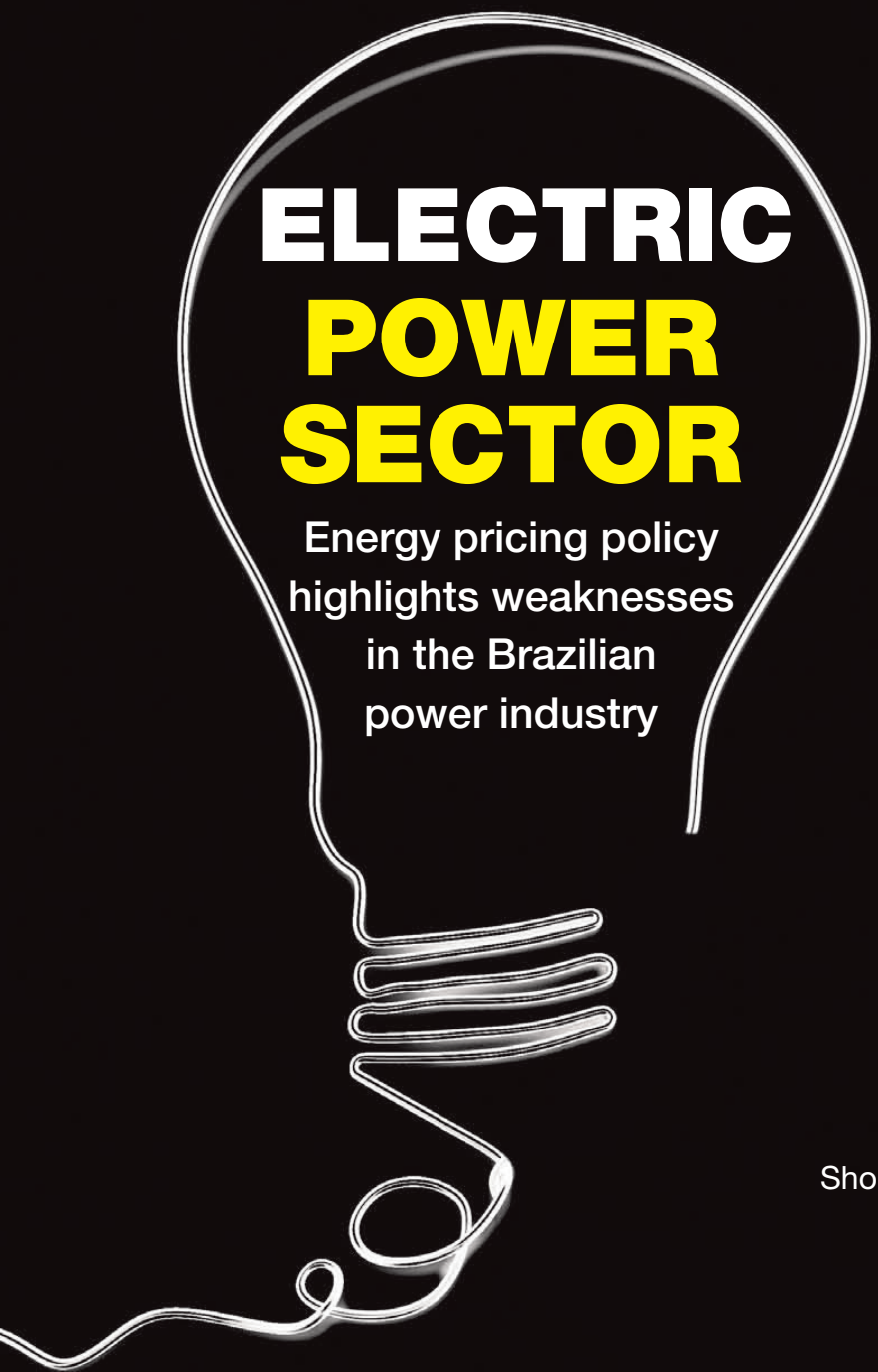
THE BRAZILIAN ECONOMY

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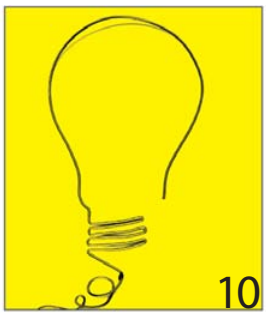
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THE BRAZILIAN ECONOMY









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In the context of Rio + 20, Israel Klabin, president of the Brazilian Foundation for Sustainable Development (FBDS), explains to Kalinka Iaquinto the relationship he sees between the global economic crisis and a global infrastructure that created demand for non-renewable natural resources. He also explains why "environmental, social, and economic factors should be brought together in the model of governance."

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23 Chile: Domestic risk

With Chile in good economic shape despite the international crisis, President Sebastián Piñera must now decide how to respond to popular calls for more spending on social programs, not to mention dealing with his administration's abysmal disapproval rate. Solange Monteiro parses the pluses and minuses of the decisions the president must make.

DEMOGRAPHICS

27 Brazil is growing old

Unlike developed countries, which managed to become rich before they grew old, Brazil will grow older before it gets rich. By 2050 the percentage of older people in the population will triple. Solange Monteiro explains why the change in demographic profile poses a risk to fiscal sustainability and could eventually become a drag on economic growth.

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For years Brazil has been living with both high interest rates and high inflation. But it is not necessarily good news that interest rates are becoming more realistic. Samuel Pessoa explains why that may be something to worry about rather than cheer.

ECONOMY

31 IBRE Economic Outlook

The Brazilian economy has stagnated since the third quarter of 2011 because of both low domestic investment and the fallout from the European financial crisis, to the point that the estimate for growth in 2012 has been revised all the way down to 1.8%. A major problem is that the confidence of both international investors and Brazilian businesspeople has worsened significantly.

ECONOMY

Payroll jobs improve in April

Formal job growth made its biggest monthly jump in April when the economy added 216,974 jobs, the Labor Ministry said, compared with an upwardly-revised 141,000 in March. However, workers'average inflation-adjusted income dropped 1.2%, to R$1,719. The April unemployment rate was down 0.2%, to 6%, according to the Monthly Employment Survey, published by the IBGE (Brazilian Institute of Geography and Statistics). (May 24)

Federal investment drops; World Cup jeopardized?

Government spending on new public works, equipment purchases, and permanent assets fell 5.5% over the same period last year, from R$11.1 billion in 2011 to R$10.5 billion in 2012. The federal government has reported that 40% (value: R$27 billion) of the works planned for the World Cup in 2014—stadiums, airports, public transit and ports—have not yet begun, though it claims to be optimistic. However, though Fifa, the world soccer governing body, has praised the efforts of governing bodies at all levels to speed up construction, it has complained of the bureaucracy and "excessive politicization" in Brazil. (May 15)

Brazil economy again disappoints

GDP grew only 0.2% quarter-on-quarter in the first quarter of 2012; though consumption held up, there was a decline in investment and a negative contribution from the external sector. The data reinforced expectations of further interest rate cuts soon. However, the scope for further credit expansion is limited because a quarter of households are over-indebted, spending more than 30% of household income on servicing debt. (June 1)

CPI inflation moderates

In year-on-year terms, inflation slowed to 5%, the lowest pace since September 2011 (7.3%); markets saw this as a signal that the central bank will keep cutting interest rates. (June 6)

POLITICS

Photo: Antonio Cruz-ABr



Former Presidents Luiz Inacio Lula da Silva and Fernando Henrique Cardoso with President Rousseff during the ceremony inaugurating the Truth Commission.

The president inaugurates the Truth Commission

At a ceremony attended by the four living former presidents of Brazil, President Rousseff opened the Truth Commission, saying that in clarifying the crimes committed during the military dictatorship (1964–1985) the commission cannot be a stage for revenge, or forgiveness. Former President Lula defined the commission as "an outstanding step," but some doubt that it will be effective. Historian Marco Villa points out that the commission's mandate is extremely broad. Also, the commission will work only part time, and its resources will be meager. (May 16)

R$1.3 million for pork barrel politics

The government has loosened the purse strings to facilitate release of funds for projects of interest to congressmen, senators, mayors, and governors in parties represented in the governing coalition. About 10% of the R$55 billion in spending that was to be postponed has now been released, and although most of it will go to mandatory spending, about R$1.3 billion will fund the pet projects of influential politicians. (May19)

TRADE

Brazil retaliates against Argentine products

The Brazilian government will no longer automatically license about 10 nonperishable products imported from Argentina; Brazil can now take up to 60 days to authorize the entry of Argentine products, which can make some seasonal exports unprofitable. The measure retaliates against Argentina's recent protectionist actions that saw Brazilian exports to Argentina fall 27% in April compared to April 2011. (May 14)

BNDES and bank agree to finance sales to Africa and Latin America

The National Bank for Economic and Social Development (BNDES) and Bradesco bank have signed a contract for financing exports of capital goods manufactured in Brazil to African and Latin American countries. Lines of credit valued at US$200 million will be transferred through Bradesco branches abroad and used to finance exports of Brazilian machinery and equipment. (May 28)

ENVIRONMENT

Forest Code provisions vetoed

President Rousseff has vetoed 12 points and made 32 other changes to the Forest Code passed by Congress. The government sought to preserve agreements not to grant amnesty to deforesters, protect smallholders, and maintain permanent preservation areas and forest reserves. For small producers, the government opted for restoration of forests according to the size of the property. (May 25)

OIL

Deep-sea discoveries upgraded

The consortium responsible for exploiring deep-sea oil has found significantly more potential in the block BM-C-33 in the Campos basin, where total resources are now estimated at more than 700 million barrels of light crude and 3 trillion cubic feet of gas. Statoil (Norway) holds a 35% interest in the consortium, Repsol Sinopec (Spain) 35%, and Petrobras 30%. The consortium is preparing an appraisal plan for the Brazilian National Agency of Petroleum, Natural Gas and Biofuels (ANP). (May 24)

ECONOMIC POLICY

Taxes reduced to stimulate consumption

Among stimulus measures Finance Minister Guido Mantega has announced are VAT exemptions on auto sales and reduction of taxes on consumer loans; bank reserve requirements have also been lowered to provide credit for vehicle purchases. (May 22)

Government reduces 2012 growth projection

Projected GDP growth has been cut by 0.5%, to a range of 3%–4%, Minister Mantega has announced. The revision reflects a worsening outlook for industry, investment, and car sales. (May 29)

Interest rate is cut

In May, the central bank again cut its benchmark interest rate, this time to 8.5%; in July 2011 the rate was 12.5%. With the global economy weak, the central bank sees little risk that inflation will rise. Analysts expect the rate to fall to 7.75% by September. (May 31)

Government ahead on 2012 surplus target

In April, the central government recorded a primary surplus (excluding interest payments) of R$11.2 billion. The target for the year is R$96.9 billion; in the first four months the surplus has met 46% of the target. (May 31)

Central bank takes over Cruzeiro do Sul

Cruzeiro do Sul, Brazil's 27th largest bank by assets, has been seized because of suspected fraud related to its credit portfolio; its main business is paycheck loans. The take-over highlights the stresses facing the financial system in a slowing economy. (June 5)

Government-owned banks lower rates

The state-controlled development bank BNDES has lowered interest rates on corporate loans and federal savings bank Caixa Economica Federal has dropped its rates for mortgages. Using credit as a policy tool to counter slowing growth, the government has repeatedly called for banks to reduce interest rates and expand lending. (June 6)

Subsidy to BNDES reaches R$28 billion

In the past three years, the government has supplied BNDES with R$28 billion at below-market rates, the Court of Audit reported in May. The Treasury re-lent borrowed funds at lower rates than it was paying so that BNDES could in turn provide cheaper loans to companies. (June 8)

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Is Brazil "emerging" into the 1990s?

THESE DAYS, LOOKING at Brazil's GDP performance is like time-traveling: the economy hasn't looked this depressing since the bad old days of the subpar growth of the 1990s. Yet the government can't seem to see past next week. As this issue of *The Brazilian Economy* makes clear, there's a serious disconnect in perceptions: at the end of May the government did reduce its forecast for 2012 GNP growth to 3-4% (News Briefs); meanwhile, independent economists reduced theirs as well—to 1.8% (IBRE Economic Outlook).

In the last few years the government has been propping up the economy—boosting domestic consumption by reducing interest rates, keeping the exchange rate devalued, and targeting tax exemptions. But conditions throughout the world have changed since we first tried that in 2008-2009. Most obviously, China seems to be slowing down, which would mean that Brazil can no longer count on it to boost our economy, because it will be consuming fewer Brazilian commodities. India—which has been growing even faster than Brazil, certainly invests more in research and development, and has a far younger population and thus a greater demographic dividend—has been threatened with loss of its investment grade credit rating. Things may look rosy in Brasilia but the picture in the rest of the world has turned gray.

Short-term stimulus is no alternative to long-term structural change.

Our cover story deals with just one example of the problems that businesses in Brazil must deal with. Even though Brazil's energy resources are incomparable, the price of electricity here is arbitrarily high. The tax burden on electricity rates is one of the heaviest in the world, seriously affecting the competitiveness of our manufactures, the power grid needs to be extended, and there's been no effort to make the regulatory changes necessary to attract investments into the sector. And power is just one on a long list of Brazil's economic liabilities.

The Politics column in this issue sets out the conflict for the administration between immediate stimulus and long-term structural change. In pointing out how reform this year must be set aside until after the local elections in October, the column also underscores another problem, one that is political rather than structural: in a multiparty coalition, no president actually has full control of the cabinet, because each party claims some of the rewards.[1] That is why Brazil has far too many ministries, the responsibilities of which often overlap (as we have seen in previous issues), further complicating the lives of those attempting to operate in the private sector.

Brazilian politicians and pundits seem to treat the Brazil cost as if it were the weather: everybody talks about it but nobody does anything. The difference is that though there's not much anybody *can* do about the weather, there are innumerable options for cutting the Brazil cost. How long will the economy have to spend in revisiting the 1990s before it finally becomes clear that short-term stimulus is no alternative to long-term structural change? ■

[1] India has a similar problem—Russia and China have the opposite problem.

How to read Brazil's crisis response

João Augusto de Castro Neves, Washington D.C.

CONCERNS ABOUT Brazil's economic growth and the policy environment have risen in recent months. After another round of disappointing economic data (in the first quarter of 2012 GDP grew by 0.2%, far below market projections), investors are beginning to wonder if the B in BRICS has lost its appeal as a promising emerging market.

Two main questions are driving this bout of market pessimism. First and more general, has Brazil's economic growth model reached its limit? Second, will the Dilma Rousseff administration seek growth at all costs—a strategy that would entail a less market-oriented and more interventionist stance and possibly a different economic policy mix?

The decision to conduct one more round of stimulus measures … suggests that the administration is increasingly bearish on growth, both domestic and international.

It is difficult to formulate a definitive answer for either question. Forecasts for sustainable growth of the Brazilian economy have become less favorable because of rising labor costs, the sluggish pace of public investment, and the effect the continuing crisis in the Eurozone is having on commodities prices. Yet even though economic growth prospects for Brazil this year are bleak (markets project that GDP growth will be less than 3%), there are reasons to believe that the pessimism over the policy environment in Brasilia may be overstated.

With concerns about industrial production growing, the government in May announced a package of measures to stimulate the economy. Among them are reductions of the tax on consumer loans and the industrial products tax on auto sales, a lowering of bank reserve requirements with the funds released earmarked for auto loans, and cheaper lines of credit from the BNDES for working capital and acquisition of trucks and machinery. The final cost of

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the package in terms of lost revenues is estimated at R$2.7 billion (about US$1.4 billion) this year, but the costs could rise since the administration has signaled that similar measures will soon follow.

The decision to conduct one more round of stimulus measures only weeks after the government announced the second version of the Great Brazil program, which certainly provided benefits to industry, suggests that the administration is increasingly bearish on growth, both domestic and international.

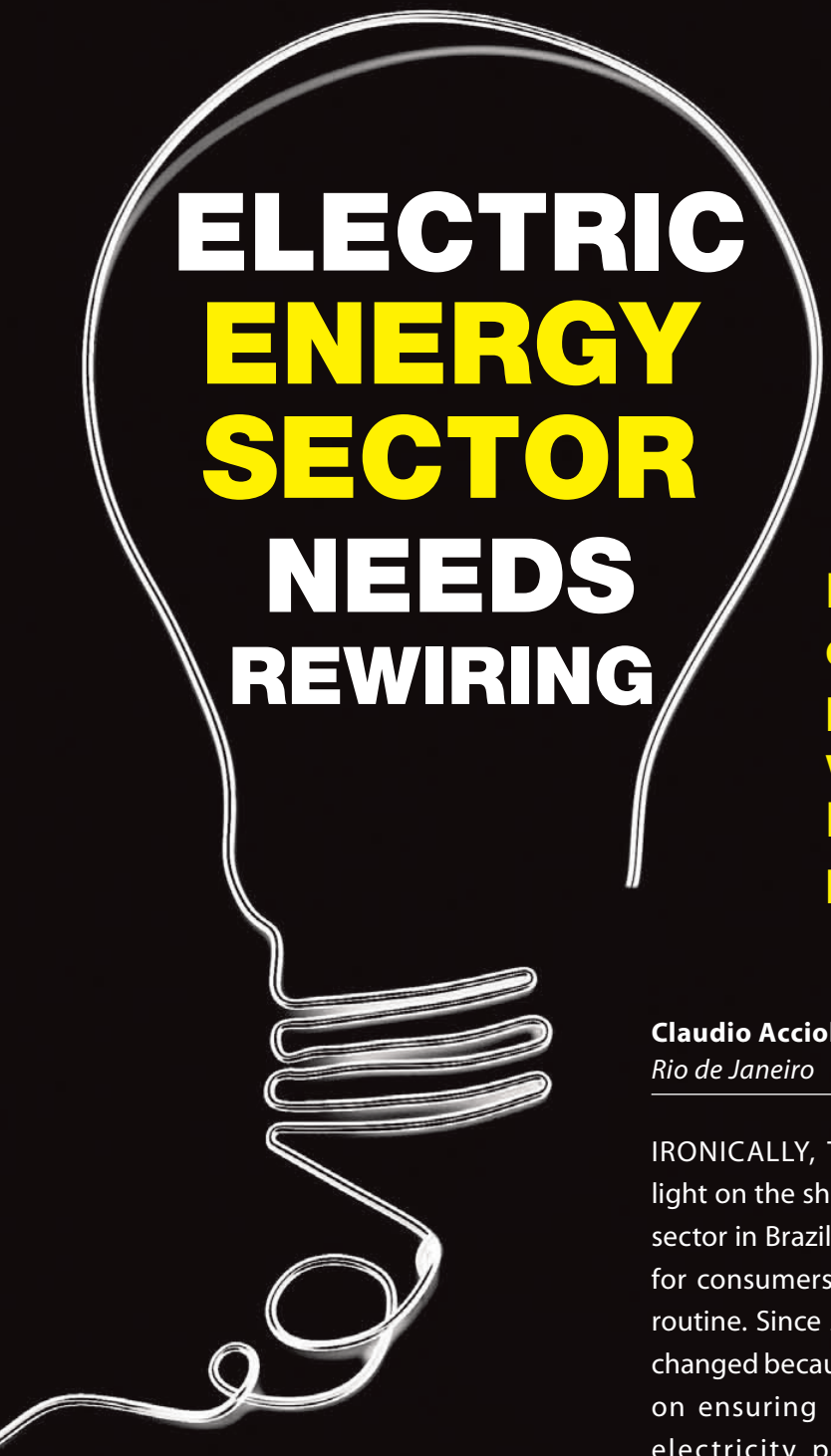
Although the effectiveness of some of these measures may be questionable, it would be a mistake to interpret these recent steps as evidence of a de facto decision to pursue economic growth at all costs. While additional measures to incentivize the economy should be expected, the fiscal policy strategy is still intact. Rousseff's focus is on delivering on the primary fiscal surplus target (3.1% of GDP in 2012) as a means to support the monetary easing being pursued by the central bank. Ultimately, her overarching goal is to reach lower interest rate equilibrium for the rest of her time in office, which could mean that the fiscal environment ahead will be more favorable.

In the short term, this policy path is likely to result in slower growth, but given Rousseff's high approval ratings and with no concern about national elections any time soon, that seems like a bearable cost. Longer term, however, these policy choices might not be enough to guarantee higher and sustainable growth. To achieve that, she would have to go beyond lowering interest rates and tackle some of the other drags on growth that constitute the well-known Brazil cost, such as the high tax burden, expensive labor costs, poor infrastructure, and low productivity.

Investors are beginning to wonder if the B in BRICS has lost its appeal as a promising emerging market.

With the political calendar abbreviated by a wide-ranging congressional inquiry on corruption, the mid-year legislative recess, and local elections in October, there is not likely to be any major reform on the agenda for the rest of the year. Whether the reform agenda will go forward in 2013 will depend fundamentally on (a) Rousseff's popularity, and (b) Brazil's fiscal situation. While the former is fundamental if there is to be a more reliable government coalition in congress, the latter usually determines whether an administration is willing to pursue reforms, such as tax reform, that could result in a revenue shortfall.

If both factors are present, chances are good that the government could abandon its muddle-through approach to problems and embrace a more long-term growth strategy. Unfortunately, there is nothing to do but wait and see.



ELECTRIC ENERGY SECTOR NEEDS REWIRING

Review of energy pricing policy highlights weaknesses in the Brazilian electric power industry.

Claudio Accioli and **Solange Monteiro,**
Rio de Janeiro

IRONICALLY, THE 2011 BLACKOUT shed light on the shortcomings of the electricity sector in Brazil, as did the power shortages for consumers and business that became routine. Since 2004, the electric sector has changed because a new framework focused on ensuring power supply, recovering electricity production capacity, and consolidating Brazil's position as a clean energy producer. It demonstrated the feasibility of alternative sources of electric power and encouraged a free market that today represents 25% of the power of the National Electric Power Grid.

Nearly a decade later, however, the restructuring process is still incomplete. This is clear from the tax burden on electric rates, which is one of the heaviest in the world, and from the faltering pace of making the regulatory changes needed to attract investments into the sector.

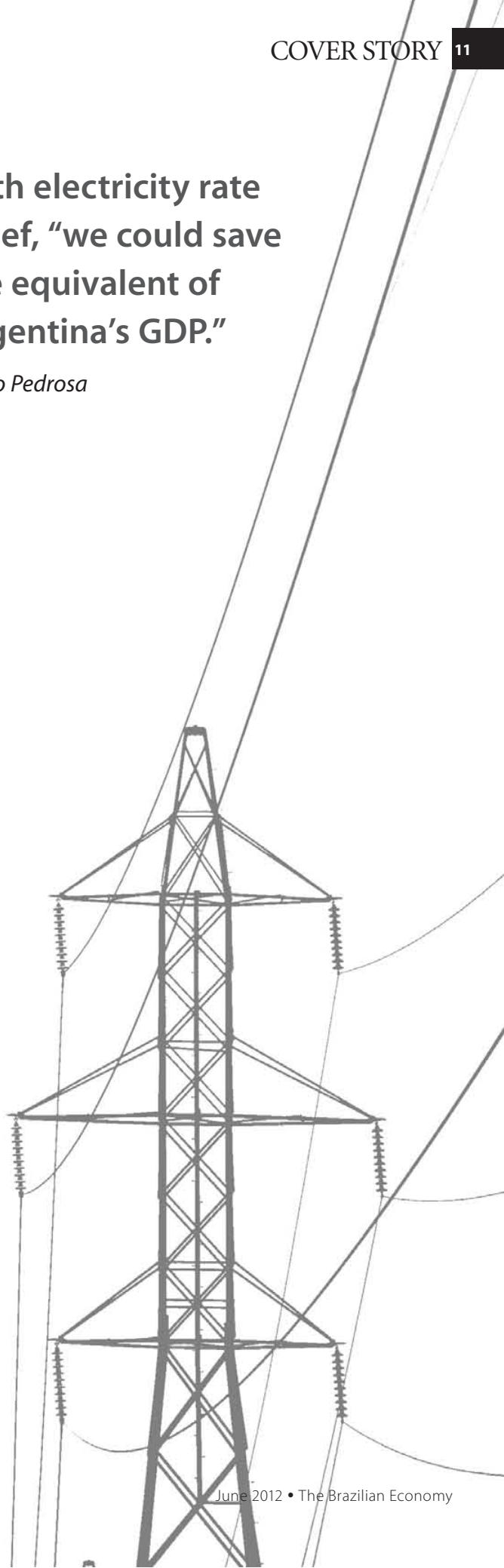
After innumerable complaints from industries suffering from the high electricity rates, last May President Rousseff promised to make the issue a priority, leading the market to expect a substantial reduction in industrial rates. "The president understands that we have an inadequate and distorted system," said João Carlos Mello, president, Andrade & Canellas consulting, justifying the need to reduce charges and taxes on electric rates. Speaking at the Brazilian Energy Seminar put on by Brazilian Institute of Economics, Getulio Vargas Foundation (FGV) in late May, Paulo Pedrosa, chief executive, Brazilian Association of Large Power Consumers and Free Consumers (Abrace), said that with electricity rate relief, "we could save the equivalent of Argentina's GDP."

To reduce the cost of electricity, the government needs to lower charges and taxes, which together represent about 45% of the electricity price, and also lower the price of the energy concessions that will expire after 2015.

Among the principal charges are those for the Energy Development Account (CDE), which gives the poor access to electric power, and Quota and Fuel Consumption (CCC), which subsidizes thermal power production in isolated regions off the energy grid. As more of these regions are connected to the national grid, the need for the subsidy should dissipate. José Goldemberg, former environment minister and now professor,

With electricity rate relief, "we could save the equivalent of Argentina's GDP."

Paulo Pedrosa



"The president understands that we have an inadequate and distorted system."

João Carlos Mello

Institute of Electrotechnics and Energy, University of São Paulo, argued for reduction of the CCC because it subsidizes inefficient thermal power systems.

Pedrosa pointed out that a major problem is the lack of transparency about how the charges collected are spent, citing the social program Light for All, which was funded by the CDE. In his opinion, "The CDE and the CCC, for example, would be better managed if they were incorporated into in the federal government budget."

Mauricio Tolmasquim, president, Energy Research Company (EPE), agreed in general with the ideas offered to solve the cost problem, but believes that charges related to social issues, especially subsidies for low-income consumers, should be maintained. If European countries do this, he said, "It is hard to imagine that a country with as many inequalities as Brazil should not have this kind of social policy"

Regarding the taxes on electricity rates, the issue is how much the federal government is willing to give up in terms of the taxes for the Social integration Program (PIS) and Contribution for the Financing of Social Security(Cofins), and what the states will be willing to do about the VAT on electricity rates. "The VAT is the tax base for the states, especially taxation of electricity, fuel, and telecommunications, whose collection is more difficult to evade," Tolmasquim explained. The state VAT varies from 12% to over 30% in Minas Gerais and Rio de Janeiro.



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Clean and renewable hydroelectric power accounts for 80% of total electric power in Brazil.

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A number of concession contracts for generation, transmission, and distribution will expire between 2015 and 2017, which should open an opportunity to reduce electricity prices. Factoring in the cost of energy investments that are completely paid off could reduce electricity rates by as much as 8%, it is estimated. But since 2008 there has been debate about how to get this done: conduct auctions, as the law authorizes, or simply extend the current concessions. The 112 power plants whose contracts expire represent 28% of Brazil's power capacity, and the transmission contracts account for 73,000 km of lines—82% of the grid.

BRAZIL'S ELECTRIC POWER IS CLEAR AND RENEWABLE

(% of total electric power)

BRAZIL (87.2% renewable energy)	
hydroelectric power	81.2
natural gas	5.8
biomass	5.6
oil	3.1
nuclear	2.6
coal	1.3
wind power	0.4

WORLD (19.8% renewable energy)	
hydroelectric power	16.5
natural gas	21.4
oil	5.1
nuclear	13.4
coal	40.3
other	3.4

Source: Energy Research Company (EPE).

In late May, Nelson Hubner, director general, National Electric Power Agency (Aneel), told the media that the government had already decide to send Congress a proposal to allow concessions to be renewed under certain conditions. This decision is opposed by the Federation of Industries of São Paulo (Fiesp), which supports auctioning of the concessions and their assets. Fiesp points out that the average selling price of older power plants, now that the initial investment has been paid off, is R$90.98 per MWh, yet the average production cost is only R$6.80 per MWh. "The auctions are a more transparent way to ensure a fair price for electricity," said Paulo Skaf, Fiesp president. "With auctions held in terms of the lowest tariff, as has been the rule in the electric sector, the competition between the parties will lower prices," he went on.

Unica studies show that the potential of biomass energy is equivalent to three Belo Monte power plants, 15 GW.

Although Fiesp represents one of the most powerful industrial groups in the country, its position is not unanimous. "With the extension of concessions, we can capture the gains [lower prices] with less distress to the corporate structure we have today," said Mario Menel, president of the Brazilian Association of Investors in Independent Energy Production (Abiape) He believes that the government delay in deciding what to do about expiring concessions has stalled investment in the electricity sector.

Speaking for an industry that carries one of the highest electricity rate burdens, Adjarma Azevedo, president, Brazilian Aluminum Association (Abal) argued for special treatment to try to make up for lost time and investment. Aluminum processors have been unable to

The tax burden on electric rates is one of the heaviest in the world.

To reduce the cost of electricity, the government needs to lower charges and taxes, which together represent about 45% of the electricity price.



build new plants since 1985, yet "Since 2001, our industry has seen an average increase in energy prices of 12.6% a year." Fiesp, on the other hand, believes the benefit of lower prices of energy should be extended to all sectors. Skaf said that "Fiesp's study estimates that electricity production and transmission costs would fall by about 75% by removing the cost corresponding to investments already amortized and auctions—and for consumers savings in energy costs could reach 20%."

For Abrace's Pedrosa, the ideal would be to set priorities now for eliminating charges and revising taxes on electricity rates to give relief to industry until concessions are renewed. He said Abrace was optimistic because "we see that the government understands that there are distortions that need to be corrected."

Marcia Leal, chief, Electric Energy Department, National Bank for Economic and Social Development (BNDES), explained that the bank has acted vigorously to finance power production and transmission in order to reduce electricity rates for consumers. She added that "In 2011, we approved more than R$14 billion investment in electricity, equivalent to 4,120 gigawatts and 2,704 km of transmission lines."

BEYOND PRICE

Reducing electricity rates, however, does not solve all the problems in the electricity sector. Joisa Campanher, coordinator, Center for Regulatory Studies, FGV Graduate School of Economics, explained that energy policy depends on more than the relationship between production costs and high electricity rates. Brazil lives the paradox of having abundant and clean sources of electric power but not having a competitive system. How can a country that has a share of renewable energy well above the world average, the third



Photo: Niels Andreas/Unica.

The potential of biomass energy is estimated at 15 GW, almost three Belo Monte power plants.

largest hydroelectric potential on the planet, and complementarity between the hydraulic and alternative sources not get better results? Production factors are only one engine of an economy; as an economy develops, it also needs to boost efficiency and innovation.

Exacerbating the poor results is the inefficiency of power distribution by the state company Eletrobras in the north and northeast and the lack of a framework for regulating natural gas to break the monopoly of the state oil company, Petrobras. "Today in the U.S. natural gas is sold for US$3.5 per thousand cubic feet, in Brazil, it is US$17," Campanher pointed out, noting that this price disparity is a barrier to productive investments. Abiape's Menel added that "We have shelved three GW cogeneration projects in São Paulo state for lack of a natural gas policy."

How can a country that has renewable energy well above the world average, the third largest hydroelectric potential on the planet, and complementarity between hydroelectric and alternative sources not get better results?

One somewhat successful alternative is wind energy. Since the Incentive Program for Alternative Sources of Electric Energy (Proinfa) established price guarantees to encourage wind power enterprises, the market has developed rapidly, and over time production of wind energy has become more efficient, bringing the price down from R$300/MWh in 2004 to R$102/MWh in 2011. "It was through this public policy that we learned how to make

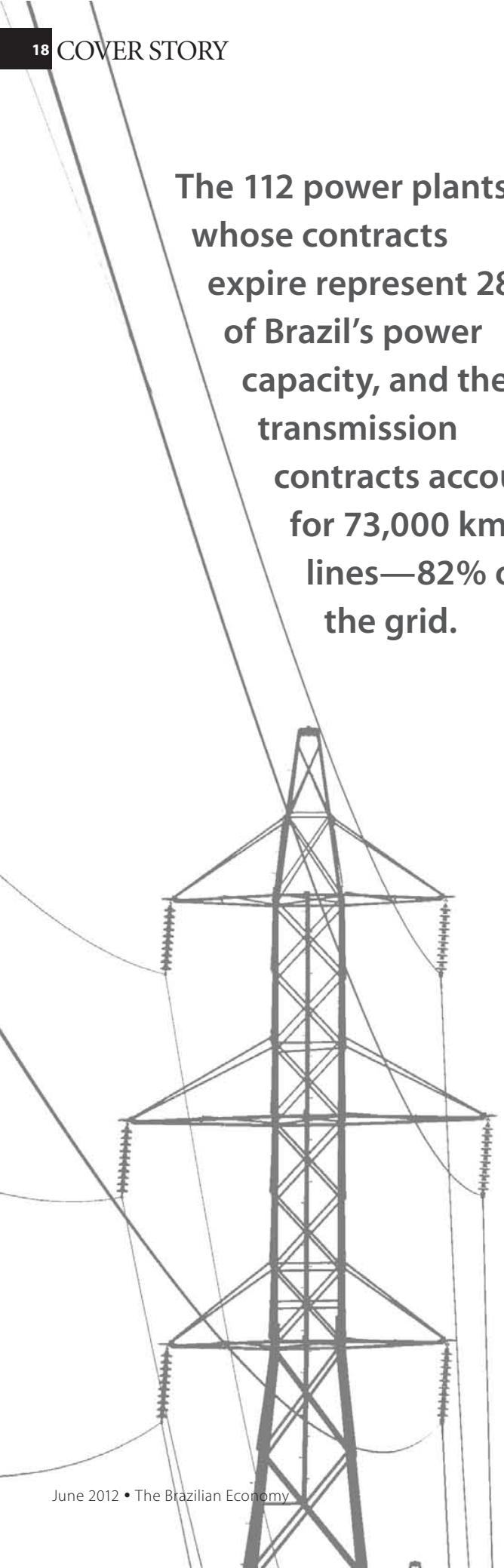
GROWING WISELY

The Brazilian Biodiesel Producers Association – APROBIO believes and defends the increasing of renewable energy sources as part of Brazil´s growth. Biofuels are a green and clean energy which contributes to the development of sustainable markets. But a country does not grow only in the economic field. It grows as a Nation consolidating democracy and the people´s identity. Biodiesel emits less than 57% of pollutant in the atmosphere. It helps to create more than 1,3 million jobs and benefits 103 thousand of small farmers. What is a technical feature to biodiesel for Brazil is a commitment to modernity. That is why this Nation is growing wisely.

APROBIO
Associação dos Produtores de Biodiesel do Brasil
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The 112 power plants whose contracts expire represent 28% of Brazil's power capacity, and the transmission contracts account for 73,000 km of lines—82% of the grid.



wind power [productive] in Brazil," said Elbia Melo, chief executive, Brazilian Association for Wind Energy (Abeeólica). The industry already has 14,258 MW to supply for the next auction. Melo added that "Today we have all [the component] industries here, like wind turbine blades and other equipment." However, environmental licensing is still a problem, and a shortage of transmission lines prevents suppliers from selling more production.

Another example of policy being somewhat reluctant is electricity generated from sugarcane biomass. "Brazilian energy policy is credited with targeting mostly clean energy, but that alone does not prevent internal imbalances like those faced by the sugarcane industry," said economist Jacques Marcovitch, who chaired the Energy Companies of São Paulo state. He argued for exempting ethanol from taxes to make it more competitive with gas prices.

According to Zilmar José de Souza, manager, Unica Bioelectricity, today the main obstacle to more sugarcane biomass generation is competing with low wind energy prices. Goldemberg added that "The government does not understand that new energy can be more expensive initially," he said, "but prices fall rapidly as production increases. To require only the lowest prices eliminates potential sources of energy, such as cogeneration with sugarcane bagasse, which has wide possibilities in Brazil." Unica studies show that the potential of biomass energy is equivalent to three Belo Monte power plants, almost 15 GW. "We need a long-term sectoral policy," de Souza urged.

The new economy: Sustainable and socially inclusive?



Israel Klabin
President, Brazilian Foundation for Sustainable Development

Kalinka Iaquinto, São Paulo

IF NATIONS do not find solutions for global environmental, economic, and social problems, human existence may be impossible. Sounding the alert is Israel Klabin, president of the Brazilian Foundation for Sustainable Development (FBDS) and a pioneer of environmentalism in Brazil. For him, the global economic crisis is rooted in misuse of natural resources. Nevertheless, Klabin is optimistic: "I believe that this crisis can bring about solutions and there will be some political leaders who can implement new models of global, national, and business governance," he says. The former head of Klabin Corporation, the biggest producer, exporter and recycler of paper in Brazil, highlights the importance of a sense of history when evaluating the issues that stimulate environmental, social, and economic discussions today.

***The Brazilian Economy*—Can you say, in the year of Rio + 20, that the Brazilian economy takes sustainability into account?**

I***srael Klabin***—I believe the term "sustainability" is becoming outdated. It refers to too many things! To answer your question, we must reflect on what we think about the present and future in terms of events of the past. By doing this we see that the very creation of the Getulio Vargas Foundation had a fundamental role, since it is linked to the present reality and has the ability to maintain all the economic data necessary for the Brazilian model to relate to others speaking the same economic language.

What are your views on the world economic crisis?

The [economic] model survived until recently, when exhaustion sent it into crisis. . . The basic reason for this entire model going down—including global and national governance and relationships between diverse economies—is an infrastructure that created demand for non-renewable natural resources, especially energy resources.

So the problem goes beyond the current economic model, and ultimately economic issues go hand in hand with environmental and social issues?

Absolutely. Environmental, social, and economic [factors] should be brought together in the model of governance and we have not seen this yet. Today more than 85% of the energy of the planet is based on a framework that exceeded the limits for the planet's survival. Why? Because greenhouse gas emissions are increasing temperatures . . . That is what we call unsustainable. Not only are temperatures rising, but other natural resources, like water, are being depleted, and there are problems with the entire structure of governance, the entire framework within which humankind lives.

Could Brazil, where most of our energy is clean, stand out in the search for a new economy?

Brazil has relatively clean energy production . . . Within its borders, Brazil has more than enough renewable energy sources to expand capacity for another 30, 40 or 50 years . . . There are a number of innovations that could boost an energy model that is extremely favorable to Brazil.

With regard to mismanagement of natural resources, why is social inclusion important?

The economic model with which we have lived since World War II no doubt increased the wealth of nations and to some extent social inclusion. The vast majority of the population that previously had no access to wealth does have access today. However, we have a much worse environmental impact . . . We now have "planetary limits" that affect not only the energy supply, but also water, social inclusion, and food production . . . It is impossible to continue developing without considering inclusion of those less fortunate.

Do you believe that nations have worked to resolve crises without looking ahead?

Individual nations have not been able to make a rational transition to [a new] economy in terms of energy distribution, governance, and life in cities. This wall of impossibility is one of the issues covered in the Rio +20 conference. If you ask me if I have any hope that there will be a short-term solution, I will say no. Nevertheless, I have much hope of raising awareness of people and governments.

Both in Brazil and globally, is there a lack of policies to educate people in how to be environmentally responsible?

In Brazil, without a doubt, education is severely lacking. You talk about environmental education, but we do not have education. Our educational process is completely outdated. We have not been able to prepare people and future generations for a sustainable world ... The world is living at a rather critical moment in an outdated economic model and is apparently unable to renovate this model

We must reflect on what we think about the present and future in terms of events of the past.

within the principles of economic and environmental sustainability and social inclusion.

In this critical scenario, what expectations should we have?

Rapid advances in terms of awareness and model changes occur only in dictatorships, and that is unacceptable. The *evolution* we would like to see is for national governments to become rapidly aware of global thinking and then set up new models, based on an understanding of the limits the planet imposes upon us.

Within its borders, Brazil has more than enough renewable energy sources to expand capacity for other 30, 40 or 50 years.

How should government promote these changes?

Some countries use tax policy to give companies incentives to provide the services the government is unable to, such as rapid evolution and deployment of new technologies in the market. The tax tool is one thing to be considered seriously for advancing solutions. The other thing we recommend is better coordination between centers of research and innovation throughout the world . . . not just making available technologies to those in need but also, of course, the exchange of information between research centers for the better advancement of science.

What lines of research would promote innovation?

Here are two areas where I consider innovation to be essential. One is the desalination of seawater. Why? Because the world is on the verge of exhausting drinking water. But we live on a planet two-thirds of the surface of which is sea water. If you can find a connection between solar energy and desalination and use the water to fight desertification and increase food production, you will have an important formula. Another is the structure of the energy supply . . . [and] the ability to find technology to absorb the emissions produced by the use of fossil fuels.

Many people have criticized the fact that climate change is not on the Rio +20 agenda.

The Conference of Parties on Climate Change to be held in Qatar in the end of the year will discuss the *effects* of climate change. Rio +20 will discuss the *causes* of climate change, [which again relate to energy, technology, and social inclusion]. The new economy will be at the center of discussions at Rio +20.

Some countries have abandoned the Kyoto Protocol.

The Kyoto Protocol was a model for solving greenhouse gases emission problem, based on the old idea that the polluter pays. That idea is correct . . . but it requires comprehensive participation. China, India, the eight or ten countries that are the greatest [polluters] would have to adopt the Kyoto Protocol if it were to be a universal remedy; that did not happen.

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CHILE: Domestic risk

With Chile in good shape despite the international crisis, President Sebastián Piñera must now decide how to respond to popular calls for more spending in social programs and deal with his administration's seriously low disapproval rate.

Solange Monteiro, Santiago, Chile

"IN 20 DAYS I THINK we have moved more than others in 20 years," recently elected President Sebastian Piñera said about the speed of his administration's action to repair the earthquake damage followed by tsunami that Chile suffered in February 2010. For the first time since Chile became a democracy, it had elected a center-right candidate. The 51.6% votes that put Piñera in office were betting that, given the stable economy, an entrepreneur's pragmatism would accelerate changes to improve their quality of life. "The president's message was to maintain the same policy stance but advance in a more efficient way," says Patricio Navia, professor, the Center of Latin American Studies at New York University and the Research Institute of Social Sciences of Diego Portales University.

In the year and a half that the administration has been in control, the scenario has become more complex. Chile is highly dependent on copper exports and the economic strength of trading partners, but this year the Piñera administration should do relatively well despite the international crisis, thanks to policies carried out by the national unity government during the previous 20 years that built up a comfortable buffer of international reserves. "Even the Organisation for Economic Cooperation



Photo: Antonio Cruz/ABr.

Presidente Piñera has a tough job ahead to respond to calls for more social programs.

and Development [OECD] recognized Chile as one of the countries best prepared to face this crisis," says Finance Minister Felipe Larraín.

But now, on the domestic front, President Piñera needs to respond to a demand that had been pent up for 20 years: more spending on education and health and reform of the pension system. The most evident sign of dissatisfaction was that in 2011 students took to the streets for seven months and helped sink the government's approval rate to 22%. The risk of a repeat this year cannot be ignored. This may become Piñera's main challenge.

Conservative stamp

The Chilean economy is expected to grow 4% in 2012, compared to 6% in 2011, now that, among other factors, some industries affected by the earthquake are back in full operation. To César Peréz, executive director of studies, Celfin Capital brokerage, this growth, though lower, would demonstrate good performance, "especially if we take into account the slowdown of Chile's main trading partners" (China, the United States, Japan, and Europe).

The drop in demand for copper and therefore its price are not minor factors for Chile, the world's leading producer. According to the Chilean Copper Commission (COCHILCO), copper exports accounted for 20% of GDP in 2010. "The price of copper reached US$4 per pound in 2011 compared to US$1 in 1990," Peréz points out. Meanwhile, says Jorge Bunster, director-general, Chile's Direction of Foreign Trade (DIRECON), efforts to diversify exports and markets have been constant.

On the domestic front, President Piñera needs to respond to a demand that has been pent up for 20 years: more spending on education and health and reform of the pension system.

"Today, products like forest products and fresh fruit have grown significantly," he says. "We have 21 trade agreements with 58 countries. Last year, we negotiated with Turkey, Malaysia, Vietnam and Nicaragua, and now we have begun talks with Thailand and Hong Kong."

Even with the range of trade agreements, though, the prediction that the trade balance will plunge is unanimous. For one thing, according to Celfin Capital, the price of copper is likely to fall to US$3.60; for another, there is likely to be a high demand for oil imports from the energy sector, which is heavily oil-dependent. Peréz says, "We believe that the trade surplus, which was US$12 billion in 2011, will fall to US$5 billion."

But such bleak prospects do not shake Minister Larraín's confidence. He says, "Every cent less in the price of copper represents a decrease of US$60 million in tax revenues; however, our budgetary policy is based on the long-term price of copper of US$3.02. We do not depend on the current valuation of copper to pay our bills." Chile's current economic strength was firmly established after a series of reforms to reduce the vulnerability caused by its heavy dependence on one commodity. In

> "We do not depend on the current valuation of copper to pay our bills."
>
> *Felipe Larraín*

2001, these reforms culminated in adoption of the concept of structural budget balance. This insulates the public budget from cyclical economic conditions because expenditures are based on potential GDP and the tax revenue trend. Revenue surpluses are saved, preparing the ground for countercyclical policies in years when cows are lean.

Furthermore, a sound structural budget has also reduced the volatility of interest rates and made Chile's debt more credible. Larrain points out that "Last September, in the midst of uncertainty in international markets, in the United States we issued US$1.35 billion in 10-year bonds at a rate of 3.35%—the lowest in history for a Latin American country."



Photo: Osmar Valdebenito/Wikimedia Commons.

Student unrest is making visible the demand for improvements in the quality of public services.

The adoption of the structural budget balance made it possible to create a reserve fund for low-income pensions in 2006 and a debt stabilization fund in 2007. "Chile's international reserves are nearly US$40 billion, and the debt stabilization fund and the pension reserve fund add another US$32 billion. These are important buffers," says Peréz.

Social demands

Though healthy public finances and high national savings (24% of GDP) make for relative economic tranquility, the Piñera administration still has social challenges to deal with. "The problem is the low supply of public goods," says economist Hernán Frigolett, partner, Aserta Consultants. The demands for action are not new but they have intensified recently. The 2010 World Economic Forum ranked Chile 30th (of 139 countries) in competitiveness and 40th in infrastructure, but the country sank to 101st in education and 123rd in the quality of science and mathematics teaching. "In public universities, average monthly tuition is US$500, yet a family's average monthly income is only US$1,500," Frigolett says. Usually families borrow to pay tuition fees, and "with interest of 7% a year plus inflation, education loans are more expensive than mortgage loans." Frigolett added, "The OECD January 2010 report points out that the poor quality of education is one of the factors that explain Chile's persistent low productivity and high income inequality."

Minister Secretary-General of Government Andrés Chadwik Piñera explains that "the 2012 budget almost doubles the number of scholarships," and "education loans with government guarantee were modified to reduce the interest rate to 2% a year, and include contingencies for periods of unemployment."

These measures will cost the government US$1.3 billion. Whether they will be effective will become apparent only in March, when students return to school—or to the streets. The student unrest is making visible the demand for improvements in the quality of public services generally, Frigolett thinks, adding, "The public health system is deficient and in need of modernization; our pensions system also excludes many people, such as informal workers."

Models for growth

The government and the opposition have begun a heated debate over tax reform to increase revenues and investment. While the government wants simply to make the tax system more efficient, the opposition argues that the tax base needs to be broadened and direct taxes—currently 18.5% of GDP—should go up.

Income tax evasion is a major problem. The OECD estimates that tax evasion costs Chile about 3% of GDP. Senator Ricardo Lagos Weber, Party for Democracy, which led the opposition in the tax debate, advocates a gradual income tax increase of 3 or 4 percentage points of GDP, though he recognizes that it is also important to curb exemptions. "With these measures," he says, "we will treat labor income the same as capital income, and we will be able to reduce direct taxes, which currently account for 60% of total tax collections."

A sound structural budget has reduced the volatility of interest rates and made Chile's debt more credible.

Finance Minister Larraín points out, however, that "the external situation is fragile, and we must have patience. We cannot have free education now. Likewise, we have to focus on tax improvements that encourage growth, investment, and good environmental practices." Chadwik Piñera says, "Around the world, the opposition asks for more than governments can offer, but we are very clear how far we can go. We grew 6% in 2011, we created more jobs than ever, and we know how to do it."

Ricardo Ffrench-Davis, former central bank chief economist now professor of economics, University of Chile, thinks that the changes the country needs go further. To reduce income inequality will only be possible with a change in the focus of macroeconomic policy—and the policy agenda—he believes. "Since the return to democracy, we have had an ambitious agenda of social reforms, which unfortunately was not directly coordinated with economic policy." The result, he says, has been a gradual decrease in Chile's growth.

These issues are likely to be factors in the 2013 presidential elections. At that point, however, both government and opposition will have to cope with a new element: changes in the electoral system, including adoption of voluntary voting, may create an unusual degree of uncertainty. That is one more reason why the administration must work to change its approval rating.

Brazil is growing old

Brazil needs to seize the opportunities offered by the current demographic bonus to mitigate future problems that will be caused by the rapidly aging population.

Solange Monteiro, Rio de Janeiro

ONE OF THE STRUCTURAL factors that enhances Brazil's growth prospects and attracts the attention of many investors is the "demographic bonus": when the balance between working people and those retired peaks to become a development booster. In Brazil, however, the current bonus will end in mid-2020. Thereafter, the growth rate of the group aged 15 to 59 will decline dramatically compared to how long the change took in other countries. France took more than a century for the number of its people who were more than 60 years to double to 14% of the total; in Brazil it will take only 20 years. By 2050, falling child mortality, longer life expectancy, and a declining birth rate will cause the percentage of elderly in the population to triple.

This scenario is beginning to attract attention. The reason is clear: unlike developed countries, which managed to become rich before they grew old, Brazil will grow older before it gets rich. The change in demographic profile poses a risk to fiscal sustainability and could eventually become a drag on economic growth. A World Bank study

Pensions and health expenditures of the population over 60 years are expected to increase substantially

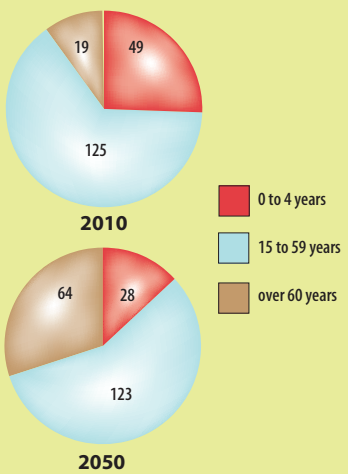
(Billions of reais at 2010 prices)

	Pensions	Health
2010	24	41
2030	50	148
2050	79	405

Source: Paulo Tafner estimates.

Brazil is getting older

(population in millions)



Source: Paulo Tafner estimates.

conducted by Paulo Tafner, an economist at the Institute of Applied Economic Research, has calculated the impact of demographic change on the public budget and found that "If social security pensions continue to be raised according to changes in the minimum wage, public spending will increase to 17% of GDP from the current 11%. In the case of health, investments to take care of an older population will reach 7% of GDP compared to the current 4%." To make up for the demographic shock, Tafner says, Brazil will need to grow 3.5% a year, "but this is unlikely to happen because in the last 35 years, the average was 3.25%."

Adjustments

So that the country does not leap directly from its current euphoria to depression, Tafner underscores the need for immediate reforms, especially to social security. "It is necessary to decouple social security pensions from increases in the minimum wage and establish a minimum retirement age," he says. These reforms would not only reduce pressures on public spending, they should also induce young people to save more for their retirement.

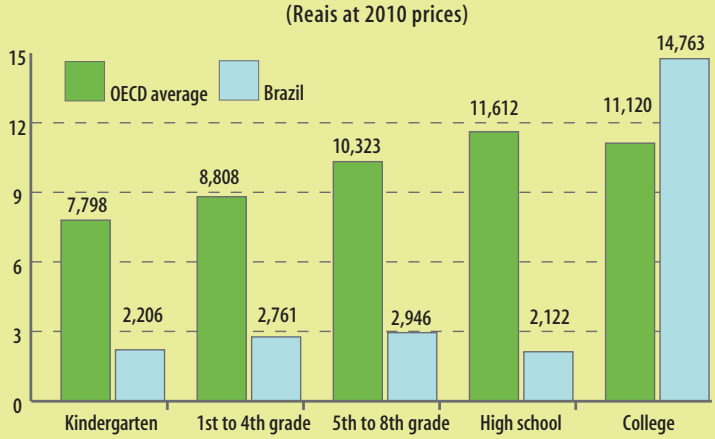
> By 2050, falling child mortality, longer life expectancy, and a declining birth rate will cause the percentage of elderly in the population to triple.

Tafner cautions that a reduction in the number of young people should not mean less focus on education. "We spend more than the Organization for Economic Cooperation and Development average on college education, but we must increase investments in basic education. We need to ensure that enrollment in high school is at least 75% of the OECD countries," he says, and emphasizes the importance of improving the quality of basic education as well as high school. He points out that investment in education will ensure that the productivity of the working population increases enough to pay the additional costs resulting from an aging population.

In the book *Growing Old in an Older Brazil*, the World Bank also makes it clear that older workers mean that the health system must be reorganized to adapt to the epidemiological profile of this group. Prevention of disease and improvements in basic education (which is fundamental for later schooling to be successful) are investments that must be initiated to make sure that Brazilians remain active, and productive, longer.

Expenditure per student

(Reais at 2010 prices)



Source: Paulo Tafner estimates.

Should we celebrate the interest rate slide?

Samuel Pessoa
Consultant to IBRE

A MAJOR ANOMALY in the Brazilian economy in recent decades has been Brazil's very high domestic interest rates. Yet, inexplicably, even with interest rates high, Brazil has also lived with relatively persistent high inflation since hyperinflation ended in 1994: in the last 10 years, inflation has averaged 6.4% a year.

Now, the big news is that Brazil's real interest rate (adjusted for inflation) seems to be finally approaching values that are more consistent with those in the rest of the world.

Until May 2007, domestic real interest rates mainly fell because the Brazil risk had been lowered, thanks primarily to the successful political transition in 2003 and the recognition by international markets—and Brazilians—that the elected government, though leftist, was committed to respecting contracts and being financially responsible. Accordingly, in mid-2007 Brazil risk, as measured by the Emerging Markets Bond Index spread over US treasury bonds, narrowed to less than 150 basis points (1.5 percentage points) from 960 (9.6 points) in mid-2003. Thereafter, however, the main determinant of high domestic interest rates was the excess of investment over savings. The recent change does not mean that the external sector has ceased to affect the domestic interest rate, but now it does so primarily through changes in the exchange rate and the prices of international tradable goods on the National Consumer's Price Index.

Until May 2007, domestic real interest rates mainly fell because the Brazil risk had been lowered, thanks to the successful political transition in 2003 and the recognition that the elected leftist government was committed to respecting contracts and being financially responsible.

From 2004 through 2008, prices of tradables in foreign markets were high. Thus, both domestic and international demand for Brazilian manufactured goods was buoyant. Investment, in turn, grew

faster than savings. On the other hand, the policy of transfers to the poor—family grants, increases in the minimum wage, generous social security benefits—meant that higher growth did not lead to higher savings. All these factors interacting pushed up the domestic interest rate.

The global crisis of 2008 and 2009 changed that process. Because growth in developed countries did not resume, there was a surplus of manufactured goods pressing down on the price of tradables in international markets. Brazil has thus had to absorb substantial disinflationary pressure.

Brazilian industry has stopped growing because of the increased international competition in manufactures. Today industrial output is 3.4% below what it was as recently as March 2010. Part of the recent decline in interest rates is therefore a result of the greater international supply and thus the lower prices of manufactured goods.

More importantly, the decline in investments associated with a fall in total factor productivity (TFP) may have helped bring down interest rates. For instance, the decline in TFP is reducing demand for investment; since the third quarter of 2010, investment has been falling. Savings have also fallen, but less than investment.

If it is falling productivity that is bringing down the real interest rate, that certainly makes celebration of this landmark event questionable.

Between 2004 to 2008, investment grew faster than savings; today the opposite is occurring.

Although reducing the gap between savings and investment is good news, the fact that the reduction in investment is caused by low TFP is very bad news. Brazil is now at risk of making the unpleasant discovery that the long- awaited reduction in real interest rates is at last happening, but only because economic growth is being suppressed by declining productivity. If it is falling productivity that is bringing down the real interest rate, that certainly makes celebration of this landmark event questionable.

The causes of the decline in productivity are a separate, and far more complex, issue.

The Brazilian economy has stagnated since the third quarter of 2011 because of both low domestic investment and the fallout from the European financial crisis. Because GDP grew by only an estimate 0.7% in the second quarter of 2012, the estimate for growth in 2012 has been revised downward to 1.8%.

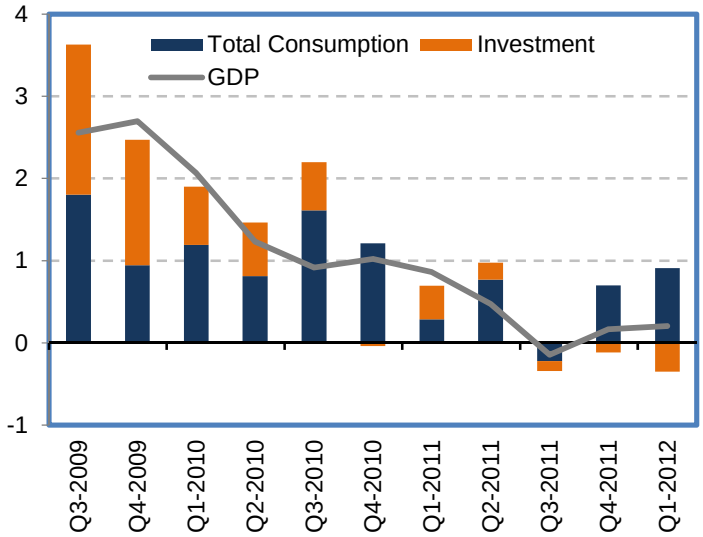
THE ECONOMY IS still slowing, though the IBRE Indicator of Economic Activity suggests there was an acceleration in activity in the second quarter. Our preliminary projection for second-quarter GDP growth is 0.7%, following growth of 0.2% in the first quarter. This considerably reduces the GDP forecast for this year, down from 3.0% to 1.8%. 2013 should see more robust growth of 3.8%.

It is worth pointing out that the contribution of physical investment to GDP growth has been declining compared to the contribution of government and household consumption since early 2010. Investment should increase by only 0.4% in 2012; household consumption (3.2%) and government (2.8%) will support economic growth for the rest of the year.

With the significant decline in economic activity, inflation has also subsided. However, the fall of inflation has been more intense in industrial goods than in services. Inflation in 2012 is projected to decline to 4.9%, but as the economy resumes growing, inflationary pressures will return, bringing inflation up to 5.3% in 2013.

The central bank will continue its monetary easing, and the policy interest rate will drop from the current 8.5% to 7.5% in August, but we see a gradual increase to 9.0% over the next year in response to inflationary pressures.

Investment contribution to growth has declined.
(% change)



Risks

As yet there is no definitive solution in sight for the European financial crisis. The risks associated with the deleveraging of the high debt burdens in developed countries remain high, and are one reason that investment flows into emerging countries like Brazil have moderated. The confidence of both international investors and Brazilian businesspeople has worsened significantly.

Also, Brazil's economy has serious structural imbalances. The acute slowdown in investment associated with both the adverse international picture and the domestic business climate has negative implications for the future growth of production capacity. If growth resumes based on domestic consumer demand without any increase in supply capacity the structural imbalances will deepen and lower potential growth.

Brazil: Revised economic outlook, 2012-2013

	2011	2012 Proj.	2012 Rev. proj.	2013 Proj.
Real GDP growth (% change)	2.7	**3.0**	**1.8**	**3.8**
Inflation (% change)	6.5	**5.1**	**4.9**	**5.3**
Central Bank benchmark rate (end-period, %)	11.00	**9.50**	**7.50**	**9.00**
Exchange rate (average, Reais per U.S. dollar)	1.7	**1.8**	**1.9**	**1.9**
Budget primary surplus (% of GDP)	3.2	**2.5**	**2.6**	**3.2**
External current account balance (% of GDP)	-2.1	**-2.8**	**-2.6**	**-2.8**
Trade balance (US$ billions)	29.8	**14.1**	**20.1**	**18.7**
Export growth (% change)	26.8	**2.9**	**1.5**	**8.3**

Source: IBRE staff estimates and projections.