelson Barbosa

Professor of economics, São Paulo School of Economics, Getulio Vargas Foundation, and former executive secretary of the Ministry of Finance

Fernando Dantas, ***Rio de Janeiro***

Nelson Barbosa, who earned a Ph.D. in economics from the New School for Social Research in New York and now teaches, held several positions in the Lula and Rousseff administrations. Barbosa analyzes what has happened in the Brazilian economy in recent years, especially during the Rousseff administration, and its prospects for the future. He believes that, driven by investment, Brazil can grow faster, to about 3.5-4.5%.

***The Brazilian Economy*—Has economic policy changed under President Rousseff?**

Nelson Barbosa—Economic policy continues to follow the same institutional framework as before: an inflation target, a fiscal target, and floating exchange rates. However, in recent years the policy has had to be adapted to a new national and international context. At the beginning of the Rousseff government, the Brazilian *real* was extremely appreciated, and the government took measures to discourage further appreciation. This is not an exchange rate target; it is simply a way of trying to regulate currency volatility so that neither appreciation nor depreciation is excessive. This policy is compatible with the floating exchange rate. When the opposite happened—when the prospect of the end of U.S. expansionary monetary policy contributed to devaluation of the *real*—the government acted to prevent excessive devaluation.

What about the changes in fiscal policy?

The target is still the primary budget surplus target, with flexibility . . . . As economic growth slowed down not only

in Brazil but also globally, the government in effect reduced the budget surplus target and will do so again this year, and probably next year as well. But even with a smaller primary surplus than in the recent past, net public debt continues to fall and gross public debt is stable. Fiscal policy was contractionary in 2011, I think everyone agrees, and yet it was in 2011 that inflation reached 6.5%. Despite the slowdown in growth from 7.5% to 2.7%, inflation accelerated because it was not necessarily associated with aggregate demand, and it was affected by some supply shocks.

Even with a smaller primary surplus than in the recent past, net public debt continues to fall and gross public debt is stable.

However, fiscal policy turned expansionary after 2011. Why?

Because the slowdown of 2011 continued in 2012, it is natural that fiscal policy became more expansionary because the minimum wage and the Grant went up, which meant that public spending did not fall in the same proportion as revenues. It is not possible or reasonable to ask for fiscal policy to tighten when GDP growth slows to less than 1%. In fact, fiscal policy should try to stabilize growth.

How about inflation?

The inflation target should be pursued primarily by using monetary policy measures, which is what the central bank has been doing recently by increasing its policy interest rate. This will eventually bring inflation down to the center of the target range. I think that by the end of next year or early 2015, Brazil will have inflation closer to 4.5%—if there is no adverse impact from the rest of the world. The policies of recent years have successfully increased employment and raised wages, and that pushed up the price of services. By 2010, most of the increase in services prices had been offset by a fall in other prices. What has happened in recent years is that other prices behaved less favorably to contain inflation. This pushed inflation up, which is a concern. It is important to bring inflation back to the target.

How do you see gross debt, which is a current concern?

Gross debt in Brazil has grown in recent years for two reasons: The first was the accumulation of reserves—the central bank has to sterilize its purchases of foreign exchange by issuing bonds. This has a high fiscal cost, but the increase in international reserves was necessary to reduce Brazil's vulnerability to external shocks. A country that has reserves has

Economic policy continues to follow the same institutional framework as before: an inflation target, a fiscal target, and floating exchange rates, but in recent years the policy has had to be adapted to a new national and international context.

room for a more flexible economic policy. It's expensive insurance, but it's necessary. It made possible countercyclical policy in 2008 and 2009, and today as well. Reserve accumulation accounts for more than half of the increase in gross debt in recent years. The second part is loans to the public banks, such as the National Bank for Economic and Social Development (BNDES), in 2009 and 2010. That was how Brazil increased credit when private banks reduced it. The Treasury lent funds to the BNDES, which in turn lent them primarily to finance working capital for small businesses, investments in machinery and equipment, and infrastructure.

Lower growth reduces government tax revenues. At the same time, the government has kept up its income transfer program.

The Treasury policy of lending to BNDES is a major target of criticism.

The policy has been successful in fighting the crisis and it achieved its goals, but there is no need for it to continue in the same volume as in the past. As I said, this policy has a high fiscal cost: the government borrows at 10%, and the BNDES lends at 5%. The challenge now is to gradually begin reducing these incentives. That cannot happen immediately, because many investments still depend on the performance of these banks, but there is no need to lend as much as in the past. Actually, each year, government loans to BNDES have been lower than in the previous year, and that will gradually reduce the cost of debt. The problem of public debt today is not a solvency issue, because there is no doubt that Brazil has the capacity to pay—especially because some of the debt is in local currency, solvency is not a big problem. It's more a matter of cost.

Why has the growth of the Brazilian economy slackened during the Rousseff administration?

On the demand side, policy tightening in 2011 slowed growth in an unfavorable international scenario, which caused a decline in our exports. So it is possible to explain most of the slowdown in terms of lower aggregate demand. Internally, there was a slowdown in investment . . . and there was also reorganization of the government's investment policy, with less emphasis on public works, and the decision to grant the private sector more concessions. This caused a temporary drop in the volume of investment. Finally, private banks reduced their lending, which hit consumption.

How can demand recover?

The economy may grow faster driven by investment. The government is doing all it can to increase its investments with concessions . . . which may boost growth. On the other hand, the world outlook does not suggest that our exports will recover quickly, so growth will be somewhat slower than in the past. But from the point of view of demand, a range of 3.5% to 4.5% is possible.

How about the supply side?

On the supply side, the challenge is to sustain growth without stimulating inflation. The big change is that we now have full employment, so there is no room for the unemployment rate to fall. That means growth now must come mainly from increased productivity. And once again it is necessary to increase investment, because increasing the amount of capital per worker increases productivity.

How do you see economic growth this year and next?

Economists generally are expecting 2.5% in 2013 and the same next year, though the government expects a little more in 2014—a goal of 4% is in the 2014 budget, though economists talk about a figure above 3%. I think what happens will depend on two factors whose direction we cannot predict. The first is the strength of the recovery of the world economy. The second, on the domestic side, will depend on the success of the current policy of increasing investment, especially investment through concessions . . . . This can create a climate of greater confidence, leading the private sector to resume its investments. . . . If successful, that may be the deciding factor for Brazil to grow more than 3%.



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U.S. monetary policy and Brazil's current account deficit will condition what happens next year.

AS THE YEAR NEARS ITS END, analyst perceptions that space is limited for unexpected changes to economic policy in the short term are solidifying. Attention is therefore turning to what can be expected in the 2014 election year, given the legacy of the current year and the external outlook. Here, uncertainties abound.

Inflation will continue to push at the ceiling of the inflation target (6.5%) even if there are no adjustments of some controlled prices, such as that for gas, that presently lag behind international prices. The legacy of fiscal policy also does not support optimism about 2014, given the modest pace of economic activity—and thus tax revenue—and the continuing difficulties (notably political) in containing growing public spending.

And there are obvious complicating factors. The fact that inflation is so close to its target ceiling leaves little room for the authorities to maneuver. Any adverse shock to prices could easily push inflation for the year beyond 6.5%. In the current economic situation, how the exchange rate will behave is also a major concern, especially considering two major potential problems.

The first has to do with the recent worsening of the perception of how risky it is to invest in Brazil. The recent depreciation of the real exchange rate can be partly attributed to that heightened country risk, because international investors are reacting badly to the worsening of the country's fiscal results: Needless to say, its high gross public debt makes Brazil's economy more vulnerable., There is also growing concern about the balance of payments, since the current account deficit has risen to 3.6% of GDP and there are no clear signs that the situation will improve. Correction of this imbalance will require additional depreciation and a substantial decrease in the oil imports deficit, which today accounts for over 1% of GDP. Any worsening of expected external financing of the current account deficit could push the exchange rate down further and push domestic inflation up.

The second problem has to do with how the United States is managing its monetary policy. Since last May, the long-term interest rate in the U.S. has increased considerably, while the dollar has strengthened significantly in international markets.

Thus, there are significant uncertainties about the external outlook in 2014, and in particular it is not possible to rule out further appreciation of the dollar. As a general rule, when this happens the Brazilian currency depreciates against the dollar. With little room to accommodate economic shocks, depending on the intensity of that depreciation the resulting inflationary pressure may become an important issue in the presidential election campaign.