THE BRAZILIAN ECONOMY

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Latin America: Growing in different directions

Foreign policy
South America: Too many regional institutions, too little integration.

IBRE Economic Outlook
The possibility of Brasil's growth softening rises as the outlook for the global economy worsens and domestic industry stalls.

Interview
Henrique Meirelles:
"Always focus on results"

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The BRAZILIAN ECONOMY

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27 IBRE Economic Outlook

The possibility of Brazil's growth softening rises as the outlook for the global economy worsens and domestic industry stalls. The latest Composite Leading Indicators from the Organization for Economic Cooperation and Development suggest economic activity in most developed economies is cooling. The prospects for domestic industry are depressing despite various government stimulus packages and a depreciating exchange rate.

ECONOMY

Retail sales rise in April
Retail sales rose 0.8% in April compared with March, according to government statistics agency IBGE. From January to April, retail sales increased by 9.2% compared with the same period in 2011. The cut in the industrial production tax spurred sales of durable goods, mainly electric appliances, but the sector also responded positively to employment stability and income growth. (June 14)

Consumer debt defaults grow
In May Brazilian household defaults grew 6% more than in April, the third consecutive monthly increase. From January to May, defaults increased by 20% compared to the same period in 2011. Defaults on consumer loans reached 8% of total loans, while delinquency on corporate loans remained at 4%. (June 26)

Jobless rate drops suddenly
Brazil's jobless rate fell to 5.8% in May from 6.0% in April—the lowest rate on record for May. Wages adjusted for inflation fell 0.1% month-on-month to R$1,725 (US$850), but that was 4.9% higher than in May 2011. (June 21)

Consumer confidence in Brazil's economy sinking
Brazilian consumer confidence waned in June and analysts chopped forecasts for economic growth as indebted households and risk-wary investors stayed cautious despite government stimulus measures. The FGV consumer confidence index slumped 2.8% in June, with household expectations worsening over the next six months. (June 25)

Moody's downgrades eight Brazilian banks
Downgraded were subsidiaries of Santander, HSBC, and ING banks and local banks Bradesco, Banco do Brasil, Itaú-Unibanco, Banco Safra, Votorantim, and the exchange operator BM&F Bovespa. Moody's aligned their ratings with the rating on government bonds (investment grade Baa2) because the banks were at risk of a government debt crisis given their high exposure to government debt. (June 28)

Industrial production falls
Industrial production fell 0.9% month-on-month in May, after dropping 0.4% in April. From January to May production declined 3.4% compared with a year earlier. (July 3)

Inflows of foreign exchange still subdued
Foreign exchange net inflows for June totaled US$0.3 billion (with a net trade outflow of US$1.0 billion and a financial inflow of US$1.3 billion). Net inflows were US$23 billion in the first half of the year, 41% less than for the same period in 2011. (July 4)

June inflation lowest in two years
Brazil's official IPCA consumer price index rose just 0.08% in June; 12-month inflation through June was 4.92 percent, the slowest pace since September 2010. Easing inflation has given the central bank room to slash its benchmark interest rate. (July 6)

LATIN AMERICA

Venezuela accepted into Mercosur
The presidents of Argentina, Brazil, and Uruguay agreed to make oil-rich Venezuela the fifth full member of the common market. However, the decision came after Paraguay was temporarily suspended, raising questions about its timing and legality. Mercosur rules require that such decisions be unanimous, and Paraguay's senate has long objected to Venezuela's membership. Uruguay's Foreign Minister Luis Almagro said his country only agreed after intervention by Brazilian President Rousseff. Despite objections from Paraguay and Uruguay, the agreement is expected to be signed July 31 at Mercosur's next meeting in Rio de Janeiro. (June 30)

SOCIETY

Fewer Catholics in Brazil
The Catholic religion lost 1.7 million supporters between 2000 and 2010, bringing its members to 123.3 million — 65% of the population, down from 90% in 1970. Over the past 10 years evangelical religions have attracted 16.1 million faithful, for a total of 42.3 million (22% of the population). (June 30)

TRADE

Brazil and China agree on trade issues

Brazil and China have signed several trade agreements to boost mutual investment and trade flows in the next 10 years. China is Brazil's biggest export market, and Brazilian officials hailed the accord as critical to the country's growth. Relations between the nations will rise to the status of a "global strategic partnership," highlighting the growing influence of both in the global economy and a cooling of previous tensions. Since Rousseff took office in 2011, Brazilian officials have complained of Chinese barriers to Brazilian manufactures, and China has complained that Brazil raised taxes on Chinese-made cars to protect its car assembly industry, dominated by U.S., European, and Japanese automakers. (June 21)



Photo: Fabio Rodrigues Pozzebom/ABr.

Brazil's President Dilma Rousseff (left) and China's Prime Minister Wen Jiabao sign trade agreements.

Exports down to Mercosur, up to the U.S.

From January to May, Brazil sold 10% less to Argentina, Paraguay, and Uruguay than in the same period in 2011, even though the region is a leading importer of Brazilian manufactures. Meanwhile, Europe cut purchases from Brazil by 5%. However, increased demand from China and the United States helped to compensate: Exports to the U.S. grew 27% in 2012, driven by a 70% increase in oil exports; there was also significant growth in exports of laminates, airplanes, cars, and transformers. (June 25)

ECONOMIC POLICY

US$10 billion in new federal credit to states

To encourage states to invest and stimulate growth, the federal government has announced, among other measures, release of a credit line of US$10 billion by the National Bank for Economic and Social Development. The states will pay subsidized rates on 20-year loans. (June 15)

Small and medium-sized banks in difficulties

Small and medium-sized banks (SMBs) are facing increased funding pressures, notably in external markets, which have been mostly closed to SMBs since the near-collapse of Panamericano Bank in 2010. The intervention of Cruzeiro do Sul Bank on June 4, has raised concerns about the reliability of financial statements of SMBs, further undermining investor confidence. (June 20)

Brazil budget surplus down on lower revenues

The government primary surplus (budget balance excluding interest payments) was R$2.6 billion in May, down from R$7.5 in May 2011, the Central Bank announced. The main reason was a decline in tax revenues. For the year, the surplus amounted to R$62.9 billion (3.55% of GDP); the 2012 primary surplus target is R$139.8 billion. (June 27)

Another stimulus package announced

In another bid to revive a struggling economy, the Rousseff administration has pledged to boost government purchases by R$6.6 billion (US$3.3 billion) and lower subsidized lending rates for companies to 5.5% from 6%. The National Bank for Social and Economic Development (BNDES), which disbursed almost twice as much in loans last year than the World Bank, is the main source of credit for Brazilian companies of all sizes. All stimulus measures so far reflect Rousseff's proclivity for state-led economic growth (perhaps emulating the Chinese model). (June 27)

Government reduces 2012 growth projection

The Rousseff administration has revised downward its growth projection of only 2% this year, similar to the financial markets, but less than the Central Bank's 2.5%. Presidential advisers think recovery is taking longer than expected because industry is not competitive and household debt is high. (July 5)

IBRE HAS ALL THE NUMBERS THAT YOU NEED FOR YOUR BUSINESS TO THRIVE

April 2011

In addition to producing and disseminating the main financial and economic indicators of Brazil, IBRE (Brazilian Institute of Economics) of Getulio Vargas Foundation provides access to its extensive databases through user licenses and consulting services according to the needs of your business.

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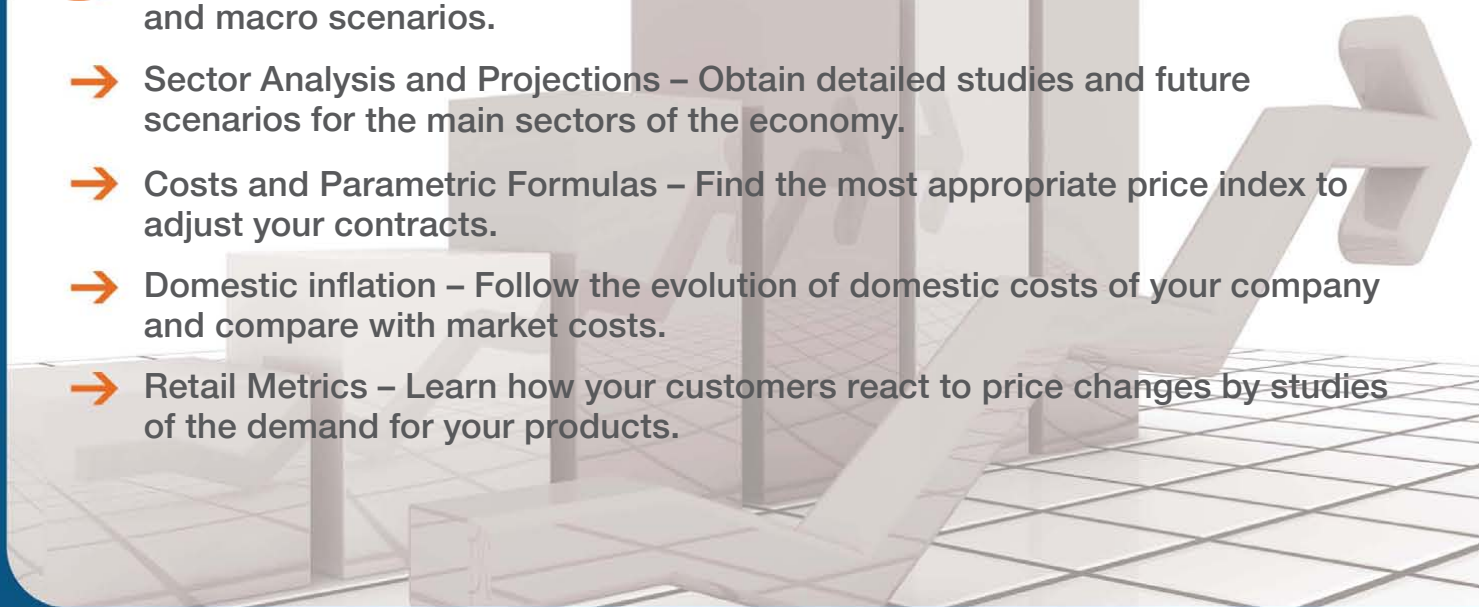

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Is Brazil learning the wrong lessons?

AFTER SEVEN NOT VERY stimulating stimulus packages, was an eighth the only option for the administration?

In 2011, well into its stream of stimulus packages, Brazil posted the lowest growth rate in Latin America. Mexico is far outpacing Brazil. One good reason for that is that when Mexico lost labor-intensive product markets to China, instead of moaning and putting up trade barriers, like Argentina (and now Brazil), it moved to diversify its industry and focus on products with higher added value—for instance, Brazil's Embraer is about to begin operations in Mexico's new aerospace cluster, joining Canada's Bombardier.

Another regional exporter of commodities, Chile, the world's largest producer of copper, has moved to insulate the public budget from cyclical economic conditions yet also to open up its economy. Chile has worked strenuously, for instance, to negotiate free trade agreements—it now has 21 agreements with 58 countries. It is also aware of the need to diversify its economy; forest products and fresh fruit are among sectors that are actively increasing their shares.

Instead of moaning and putting up trade barriers, like Argentina (and now Brazil), Mexico has moved to diversify its industry and focus on products with higher added value.

Peru meanwhile took advantage of the expansionary cycle in the last decade to seek more inclusive growth. Like Brazil it reduced poverty markedly; unlike Brazil it made itself much more competitive by protecting property rights and allowing foreign investors total freedom for long- and short-term capital flows.

In Colombia prudent and steady economic management and good regulation last year attracted foreign direct investment that accounted for 3.5% of GDP, compared to 2.7% for Brazil. It has many of the same problems as Brazil—social security benefits linked to the minimum wage that put pressure on government budgets, protectionism in the form of high import tariffs, infrastructure deficiencies, a regressive tax structure. But unlike Brazil, it seems to be recognizing the problems; also it has managed to mitigate the stigma of violence and drug trafficking, which suggests it can manage its other problems equally well.

That leaves Argentina, the least successful economy in the region. Argentina, like Bolivia, Ecuador, and Venezuela, is following the old, tired Latin American policy of populist spending for political patronage rather than investment. And every time Argentina puts up a trade barrier at the Brazilian border, Brazil's only response has been to put up its own.

In recent years, Brazil, like Argentina, has also increased government intervention in the economy in the mistaken belief that state-led economic growth will lead to sustainable growth. However, without addressing the underlying causes of our depressed investment and low productivity, Brazil risks stagnation.

Brazil has made great strides toward fiscal responsibility, keeping inflation low and stabilizing the economy. But that is no longer enough. Brazil must move forward, fast, to address the chronic diseases that are stunting its growth—a business climate that deters investment and a miserable quality of education. The choice is clear: regress to traditional Latin American populist policies, or advance to embrace reforms to modernize the economy.

South America: Too many regional institutions, too little integration

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

REGIONAL INSTITUTIONS are everywhere in South America's political landscape. In a continent with just 12 countries, there are at least two regional parliaments, a couple of customs unions, and one overarching intergovernmental union. Yet, despite the plethora of initiatives, most of the institutions are weak, unfinished, or both. To paraphrase an observer of Latin American diplomacy, the ability of local leaders to turn an ounce of facts into a ton of words—or, in this case, ineffective regional institutions—is impressive.

To a large extent, the main takeaway from Mercosur's summit meeting last month demonstrates how ineffective the South American bloc is when dealing with major problems. Amid deep concerns about the global economy and worries about a possible wave of protectionism in the region, leaders from South America's largest customs union focused largely on politics. The abrupt ouster of President Fernando Lugo last month prompted the suspension of Paraguay from the bloc until next year's presidential elections. Meanwhile, Hugo Chavez's Venezuela finally received unanimous support to become a full member—a process that was only possible after the temporary removal of Paraguay from the decision-making process.

The Paraguay-Venezuela swap was unfavorable to Mercosur because it sends mixed signals about the region's commitment to democratic norms. The lack of clear benchmarks to define what constitutes a coup subjects the decision to uphold the bloc's democratic clause to a highly subjective—and politically charged—decision-making process. While in theory a sudden breakdown of democratic order is easier to recognize (although even that may be questionable in Paraguay's case), the same cannot be said of a gradual process of deterioration of democratic norms, as seems to be the case in Venezuela.

But Venezuela's admittance to Mercosur will create problems beyond the political realm. Currently, every Mercosur decision requires unanimity. That includes negotiation of free trade agreements (FTAs). It is notorious that the numerous trade disputes between the bloc's two main economies, Brazil and Argentina, hamper Mercosur's capacity to negotiate with other countries. In the past few years, while other Latin American countries have succeeded in signing FTAs with the world's major economies (United States, European Union, and China), Mercosur has signed only three: with Israel, Egypt, and Palestine.

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Last month's Mercosur summit underscores the general procrastination about definitive solutions to trade disputes and a more aggressive external trade agenda.

Add a contrasting economy like Venezuela to the mix, subject to Chavez's ideological whims and with its interests mostly in the energy sector, and the bloc's cohesiveness in external negotiations is likely to diminish. In fact, this may explain why the leaders who convened in Argentina last month declared their intention to increment trade relations with China without any mention of or timetable for an FTA. If this is really the case, sooner or later, as Mercosur seeks horizontal expansion, it will be pushed to address the shortcomings of its vertical institutionalization.

Thus far, there is no political will to address these shortcomings. Last month's summit in Argentina fell short of any noteworthy economic measures to quell the specter of protectionism in the region. Long-standing trade disputes between member states remain unresolved. And the hurdles to regional trade are likely to get higher as protectionist measures make their way into the policy repertoire of local leaders seeking responses to the global economic crisis.

By numbers alone, Brazil's exports to Argentina have been slowing consistently in recent years, due mostly to unilateral safeguards imposed by Buenos Aires. In the first five months of 2012, Argentina absorbed less than 8% of Brazil's total exports, far below the 13% peak in 1998. Moreover, Brazil recently indicated that it may voluntarily reduce by about 30% (to US$2 billion) its trade surplus with Argentina as a way to help Buenos Aires meet its financial obligations.

In conclusion, by highlighting Mercosur's shortcomings, last month's summit underscores the general procrastination about definitive solutions to trade disputes and a more aggressive external trade agenda. As for Paraguay, its political troubles are likely to dissipate before they have any significant impact in the region, except in the unlikely event Paraguay decides to permanently abandon the bloc and seek FTAs on its own—or create yet another regional institution.

Amid growing concerns about the global economy and worries about a possible wave of protectionism in the region, leaders from South America's largest customs union focused largely on politics.



LATIN AMERICA:

GROWING IN DIFFERENT DIRECTIONS

As the world moves, slowly, past the global crisis, Latin American countries will be testing their economic strength after a decade of high growth. How successful they will be depends on where each is now.

Solange Monteiro, *Rio de Janeiro*

WITH ABUNDANT global liquidity and high demand for natural resources and agricultural commodities, the last decade was a period of growth and euphoria for Latin America. Peru, for example, despite its history of internal strife, recorded growth similar to those of Asian countries, Colombia's debt is now considered investment grade, and Brazil has attracted investor attention with a domestic market reinforced by its new middle class.

In the next decade, however, the external environment is likely to be more volatile and less favorable to growth. This issue looks into the policy challenges for Latin America that will be discussed on August 9–10 at a seminar organized by the Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation. We focus on six economies: Brazil, Argentina, Chile, Peru, Colombia, and Mexico.

In the short term, analysts do not see great turmoil in the region. "In the first quarter of 2012 the region has already reduced the slowing of growth of the last quarter of 2011 and may grow 3.7% in 2012," says Juan Alberto Fuentes, director, Economic Development Division, UN Economic Commission for Latin America and the Caribbean (ECLAC). His bird's eye view of the region, however, conceals considerable variances. Mexico, which grew less in the last decade, has the best prospects now, thanks to the slow but real recovery of the U.S. economy, which accounts for 80% of its exports, and investments that stimulate the domestic market. Argentina's fate depends on whether it can correct its large fiscal deficit, which is independent of the environment. Brazil, Chile, and Peru are more vulnerable to the slowdown in China. "With its huge demand for natural resources, China . . . allowed Latin America to export enough to finance all its imports. Latin America has historically had short

cycles of growth that produced large external accounts deficits and exchange rate crises that stopped growth," says Armando Castelar, IBRE coordinator of applied economics.

To a greater or lesser extent, problems with infrastructure, training of qualified workers, and low savings are common to many countries in the region, and how they deal with them will make considerable difference to their competitiveness. "Today, Asian countries can grow at rates above 6% without problems, whereas in Latin America, growth above 4% means increasing inflation," says Tito Cordella, World Bank economist for Latin America and the Caribbean.

CHILE: A WORKING MODEL

With a domestic market of 18 million people and as the world's largest producer of copper, Chile has moved to open its economy and mitigate its vulnerability to external shocks. Today, the country monitors the international situation closely. "If some Spanish banks, such as Santander and BBVA, want to repatriate capital that could bring about a domestic liquidity problem, demanding government and central bank action," said Rodrigo Fuentes, associate professor, Institute of Economics, Catholic University of Chile. "[But] we have a solid financial system and a situation of almost full employment." Chile is expected to grow 4% to 5%, its central bank predicts; however, to do so, it will need much higher domestic demand to offset the decline of external demand.

Chile in the coming years will stick to its current model of monetary responsibility, control of inflation, fiscal discipline, and high international reserves (US$40 billion). "In the long run countries do not grow because the government spends more, because that

"Today, Asian countries can grow at rates above 6% without problems, whereas in Latin America, growth above 4% means increasing inflation."

Tito Cordella

implies the need to increase tax revenues to cover these expenses. It's like mortgaging future growth," Fuentes says.

Chile's adoption of a structural public budget balance 10 years ago insulates the public budget from cyclical economic conditions. Revenue surpluses are saved to cushion the drop in tax revenues when copper exports fall. In addition, Fuentes explains, "When you have an open economy subject to external shocks, a flexible exchange rate helps to partially insulate the economy." Chile has also been negotiating trade agreements to diversify its markets.

However, Fuentes says, "Chile's economic expansion has not been sustained by productivity growth, but by investment growth." He thinks the productivity problems are rooted in the failure of the educational system. "Our biggest problem today is basic education," he says. "To [benefit from] new technology, it is necessary to have … human capital capable of absorbing the technology."

Another risk factor is whether Chile can generate enough energy to sustain growth. The situation has worsened in the last decade with cuts in the supply of natural gas from Argentina, high oil prices (oil accounts for 43% of energy consumption), and public

New laws make Peru one of the most competitive countries in terms of securing property rights and allowing foreign investors total freedom to move their capital in and out of the country.

resistance to hydropower projects. "We need to define what our energy future will be," says Fuentes. Historically, Chile's electricity demand doubles every 10 years. "Oil-fired power plants have environmental impact, nuclear power is risky in a seismic country, and alternative sources may not be able to meet the demand."

PERU: INCLUSIVE GROWTH

Although it represents less than 5% of Latin American GDP and lower growth is expected in 2012, Peru has taken advantage of the global expansionary cycle in the last decade to seek more inclusive growth, says Claudia Cooper Fort, an economist at the Research Center of the Universidad del Pacifico in Lima. Moreover, according to the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), between 2002 and 2010, Peru reduced poverty by 23 percentage points, thanks mainly to the economic expansion. Fort points out a number of vital reforms: "New savings instruments have been set up that made it possible to reduce interest rates and finance investment on competitive terms," she says, citing as an example the pension funds, and stricter banking supervision rules. And new laws now make Peru one of the most competitive countries in terms of securing property rights and allowing foreign investors total freedom to move their capital in and out of the country.

As a result, in 2011 Peru recorded a 5% increase in foreign investment flows, which reached US$7.7 billion, well above the US$ 3.6 billion average for 2000–10. However, despite the legal guarantees offered, Peru has not overcome domestic resistance to foreign investment in mining. "We have massive Chilean and Spanish investments in sectors such as retail, real estate, and finance, for instance. When it comes to projects related to natural resources, however, we are not able to channel the regions' demands

Latin America's growth slows
(GDP growth, %)

	2008	2009	2010	2011	Projection 2012	
Argentina	6.8	0.9	9.2	8.9	3.5	
Brazil	5.2	-0.3	7.5	2.7	2.7	1.8*
Chile	3.7	-1.0	6.1	6.0	4.9	
Colombia	3.5	1.7	4.0	5.9	4.5	
Mexico	1.2	-6.3	5.6	3.9	4.0	
Peru	9.8	0.9	8.8	6.9	5.7	

Source: ECLAC. *IBRE latest projection.

BG BRASIL



Long-term commitment to the development of Brazil

BG Brasil is part of BG Group, an integrated natural gas company operating in the exploration and production of hydrocarbons in over 25 countries. The company also invests in the Bolivia-Brazil gas pipeline.

Active in Brazil since 1994, BG Brasil has a long-term commitment to the country and a multi-billion dollar programme for the pre-salt. Its deepwater drilling programme in the Santos Basin boasts a high success rate, where the company participates in five blocks. BG Brasil has invested over US$5 billion in the country.

Among BG Brasil's priorities are education and human capital development, great contributors of a knowledge-based economy. The company's sustainability strategy is focused on technology, social investment, local content, environment and safety – pillars that are closely aligned with Brazil's national interests.

www.bg-group.com/brasil

With the reduction of violence in rural areas, investors, some of them Brazilian, have begun to buy large tracts of land in Colombia.

and resolve them in Congress," says Fort. That is why a proposed US-Peruvian US$4.8 billion investment in copper exploration in Cajamarca has been stalled since last November. Fort also points out that "We have resources in the public budget for infrastructure investment, but we cannot channel it cost-effectively because local governments lack capacity."

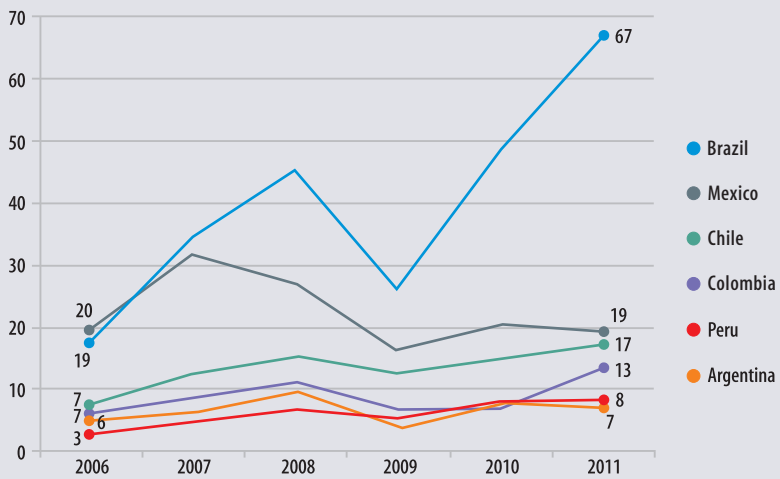
Despite prudent economic management and high reserves, Fort warns that the Peruvian economy must prepare for the effects of a possible fall in copper prices, such as a slowdown in new mining projects because of the perception of reduced external demand, and less tax revenue. "To mitigate the fall in tax collections, the first step is to encourage Peru's underground productive sector to join the formal economy," says Fort—informal activities represent 60% of Peruvian GDP. Reducing the informal sector would increase tax collections.

COLOMBIA: THE COMPETITIVE ISSUE

Reducing the informal sector is also important in Colombia. "While in Peru informality in the labor market is a historical feature, here it has surged over the past 20 years and now exceeds 60%," says Roberto Steiner, research associate and former director, Foundation for Higher Education and Development. Also, rises in the minimum wage (now about US$320/year) have not been followed by higher labor productivity. And Steiner adds that "As in Brazil, social security benefits are linked to the minimum wage, putting

Latin America became more attractive to foreign investment

(US$ billion)



Source: ECLAC.

pressure on the public budget."

Steiner believes that the Colombian economy could become more dynamic if the tax structure were changed. In addition to reducing the social security tax on labor, the economist argues for changes in two main taxes, the VAT (value-added tax) and the income tax, to prevent tax evasion, ensure progressivity, and distribute taxation more equally between individuals and businesses. Moreover, he adds, "Inheritance is punished, pushing Colombians to accumulate assets abroad and discouraging companies to capitalize, which has a direct negative impact on growth."

"Colombia has managed to mitigate the stigma of violence and drug trafficking with good public policies to attract investment," Steiner says. Prudent and steady economic management and good regulation have shown results in the main exporting sectors, oil and coal. In the last decade, foreign direct investment accounted for 3.5% of GDP, against 2.7% in Brazil, for example. The valuation of commodities, as in other countries in the region, also made a big difference: while the volume of Colombian exports increased by 56% between 2000 and 2009, export receipts rose by 133%.

However, Colombia still has a high degree of protection compared to its neighbors. Average import tariffs exceeded 9% from 2000 through 2009. "Hence the importance of trade agreements," says Steiner, highlighting the need for reducing protection, especially for agriculture. "In Colombia, over the last ten years while the economy grew on average 5% a year, agricultural GDP did not reach 2%," he says. Beyond coffee, Steiner believes, "We can quadruple the acreage without touching the rainforest, and supply external demand for tropical fruits, vegetables, and other products, where we have comparative advantages." With the reduction of violence in rural areas, investors, some of them Brazilian, have begun to buy large tracts of land there.

When it lost labor-intensive products to China, Mexico began to focus its industry on products with higher added value.

However, in addition to overcoming its infrastructure deficits, Colombia must also mitigate the effects of a paradoxical situation: although it has access to two oceans, 80% of its GDP is concentrated in three cities at 1,500 meters elevation, far away from the coast. "To take a container from Bogotá to Bonaventure port on the Pacific costs more than to get it from Bonaventure to China," Steiner notes.

MEXICO: OUTLOOK SUNNY

Mexico was the Latin American country that profited least from the commodities boom and high growth. However, that lower exposure to commodities now means that the country is among those best positioned to grow in the next decade. Last year, Mexico's growth surpassed Brazil and ECLAC's Fuentes estimates that Mexico will grow 4% this year, from heightened domestic demand as well as exports.

After a painful transition to an open economy, which saw the entry of China into the WTO and the loss of Mexico's share in the U.S. market, today the gradual recovery of the U.S. economy has increased demand for Mexican products while the restructuring of the Chinese economy makes Chinese

While Chile, Peru, Colombia, and Mexico have based their growth on an open economy, Argentina has done the opposite.

exports less competitive in the United States. Although the U.S. economy will remain fragile for some time, Manuel Molano, deputy director general, Mexican Institute for Competitiveness (Imco), expects Mexico's external trade to improve. "The adoption of a free-floating exchange rate since 1994 has given us a completely different dynamic from the Chinese," he says, noting that the Chinese artificially devalued exchange rate is not sustainable.

Latin America's productivity has grown more slowly than Asia's

(Total factor productivity average growth, %)

	1981-90	1991-2000	2001-08
Argentina	-2.5	2.0	1.4
Brazil	-3.3	-1.7	0.5
Chile	-0.5	2.9	0.5
Colombia	-1.3	0	1.3
Mexico	-0.9	-1.6	0.3
Peru	-3.8	0.5	2.9
Venezuela	-1.6	-0.5	0.2
Korea	3.6	1.4	1.9
Singapore	1.7	2.9	2.6
China	1.6	3.4	6.2

Source: World Bank.

Molano notes that, when it lost labor-intensive products to China, Mexico began to focus on products with higher added value, such as the automotive sector, which last year exported US$2 billion. He points to the growth of an aerospace cluster in Querétaro, where Canada's Bombardier is already in operation and Brazil's Embraer is expected. A fall in the productivity of Pemex, the state oil company, has also helped change Mexico's export profile, Molano points out: "The composition of Mexican exports in 1980 was like Russia's today: oil accounted for 70% of total exports and non-oil exports were in general low value added. Today oil exports are 15% of the total, and non-oil exports are increasingly more value-added."

But José Gerardo Traslosheros, Mexican consul general in São Paulo city, sees some competitiveness problems: like Brazil, he says, "We need a more flexible labor market, upgraded infrastructure, and better training to increase the number of skilled workers." In this area Molano cited the lack of controls on spending by states and municipalities, where tax revenues are low, making them highly dependent on Pemex. Before the 1970s, Molano said, "Tax collection was very similar to Brazil, with taxes differentiated by region. Now the federal government collects most of the taxes and distributes them to the states … The biggest problem is that state governors spend irresponsibly." Tax reform to mitigate the damage is unlikely: any change demands a majority in Congress or wisdom among legislators.

The biggest factor weighing on public finances is pension liabilities, which Molano believes already exceed 104% of GDP and are growing at an estimated 16% a year. This will create serious problems in the next 30 or 40 years. Also, he says, "We have high

savings that exceed 20% of GDP, but we are investing in businesses with low yields. … We should focus efforts on increasing productivity."

ARGENTINA: WHAT NOT TO DO

While Chile, Peru, Colombia, and Mexico have based their growth on an open economy, Argentina has done the opposite. Enduring high inflation, large fiscal deficits, restrictions on external financing, and protectionist trade policy, the country has not taken advantage of favorable commodity prices to create a robust model of growth.

"The Argentine model is taking on water," says Samuel Pessoa, consultant to the IBRE. Argentine's growth has been intense and prolonged because of the reforms of President Carlos Menem (1989–99), the high price of soybeans, and fiscal discipline until the 2008 crisis. Menem had carried out a wave of privatizations and introduced profound reforms of the labor market, social security, and taxation, but at the time, Pessoa says, the reforms were not successful because the exchange rate was fixed. When in the 1990s Latin America was hit by unfavorable export and import prices, Argentina's terms of trade fell by 28%, which was extremely difficult to accommodate with a fixed exchange rate. The Menem reforms only began to bear fruit during the Kirchner administration.

Daniel Artana, chief economist, Latin American Economic Research Foundation, says that after the 2008 crisis, the Argentine government abandoned fiscal prudence. Because of populist energy subsidies, he says, "the government has absolutely destroyed the [energy sector] fortress … The result is an external trade deficit of US$3 billion in the energy sector compared with a surplus of 2% of GDP for the previous decade."

"Argentina has no more room to offset one inconsistent policy by creating another. To some extent, Brazil's economy is moving toward this pattern of economic policy, though more gradually."

Samuel Pessoa

Today, given fiscal deterioration and the subsidy policy, which was extended to other utilities to contain rising inflation, is unsustainable. "With the depreciated exchange rate, drought, and the economic downturn in Brazil," Artana says, "a recession is very likely. With inflation above 20%, we are in a difficult situation."

Latin American countries are among the least competitive.

(competitiveness ranging, best=1)

	2011	2012
Hong Kong	1	1
Singapore	3	4
Korea	22	22
Chile	25	28
Mexico	38	37
Peru	43	44
Brazil	44	46
Colombia	46	52
Argentina	54	55

Source: IMD World Competitiveness Yearbook 2012.

In the short term, the only option for the Kirchner administration would be a spending shock, cutting subsidies and improving the budget balance. With the president's popularity plummeting as the economy deteriorates, allegations of corruption, and measures to restrict the supply of dollars, drastic and unpopular measures are probably not on the agenda. "Argentina has no more room to offset one inconsistent policy by creating another. To some extent, Brazil's economy is moving toward this pattern of economic policy, though more gradually," Pessoa warns.

As for the medium term, Artana lists the need for Argentina to attract foreign investment, eliminating the negative marks left by the nationalization of oil company YPF, and to increase productivity. "Currently, Argentina is carrying out the protectionist policies of the 1950s," he says, referring to trade barriers to imports to contain the trade deficit and the 5% tax levied on industrial exports since 2002. British consultancy Capital Economics reports that between 2009 and 2011, Argentina recorded 130 episodes of trade protectionism. This is one reason why analysts are forecasting lower growth for Argentina than for Peru and Colombia. And because "Argentina's economy is 20% of the size of Brazil's, we cannot achieve any scale [of production] from just the domestic market," Artana says.

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Brazil: Growth is elusive

Claudio Accioli, *Rio de Janeiro*

ANOINTED AS THE development front-runner for the hemisphere, Brazil has not lived up to its promise—last year it posted the lowest growth in Latin America. Since 2009 an increasingly worried Brazilian government has come up with eight economic packages to try to turn the situation around. They do not seem to be working.

Investment and productivity

Armando Castelar and Regis Bonelli, IBRE researchers, warn of problems associated with the administration's recent strategy of stimulating domestic demand well above the economy's capacity, covering the gap through imports. What made it possible so far for Brazil to pay for those imports were rising prices for its commodities and heavy demand from China. Today export prospects are no longer favorable. Castelar believes that to get the economy to grow, Brazil will have to invest more, and become more productive.

This is where the country's problems begin. In recent decades investments in Brazil have been a minimal 20% of GDP. "The government invests little and has little implementation capacity; businesspeople do not invest because of the uncertainty that still surrounds the world economy and the unfavorable business environment in Brazil," says Bonelli.

Castelar adds that Brazil needs to raise the current level of investment in infrastructure from 2.3% of GDP to at least 4.0%. Government needs not only to invest itself but to foster investment through concessions to the private sector, public-private partnerships, more helpful and cost-effective regulation, and faster action in areas like environmental licenses. "There have been isolated initiatives, but nothing commensurate with our needs," says Castelar. "There has been resistance from the current and the previous government to expand the role of the private sector in infrastructure," Bonelli notes.

Poor business climate

"Brazil is ranked as one of the worst business climates in the world with regard to size and complexity of taxes, poor infrastructure, complex bureaucracy, and legal risk," Castelar points out. To make matters worse, the government distributes benefits arbitrarily to some sectors and ignores others.

Labor productivity is also not encouraging, Bonelli says, noting that it has fallen in recent years. As population growth declines, the workforce will no longer expand, and neither will GDP growth. So it is even more relevant to make labor more productive; the best way to do that would be to improve the quality of education.

The economists agree that recent stimulus measures will not be very effective. "One cannot continue to expand credit for consumption indefinitely without compromising the financial health of banks," Bonelli warns. Castelar adds that heavily-indebted Brazilian households will pay off debts rather than buy. Growth will slow, he says, noting that sales of durable goods like automobiles and electric appliances will decline because they need replacement less often.

Brazil is risking stagnation. Argentina, Bolivia, Ecuador, and Venezuela have followed traditional Latin American populist policies, increasing spending for political patronage and investing little. Meanwhile, Chile, Colombia, and Peru have been modernizing, improving the business climate, keeping inflation low, and stabilizing their economies. Brazil seems to be heading toward the wrong end of the spectrum.

"Always focus on Results"



Henrique Meirelles

Chairman of the Board of Directors of J & F, and former central bank governor

Claudio Accioli, São Paulo

HENRIQUE MEIRELLES appreciates challenges. After building a solid career in finance, culminating in the presidency of Bank of Boston in the U.S., he returned to Brazil in 2002 to take up politics. He was elected representative for the state of Goiás but chose instead to accept appointment by new President Lula as head of the central bank, although he was affiliated with the PSDB, which had just lost the election, and there was much concern about the economic policy of the new government. He served throughout Lula's two terms, becoming the longest-serving central bank governor and enhancing the bank's credibility. He then assumed the presidency on the board of directors of J & F, one of the world's largest food processors. Although he warns about the dangers of financial collapse in Eurozone countries and is concerned about indebtedness in some sectors of the Brazilian economy, he remains optimistic: "We will not return to the time of crisis."

***The Brazilian Economy* — What led you to move from the financial to the manufacturing sector?**

Henrique Meirelles — What was missing in my career was working directly in the productive sector, in a company in the most competitive area of our economy, producing commodities from animal protein and cellulose, in the domestic consumer market with hygiene and beauty and dairy products, and in financial markets. Furthermore, it is a global conglomerate—most of its sales and production take place abroad. I am finding it a rich and interesting experience.

To what do you attribute your success as central bank governor?

I always try to focus on results. That means having a very clear definition of what the result will be and having an intense, exclusive dedication to delivering the expected result. For the Brazilian economy, the goal was stabilization. We were in monetary crisis, with inflation at times exceeding 2% per month; an exchange rate crisis, with very low and falling international reserves; and a quite severe problem of financing the

domestic debt. . . . I think this is the reason for my longevity in office: maintaining a focused, rational, objective stance so that the president had the comfort of knowing that monetary and exchange rate policies were in the right direction and delivering the results that the country expected.

Did you feel at ease politically?

I made only one campaign, which let me see Brazil from another view. The campaign exposes you to another side of the country not visible from large cities or markets. It was a very important experience for me to have a better understanding of reality and politics in Brazil. Once in government I tried to maintain an open dialogue with peace of mind to listen and consider everyone's opinions, but with absolute firmness as to the objectives, so that, over time, the results began to speak for themselves. Even the staunchest opponents have begun to recognize that the policy was working, that Brazil was growing, creating jobs. In short, I tried to prevail by results and professional conduct, not by political alliances.

Under your management, the central bank's benchmark interest rate was among the highest in the world. Now, the interest rate is declining to international levels. What are your views on these two different periods?

First of all, I have chosen not to comment on the management of my successors, which is a good practice among central bankers. But without making comparisons, I can say that the real interest rate in Brazil has been falling consistently since 2003. At that time, the benchmark rate was 25% a year; it went up to 26.5% but then we brought it down to 8.75%, which was a record low. Then we again increased it to 11%, and the current central bank management increased a little before starting to cut it as economic activity weakened. But . . . despite tightening and loosening cycles of monetary policy, the trend has been downward since 2003. Risk premiums have declined and credit and maturities increased, because in recent years Brazil's monetary policy has been more effective.

Despite falling interest rates and measures to stimulate consumption, Brazil still has the lowest growth among the BRICs and Latin American countries. How can this be changed?

There are several issues. Regarding credit, . . . clearly some sectors in the Brazilian economy have reached their borrowing limits. . . . The economy is recovering, but there is no doubt that structural factors are limiting growth. Domestic and external factors have contributed to growth in recent years. The external factor was the large increase in prices and volumes of commodities exports. Among the domestic factors are — what I call the stability bonus — the fall in real interest rates and expansion of credit from 22% of GDP to almost 50% today. Also, because the

[The campaign] was a very important experience for me to have a better understanding of reality and politics in Brazil.

economy is more predictable, markets expanded. Finally, the fall in unemployment from 13% per year to less than 6% now makes a difference.

But the credit expansion is reaching its limits, as we have seen, and so is the fall in unemployment. To maintain higher growth, we must increase productivity. We must address infrastructure, regulatory, bureaucracy, and fiscal issues, and most importantly education. The country has advanced in recent years with regard to increasing the number of students in various grades. The next step is to improve the quality of education.

Overall, I see balanced moderate growth for the region, with question marks about the resolution of European financial crisis and the U.S. fiscal situation.

On external growth factors, what is your view about how the euro crisis might affect the Brazilian economy?

The euro monetary union made great sense as a fiscal union followed by a political union, as was the original plan. But the Maastricht Treaty set out only [fiscal] commitments, without the corresponding sanctions [for countries that did not comply]. It was an error that had very serious consequences. It created a group of countries with a common currency but with diverse practices, cultures and labor, and fiscal and commercial policies . . . Because they have completely different inflation rates, these economies have evolved with different degrees of competitiveness, generating a crisis whose most visible component was the fiscal side, and then the financial. According to a central banker at the Federal Reserve Bank of New York, Europe has only two alternatives: either most countries leave the euro … or they go for full fiscal and political union. As a theoretical solution the latter may be very good, but the problem is the political and cultural realities.

The effects on Brazil will depend largely on the ability of our policymakers and the European Central Bank to prevent a collapse of the European financial system, because this is the great watershed. . . . If the European financial system continues to function normally, the impact on the Brazilian economy will occur mainly through reduced trade flows and investments from Europe, repatriation of capital, and cuts in lines of credit from European banks, which are already happening. … Brazil has a strong domestic consumer market, high international reserves, a relatively low net public debt-to-GDP ratio, and a healthy financial system, with high reserve requirements. Brazil has been able to cope successfully, as we did in 2008.

Will the U.S. economy resume the role of global growth engine? What about China?

The United States is experiencing a process of moderate recovery, with high unemployment and household indebtedness, corporations less leveraged and more productive and profitable, and a housing market that is beginning to show signs of recovery. The recovery was based entirely

on the Federal Reserve monetary stimulus. What is generating pessimism is the great uncertainty surrounding the likely fiscal situation at the end of the year. A general increase in taxes would bring about a contraction of the American economy in 2013. That is a risk, but there is not likely to be any resolution before the election . . . But I believe that the U.S. will solve this equation and resume moderate growth. In China's case, its export model has reached its limits because of low demand from the United States and Europe, the biggest buyers of Chinese products. China is now facing the enormous challenge of changing from export-led growth to a domestic consumption-led model, as a large part of the population has low income . . . China is likely to grow less in the coming years.

The real interest rate in Brazil has been falling consistently since 2003.

How do you assess the prospects for Latin America?

The changes taking place in the U.S. and China will have different effects across Latin American countries. As Mexico is a major exporter of manufactured goods to the United States and its major competitor is China, recent developments greatly improve its prospects. With the gradual recovery, the U.S. economy will demand more Mexican products, while the transformation of the Chinese economy will make its manufactures less competitive . . . In other Latin American countries, mineral commodities exporters will suffer more, mainly because of the decline of the construction industry in China. More diversified commodity producers, like Brazil, will be less affected because the demand for food is expected to remain strong in China and other Asian countries. Overall, I see balanced moderate growth for the region, with question marks about the resolution of the European financial crisis and the U.S. fiscal situation.

Are you optimistic about Brazil?

Yes, I think Brazil has significant challenges in terms of productivity, but the country will not return to the crises and high volatility of growth that we lived through for several decades. The economic fundamentals are very solid, the domestic market is large, and income distribution less unequal. We have much more capacity to stabilize growth.

But the credit expansion is reaching its limits, as we have seen, and so is the fall in unemployment. To maintain higher growth, we now must increase productivity.

Latin America: Changing climate and common problems



Lia Valls Pereira , *Rio de Janeiro*

IN 2009 the gross domestic product (GDP) of Latin America as a whole fell by 2%. In 2010, stimulated by Chinese demand and expansionary domestic policies, GDP in the region tripled to 6%. In 2011, a deterioration in international conditions lowered growth to 4.7%. For 2012, the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) projects an increase of 3.7%.

In the current scenario, how are the major economies of the region behaving? We will consider six major economies in terms of participation in the GDP of Latin America (current dollars, 2011): Brazil (43.7% of regional GDP); Mexico (20.3%); Argentina (7.9%); Colombia (5.9%); Chile (4.4%); and Peru (3.2%).

Every quarter the Brazilian Institute of Economics of the Getulio Vargas Foundation (IBRE / FGV), in partnership with the German institute Ifo, conducts a survey of Latin American economies. The survey monitors and anticipates economic trends based on information provided by experts in the economies covered. The Economic Climate Index (ECI) is the summary indicator, composed of the average of two qualitative questions, the Present Situation Index (ISA) and the Expectations Index (IE), which deal with the general economic situation of the country at the moment and forecast over the next six months.

The graphs show the behavior of the ECI in selected countries from July 2008 to April 2012. Results above 100 indicate a favorable evaluation and below 100 an unfavorable one.

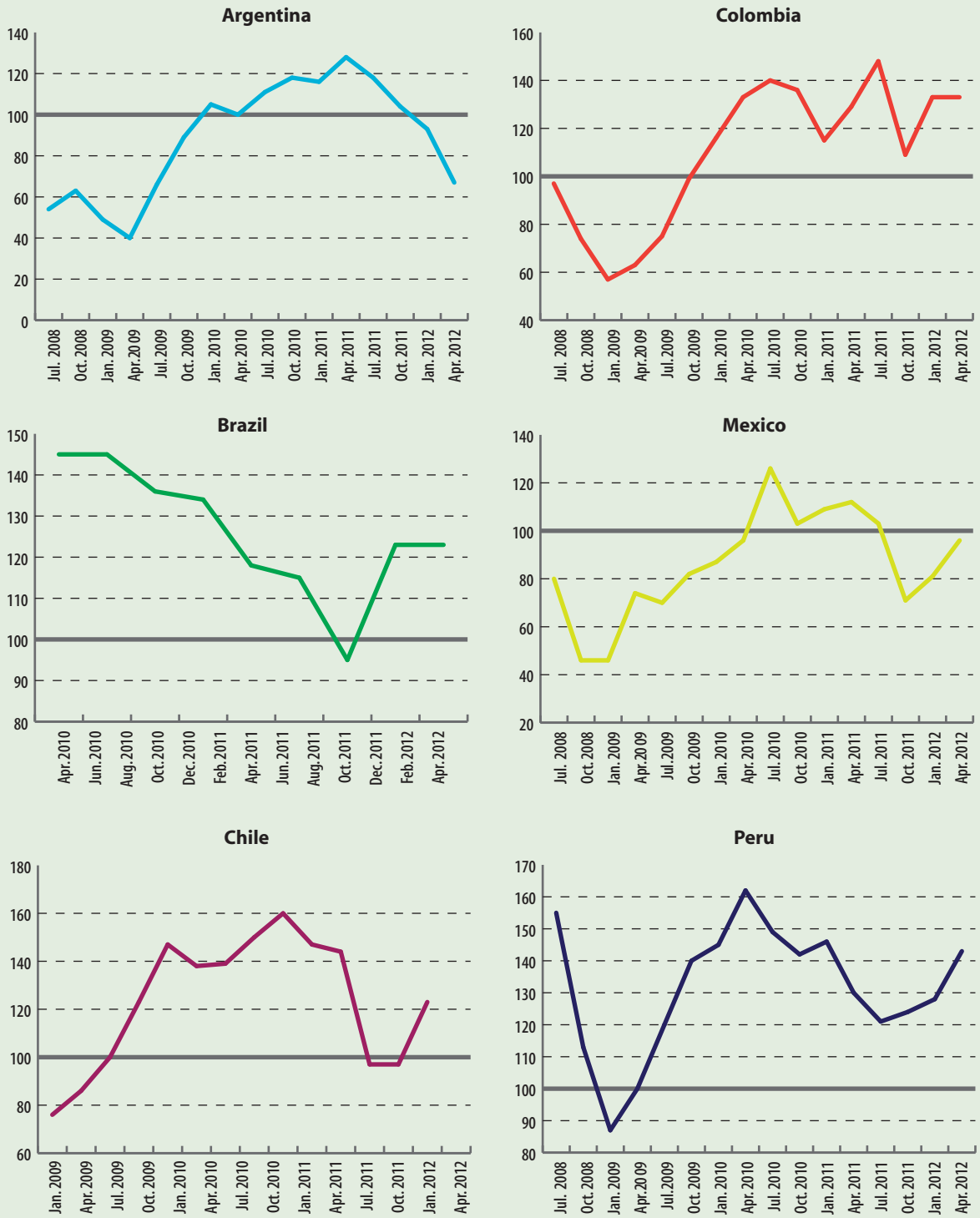
Changing climate

Brazil and Peru were those that suffered least from the 2008 crisis, although other factors may have influenced the results. Their economic climate was unfavorable only in January 2009 and was already positive again in July 2009. It took longer for Argentina and Colombia, where the economic climate was unfavorable in 2008 and become favorable only in January 2010. However, Argentina's ECI was much less favorable than Colombia's. In Chile the economic climate turned favorable in October 2009 and in Mexico in July

Coordinator, Center for External Sector Studies, IBRE

ECONOMIC CLIMATE INDEX

(Above 100 favorable climate)



Source: IBRE and Ifo institute.

2010. Since mid-2010, the ECI has been increasing for all these countries.

The most recent survey, in April 2012, shows that, except for Argentina, in all the countries about which we are concerned the ICE held steady or improved. In some countries like Brazil, more recent economic activity data shows, however, that in April the ECI was optimistic and is likely to drop in the August survey.

In April evaluation of the current situation was favorable in all countries except Brazil and Argentina. Assessment of the future situation worsened only in Argentina, held constant in Colombia, improved in Chile and Mexico (though both remain in the negative), and increased significantly in Peru and Brazil.

Common problems

As the global crisis lingers, domestic factors become more prominent in the evolution of the ECI. In the April 2011 survey, inflation and a lack of competitiveness were identified as very important problems for Brazil, while in Peru the lack of competitiveness and the scarcity of skilled labor were identified as only moderately important.

In all countries the lack of competitiveness (except in Chile) and of skilled labor (except in Argentina) were considered important. Unemployment is a major concern only in Mexico. Lack of confidence in government policy and inflation are the main issues in Argentina.

Finally, the survey underscores similarities and differences. In all countries competitiveness and education (skilled labor) need to be addressed—the agenda is the same throughout the region. But ECI trends suggest that Chile, Peru, and Colombia have a more favorable environment for growth than their neighbors.

In all countries competitiveness and education (skilled labor) need to be addressed—the agenda is the same throughout the region.



The BRAZILIAN ECONOMY

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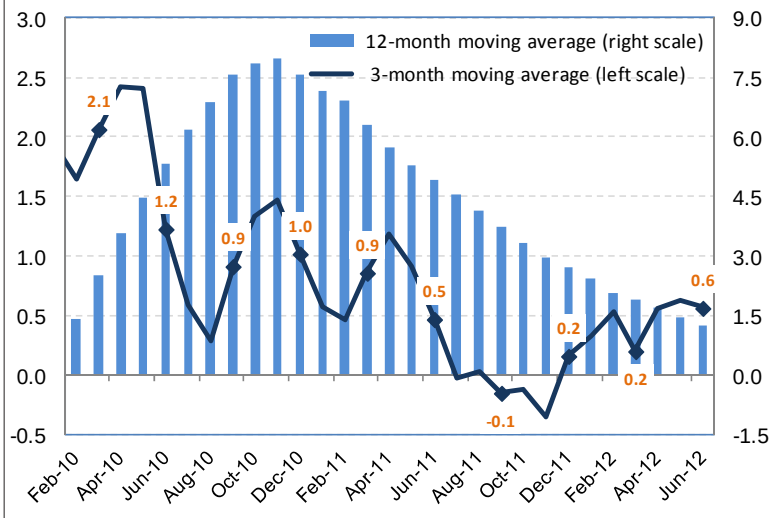
The possibility of Brazil's growth softening rises as the outlook for the global economy worsens. The latest Composite Leading Indicators from the Organization for Economic Cooperation and Development suggest economic activity in most developed economies is already cooling.

THE IBRE INDICATOR of Economic Activity predicts growth of 0.6% of GDP in the quarter ended June, three times as much as in the first quarter (0.2%). However, there is considerable uncertainty about the strength of Brazil's recovery for the rest of the year.

On the supply side, it is clear that this year the contribution of agriculture will be negative, and of industry almost as bad. Therefore, hopes turn again to the services sector. Can it add enough momentum to economic activity later this year even as demand is faltering?

On the demand side, rising household defaults and high indebtedness do not encourage consumption, even though government has cut taxes on some durable goods. Household consumption could contribute 1.5 to 1.6 percentage points to GDP growth this year, and government 0.4 to 0.5 percentage points; investment demand is expected to remain flat. So, GDP growth will depend fundamentally on the contribution of net exports—which is expected to be negative with the global economy still slowing. A growth rate of 2% of GDP in 2012 now seems ambitious.

IBRE Economic Activity Indicator, Feb. 2010- Jun. 2012
(% change over the previous period, seasonally adjusted)

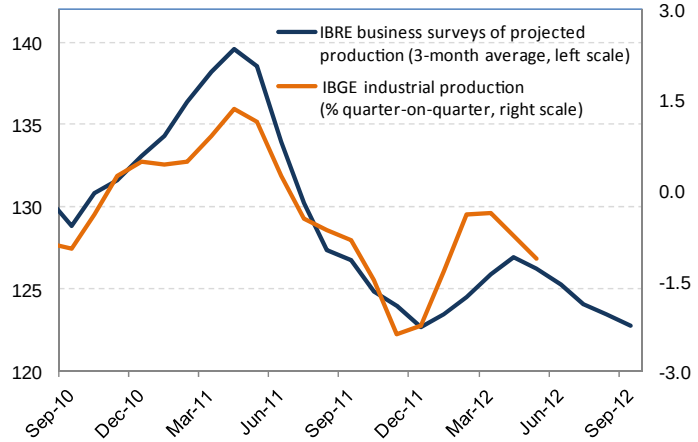


Sources: IBRE staff estimates.

Manufacturing is ailing

The results for Brazil's manufacturing industry through May and IBRE business surveys of projected industrial production through September are depressing. For the second quarter, IBRE estimates a 1.3% decline quarter-on-quarter in manufacturing production, and business surveys point to a decline in future production. Despite various government stimulus packages and a depreciating exchange rate, the underlying causes of manufacturing's lack of competitiveness and productivity remain. Brazil still ranks as one of the worst business venues in the world because of the size and complexity of taxes, poor infrastructure, complex bureaucracy, and legal risk. Labor productivity is also low due to deficiencies in the education system.

Both industrial production and business surveys of projected industrial production are declining, Sep. 2010-Sep. 2012.



Sources: IBGE data, and IBRE staff estimates.