THE BRAZILIAN ECONOMY

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IBRE Economic Outlook

Recovery continues fragile, and long neglected structural weaknesses are weighing on markets.

Interview

Arminio Fraga:

Brazil is back to a more conventional economic cycle.

Politics

Corruption and politics in Brazil

Business

Upgrading Brazil's export processing zones.



WHY INVESTMENT IS STILL TIED UP

The federal government's limited capacity to carry out investments undermines economic growth. Enter private enterprise?

GETULIO VARGAS FOUNDATION

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The BRAZILIAN ECONOMY

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Corruption and politics in Brazil

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The federal government has limited capacity to carry out investments itself and discourages the private sector with red tape. The problem is exacerbated by regular accusations of corruption that have particularly affected the Ministry of Transport. Experts interviewed by Kalinka Iaquinto and Solange Monteiro spell out how the situation undermines Brazil's ability to boost economic growth, and what it would take to bring private enterprise to bear.

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Former Central Bank Governor Arminio Fraga Neto, now head of asset management firm Gavea Investments, points out to Claudio Accioli the need for government to increase investment, especially in infrastructure; calls for more rational and less emotional debate on the reduction of bank spreads, and speaks of the fall of interest rates as a factor to induce growth and how the international financial crisis reduces Brazil's room to maneuver.

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Export processing zones have gained new momentum. Kalinka Iaquinto inquires into how in a scenario of international crisis EPZs, which have been around for quite a long time, can support an economic model based on exports, and how a proposed revision of the laws related to EPZs might bring new life to states, municipalities, parliamentarians, and businesses, and help reduce regional imbalances.

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Economic activity is still so weak that even if recovery picks up in the second half of the year, GDP growth is likely to hover around only 1.5%. Long neglected structural weaknesses are weighing on markets, leading to a more sober view of the Brazilian economy.

ECONOMY

Brazil retail sales plunge

In May, Brazilian retail sales posted their biggest monthly drop, 0.8%, since the 2008 financial crisis, eroding one of the few recent drivers of growth in a stagnating economy. Brazilian households have been struggling increasingly with record debt. (July 11)

Consumer confidence falls yet again

Consumer confidence fell in July for the third straight month as Brazilians grew increasingly dissatisfied with current economic conditions and less optimistic about the near future. Brazil's consumer confidence index fell from 123.5 in June to 121.6 in July after seasonal adjustments, private research institute the Getulio Vargas Foundation said. (July 25)

June industrial production weak

Industrial production grew just 0.2% in June compared to May. In comparison with June 2011, industry activity declined 5.5%. In the first half, the sector contracted by 3.8%. (August 1)

Trade surplus improves in July

Brazil's trade surplus grew in July after a weak June, according to the Ministry of Trade, which said the foreign-trade surplus rose to US$2.88 billion from US$807 million in June. Through July, the 2012 trade surplus was US$9.9 billion, a 38% decline from the US$16.1 billion for same period last year. (August 1)

Inflation up in July

Official inflation (IPCA) rose 0.33% in July, compared with 0.18% in June. For the last 12 months, the IPCA registered an increase of 5.24% above the previous 12 months. Most of the increase was due to food and personal expenses inflation. (August 10)

POLITICS

New anti-money laundering law

President Dilma Rousseff signed into law (Law 12.683/2012) a bill to curb money laundering in Brazil, another move in her campaign to stamp out the corruption that is slowing the country's progress. Prison sentences have been increased from three to ten years and fines drastically increased from R$200,000 to R$20 million. However, the new law fails to engage financial institutions as surveillance agents, as the U.S. and Europe do. (July 10)

Senator expelled over corruption claims

Senator Demostenes Torres has been expelled from the Senate over alleged links with a gambling ring. Torres, an independent, is only the second senator to be removed by his colleagues in the Senate's 188-year history. Police say Torres helped a detained gambling magnate obtain favors for his companies in exchange for money. (July 11)

Corruption trial starts

Brazil's Supreme Court is hearing the cases of 38 people—politicians, businesspeople, government officials, and bankers—whose charges of corruption rocked the government of then-President Lula in 2005. The defendants are accused of involvement in a scheme that used public funds for monthly payments to coalition partners to support the government's agenda. Among those accused are former leading members of Lula's Workers' Party (PT). All deny the charges. (August 2)

SOCIETY

Changing women's role

In 1960, just 17% of Brazilian women worked outside the home, among the lowest rates in Latin America; now 66% have jobs, one of the highest rates in the region. Perhaps relatedly, in 1960, Brazilian women averaged six children each; now they average 1.9, fewer than anywhere else in Latin America except Cuba. (July 1)

FOREIGN POLICY

Brazil losing influence in South America?

In an interview with the magazine *Veja*, former president Fernando Henrique Cardoso said that Brazil is rapidly losing influence in South America to Venezuela. Cardoso said that although he favored bringing Venezuela into Mercosur, "they had at least to comply with the basic requisite of adopting a common external tariff." Cardoso also warned about the dangers of protectionism emphasizing, "Argentina has an open determined protectionist tendency, which drastically erodes productivity". (July 20)



Photo: Renato Araujo/Agencia Brasil.

Former President Fernando Henrique Cardoso

ECONOMIC POLICY



Photo: Wilson Dias/Agencia Brasil.

Central Bank Governor Alexandre Tombini

Policy rates cut to a record low

As expected, the central bank cut its benchmark interest rate by 50 bps to an all-time low of 8%. The Monetary Policy Committee, its statement worded as for the previous two meetings, sees limited inflation risks due to the disinflationary forces arising from the fragile global economy. Just hours after the central bank cut, state-run banks Banco do Brasil and Caixa Economica Federal and private bank Banco Bradesco announced lower rates on loans for both individual clients and companies. (July 12)

BNDES loans up

Lending by Brazil state development bank BNDES unexpectedly rose in the first five months of the year, led by disbursements to infrastructure projects—an encouraging sign of a possible recovery in investment in Latin America's largest economy. The bank lent a total of R$44 billion (US$22 billion) from January through May, up 1 percent from January–May 2011. (July 19)

Federal tax revenues drop in June

Brazil's federal tax revenues dropped more than expected in June compared to the year before, as a stubborn economic slowdown slashed corporate profits and prompted the government to grant tax breaks to some industries. Federal tax revenues were R$81 billion (US$40 billion) in June, 6.6% less than in June 2011 when adjusted for inflation, Brazil's tax authority said. (July 24)



Photo: Jose Cruz/Agencia Brasil.

Federal public employees protest for higher wages in front of Planning Ministry in the Brazilian capital, Brasilia.

Public employee demands stymie cost-control push

A slowing economy, dwindling tax revenues, and falling demand for Brazil's commodity exports mean the government must tighten its belt, President Rousseff argues. But across the country customs workers, university professors, and myriad other federal employees are striking for salary increases worth R$92 billion (US$45 billion).The strikes are a growing headache for Rousseff at a time when she sees unexpected public spending as counter to her priority of reviving Brazil's stagnant economy. (July 26)

Decline in the budget surplus

The primary surplus (budget balance, excluding interest expenses) of the consolidated public sector (federal, state, and municipality) was R$66 billion in the first half of this year, said the Central Bank, 16% lower than the R$78 billion recorded in the first half of last year. (July 31)

IMF: Household credit growth in Brazil needs watching

Brazil's financial system is still strong, the IMF reports, but rapid credit growth to households is a risk that needs to be carefully monitored. "There are some signs of financial distress in parts of the household sector," the IMF said in its health check of Brazil's financial sector. In particular, the IMF said, there were signs of emerging strains because Brazilians have been using credit cards and bank overdrafts to finance consumption. (July 31)

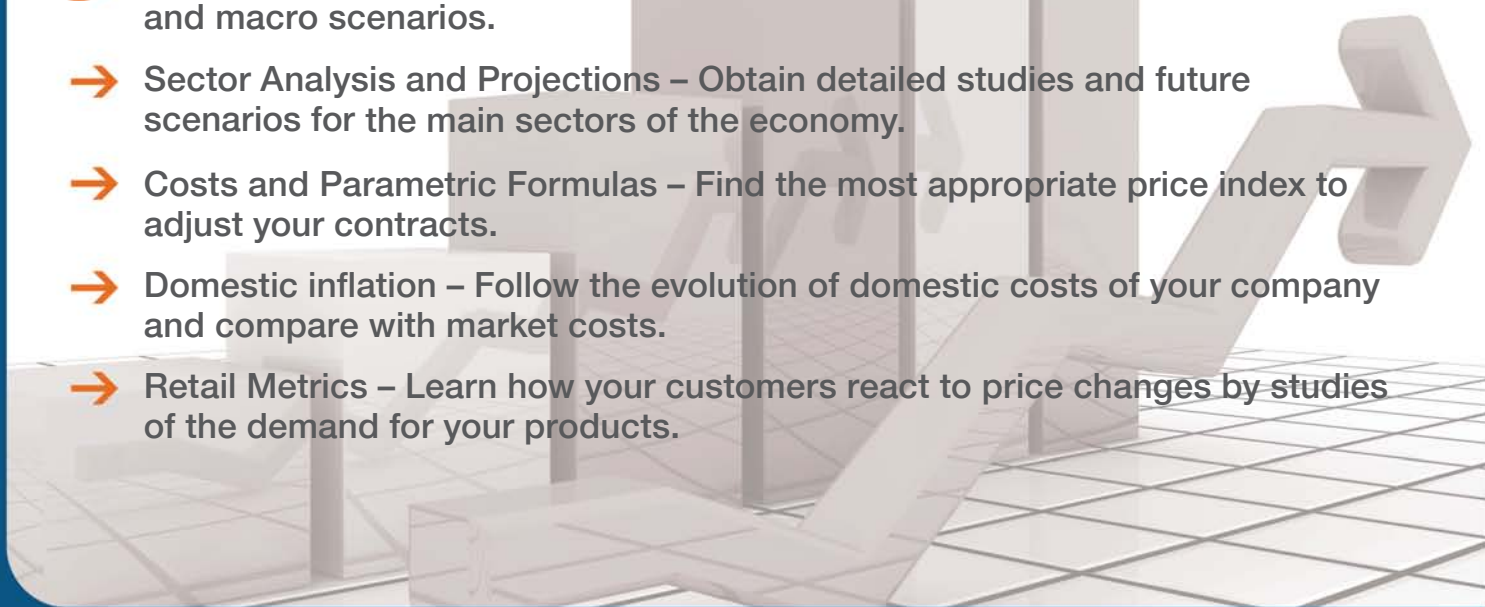
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April 2011

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Are we ready for the great sporting events?

"THE GREAT SPORTING infrastructure works have become the focus of attention," our cover story says. Meanwhile, the World Economic Forum ranks the quality of Brazil's infrastructure at 104th out of 142 countries, the worst of all the BRICS. How can we invite tens of thousands of people to the World Cup and the Olympics when only 14% of our roads are paved?

And the federal government seems to be unable to finish anything—the Ministry of Transport only spent 0.17% of GDP in the first half of 2012, and the second half may be even worse because changes in personnel necessitated by corruption problems have not yet been completed. Yet a 2010 report from Morgan Stanley found that Brazil would need to spend 6–8% of GDP annually on infrastructure if it wants to catch up with Korea in 20 years, and it would have to spend 4% annually just to catch up with Chile. Yet even if the Ministry of Transport could spend every penny allocated to infrastructure, the total budgeted is no more than 1% of GDP.

The Rousseff administration is recognizing that infrastructure investment needs to be speeded up, and is preparing to call in the private sector. But why should the private sector answer the call?

Our cover story reports that the Rousseff administration is recognizing that infrastructure investment needs to be speeded up, and is preparing to call in the private sector. But why should the private sector answer the call? Private investors want a decent return on investment, and that includes their investment of time as well as money. One investor in a port terminal had to get sign-offs from 21 separate government entities. Just getting the environmental licenses for large projects can take as long as five years. It's no wonder U.S. Treasury bonds look more attractive.

That's not even taking into account the fact that in Brazil corruption affects many more agencies than the Ministry of Transport—as we've seen from the turnover among ministers in the Rousseff administration—and the more agencies an investor has to deal with, the more people are likely to have their hands out. Add on top of that the arcane and expensive tax structure, just one part of the Brazil cost that Arminio Fraga Neto reminds us in the interview in this issue is a serious structural, not cyclical problem, and the high cost of long-term financing in reais, and savvy investors can only look at their calculators, shake their heads, and walk away. The government is willing to allow projects funded by private investors to issue tax-free infrastructure bonds, but so far there's been no interest. Why should there be? There are so many other ways to invest that carry less risk and promise higher returns.

So what should the administration do? The foundation for change is to stop acting as if the Brazil cost is like the weather, as if nothing can be done about it. Stop putting Band-Aids on the economy when it needs major surgery. Simplify the business tax structure and licensing to open new businesses. Stop political interference in regulatory agencies. Instead of giving more money to public servants, put more into infrastructure. Get moving, and we can welcome guests from around the world without embarrassment—and they can get to where they want to go.

Corruption and politics in Brazil

João Augusto de Castro Neves, Washington D.C.

DESPITE CONTINUING corruption scandals, there have been some institutional improvements in Brazil over the last two decades or so. Lessons from past scandals have led to more independent oversight agencies and more transparency in public finances. However, these advances are far from permanent and seem to have fallen short of solving the problem, though they have to some extent raised the political cost of corruption. In some sense, it is reasonable—although not very reassuring—to say that to be corrupt in Brazil today you need to be more creative now than before.

Unfortunately, there is no silver bullet that will kill off public corruption. A number of proposals currently in Congress demonstrate that there are many different angles from which to tackle the problem. Regulation of lobbying, legislation on campaign financing and harsher penalties on companies involved in public corruption schemes are just a few examples. However, the elevated costs of campaigns—a problem that is clearly not unique to Brazil—will most likely maintain the incentives for corruption and mitigate the positive impact of any new legislation.

The elevated costs of campaigns will most likely maintain the incentives for corruption and mitigate the positive impact of any new legislation.

However, if the lack of legislation and an electoral system that promotes competition largely as a function of economic power are a serious part of the problem, they pale in comparison to the sluggishness of Brazil's judicial system. The *mensalão* (monthly stipend) trial, set to begin seven years after the scandal broke out, is just one example that justice moves more slowly where there is political and economic power. A vicious cycle, to say the least.

Political fallout of a "historic" trial

Earlier this month Brazil's Supreme Court began to hear the cases of the 38 former government officials and lawmakers charged with participating in a vote-buying scheme, which became known as the mensalão scandal. Allegedly, the vote-buying scheme began in 2005 during President Lula's first term. The proceedings

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should last several weeks and will most likely draw a significant amount of press coverage. However, while the media attention surrounding the trial will probably to some extent rekindle public interest in the scandal, the impact on the Rousseff administration should be modest.

From the outset, the inner circle of the Rousseff government had few or no ties with those involved in the scheme. Since the scandal broke out, officials involved in the mensalão have been removed from political positions in the administration and in congress. In fact, Rousseff's rise to political prominence was a direct result of the scandal, because she replaced José Dirceu—regarded as the mastermind behind the scheme—as Lula's chief of staff. Of the 38 suspects, only two are still in congress, though a former Workers' Party (PT) chairman, José Genoíno, has a mid-level position in the Ministry of Defense.

Barring the unlikely discovery of any new and significant evidence involving Rousseff or her inner circle, the government's exposure to the case is minimal. Rousseff's approval ratings remain very high at 77 percent, and according to the polls the president's anti-corruption credentials are a major factor sustaining her popularity. After some of her cabinet members were accused of corruption (unrelated to the mensalão case), she not only sacked them but also replaced several second-tier political appointees in ministries and departments. She is also expected to carry on with her house cleaning if new accusations erupt

If the lack of legislation and an electoral system that promotes competition largely as a function of economic power are a serious part of the corruption problem, they pale in comparison to the sluggishness of Brazil's judicial system.

or in the unlikely chance that members of her administration are dragged into the mensalão scandal.

As for the PT, several weeks of excessive exposure will probably translate into some political damage in the run-up to local elections in October. Regardless of the verdict, the trial could also prompt the public to revisit Lula's presidential legacy. While this does not necessarily mean the tide will turn against the former president, PT candidates in major cities will be somewhat wary of the risks of linking Lula's image to their campaign.

So what to expect of the trial? Regardless of the verdict and despite its modest immediate political impact, it should be noted that the mensalão trial is part of a broader process of increased oversight and more accountability in Brazil's public administration. Definitely a small step in the right corruption-fighting direction.



Why investment is still tied up

The federal government's limited capacity to carry out investments undermines its ability to boost economic growth. Enter private enterprise?

Kalinka Iaquinto and
Solange Monteiro, *Rio de Janeiro*

THE BRAZILIAN economy's downturn earlier this year was worse than expected and the government's incentive programs have had little visible effect on the economy. The lost growth in the first half of the year has turned attention to one of the shakier pillars of the economy: investment.

With the end of the cycle of durable goods purchases by Brazilian households and with an adverse international scenario discouraging any increase in manufacturing investment, the great sporting infrastructure works have become the focus of attention as a lifeline to boost economic activity and increase economic competitiveness in the medium term. The timing, however, could not have been worse: so far in 2012 federal government execution of budgeted infrastructure has been below expectations, in part because key institutions have been weakened by accusations of corruption. The main problem is the Ministry of Transport and its principal agency, the National Department of Transport Infrastructure (DNIT), where, according to statements by Minister Paulo Sérgio Passos, changes in personnel have not yet been completed.

"The Ministry of Transport's execution of the investment budget in the first half of the year was 0.17% of GDP—below the 0.31% of GDP in 2010 and 2011 and very close to the average for 2006 to 2008," says Samuel Pessôa, consultant to the Brazilian Institute of Economics. With this meager investment rate, there is not much hope of saving the economy.

Federal public works under the Growth Acceleration Plan (PAC) have been equally feeble. "At its peak the PAC has meant an increase of only 0.5% of GDP in infrastructure investments . . . far below the desirable level," says economist Claudio Frischtak of Inter.B consultants. "When the PAC was launched in 2007, the expectation was that it would bring much more frequent diagnosis of government investment projects, facilitating the correction of problems. That did not happen," points out economist Mansueto Almeida, a specialist in public accounts with the Institute of Applied Economic Research (IPEA).

The Roussef administration seems to recognize that the leisurely pace of adjustments in the public administration despite the need for rapid response is a problem and is now calling on the private sector to participate in the solution. After a burst of the Keynesianism of Finance Minister Guido Mantega, who has called on entrepreneurs to invest, the expectation is now that the government will come up with a package of concessions for roads, railways, ports, airports, and power projects.

The initiative is not just welcome, it is necessary. "The country needs

The lost growth in the first half of the year has turned attention to one of the shakier pillars of the economy: investment.

investments in concessions and public-private partnerships (PPPs) . . . But we failed to do more and learn from them, to release resources for other important public works," says Julio Almeida, consultant to the Institute for Studies in Industrial Development. Pessôa observes that "The government does not have resources to raise public investment in infrastructure to 4%, 5% of GDP. Government investments are about 1%, states and municipalities another 1%." Frischtak emphasizes that Brazil must take advantage of this opportunity to attract investments while the window is still open.

RELEARN HOW TO INVEST

Among the problems with investments that analysts identify is the lack of long-term planning, the result of decades without the country undertaking any large infrastructure projects. "Today the country has specific programs, but not exactly a plan with a strategic vision," says former Planning Minister João Paulo dos Reis Velloso, president of the National Forum of the National Institute of Advanced Studies. From his years of experience as coordinator of two development plans in

So far in 2012 federal government execution of budgeted infrastructure has been below expectations in part because key institutions have been weakened by accusations of corruption.

the '70s, a time when the country invested 25% of GDP and grew 6% a year, he responds impatiently when asked about the exhaustion of the economic model based on consumption. "Nothing begins with consumption; it begins with public and private investments that generate employment and income. If not, the inevitable occurs: increasing debt, default, banks panic, and the bubble bursts."

Yoshiaki Nakano, director of the São Paulo School of Economics of Getulio Vargas Foundation, agrees that the lack of a strategic plan is reflected in the quality of investment projects: "All activities that are crucial for development of projects and their implementation were deactivated." Projects of poor quality are barred by the Court of Audit or by delays in acquisition of environmental permits, slowing their execution. However, says Almeida, "We have many requirements for public sector projects that are correct. Sometimes there are excesses, but in general delays reflect an inability of the public sector to carry out projects." Pessôa adds, "It's worth spending much more time with the project design because it is cheap, equivalent to 5% of the total cost. Imagine doing a good project

Brazil: Investment in infrastructure

(Billions of reais)

	2007	2008	2009	2010
Federal government	11.4	14.6	19.1	22.9
% of GDP	0.43	0.48	0.60	0.62
State-owned companies	18.2	23.9	33.7	32.9
% of GDP	0.68	0.79	1.06	0.90
Private companies	24.9	41.7	32.8	37.2
% of GDP	0.94	1.38	1.03	1.01

Source: Inter.B.

and saving 20%. The fact is that we do not have in the public sector . . . an excellent institutional framework to choose projects. This is a major bottleneck."

To change this reality, however, implies making far more delicate changes, those related to the high degree of politicization of public offices. "We have an excess of appointed positions compared to career civil servant technicians. Thus, the possibility of each new government starting from scratch is high," says Francisco Gil Castello Branco, secretary general of Open Accounts, an NGO. This opinion is supported by former Minister Velloso, who says that "In the '70s, we had 15 ministries; today we have 40."

The Roussef administration seems to recognize that the leisurely pace of adjustments in the public administration despite the need for rapid response is a problem and is calling on the private sector to participate in the solution.

Brazil: Investment in infrastructure by sector

(Billions of reais)

	2007	2008	2009	2010
Eletric power	18.7	21.1	23.8	27.3
Telecomunications	12.4	24.3	18.2	16.6
Roads	11.0	15.8	22.4	28.6
Railways	2.7	4.3	2.7	3.0
Subway transportation	1.2	2.5	5.1	3.0
Airports	0.6	0.4	0.4	0.6
Ports	1.0	1.3	1.7	2.1
Waterways	0.3	0.4	0.6	0.7
Sanitation	6.6	10.2	10.6	11.0
Total investment in infrastructure	54.5	80.3	85.6	93.0
Nominal GDP	2,661	3,032	3,185	3,675
Investment (% of GDP)	2.05	2.65	2.69	2.53

Source: Inter.B.

"Today the country has specific programs, but not exactly a plan with a strategic vision. … Nothing begins with consumption; rather it begins with public and private investments that generate employment and income."

João Paulo dos Reis Velloso

CREAKY BUREAUCRACY

The private sector laments the lack of efficient public sector management and the excess of red tape. Nakano says outright, "What we need is reform of public administration. The Brazilian bureaucracy is still at the standard of the nineteenth century. It has no concern for cost or regard for results. There is no oversight, [and there is] very limited implementation capacity."

Renato Poltronieri, partner, Demarest e Almeida Advogados, says that for his clients who have contracts with the government, the major obstacle is the lack of political will to accelerate decisions. "In 2008, we prepared a study on the situation of Brazilian airports, commissioned by

Public-private partnerships welcome

It is evident that the government is unable to invest and carry out the public works necessary for the country to grow. One solution is cooperation between the private and the public sectors to provide essential infrastructure. "With the current lack of [public] infrastructure investment, granting concessions and establishing public-private partnerships [PPPs] can be an alternative for the government to try to close the [investment] gap," says Ronald Munk, Accenture head of health and public services.

Established by law in 2004, PPPs are still in an embryonic stage due to lack of interest or even knowledge by both public and private entities. Nevertheless, Munk believes that PPPs should be pursued and may even help improve management of the public sector: "It is necessary that we have effective leadership in government who want to make changes, have a more modern approach to management, and view collaboration between the public sector and private companies not as a necessary evil, but as welcome opportunities."

However, experts are unanimous that if this is to be a viable alternative, it is necessary that there be more understanding of PPPs and better design of their contracts. "You can build a lot of wonderful roads that become useless white elephants and bankrupt the government," said Samuel Pessôa, consultant to the IBRE, who thinks that until now PPPs in Brazil have been a disappointment.

the National Bank for Economic and Social Development; only in 2012 did the government grant airport concessions to the private sector. Four years of waiting . . . ," he says. "All major projects carried out today are from the '70s. And others, like the bullet train project, seem administrative caprices because of the quality and high cost of the project."

"The Brazilian bureaucracy is still at the standard of the nineteenth century, has no concern for cost or regard for the result, … [and] there is no oversight.

Yoshiaki Nakano

NOW OR NEVER

Despite the uncertainties, there is optimism about the expected government announcement of the package of concessions. Recent experience with three airports—Brasilia, Guarulhos, and Viracopos—has been positive. "It is not a simple process . . . the combination of risk and return cannot be too favorable to one side or the other. If it is very favorable for business, prices are very expensive; if unfavorable, no one invests," says Almeida.

Doing more with less

Brazilians no longer accept government claims that progress is crippled because a lack of resources undermines investment. Perhaps this is why some municipalities, states, and even federal agencies are seeking ways to do more with less, focusing on management improvements. "There's been a quiet revolution in the country. Governments at all levels are seeking the same management tools used successfully in the private sector," says Erik Camarano, CEO, Movement for Competitive Brazil (MBC). The MBC is a private organization that helps the public sector to balance its budgets and regain the ability to invest, which leads to gains in efficiency and competitiveness for the country.

Because the Brazil Cost affects private companies, Camarano explains, MBC works on five fronts—strategic planning, expenses, project management, redesign of processes, and revenues—and results come quickly: "In the projects we carry out, in general, revenues increase and expenses fall in the first six months." Between 2005 and the first half of 2011, 25 public entities assisted by MBC reported profits of R$14 billion and investments of R$79 million.

The gains are not just financial. For example, the Pact for Life program in Pernambuco state, through better management tools and design goals, achieved positive results in safety, health, and education.

"When the Growth Acceleration Plan was launched in 2007, the expectation was that it would bring much more frequent diagnosis of government investment projects, facilitating the correction of problems. That did not happen."

Mansueto Almeida

Carlos Campos Neto, IPEA coordinator of Economic Infrastructure, says that regarding airport concessions, there is a clear maturing process. "It's the first time that airport concessions were granted in Brazil . . . these concessions have positive aspects in seeking to ensure the quality of service and comfort to the users," he says.

According to Frischtak, for new concessions to succeed, "We need depoliticized regulatory agencies." He also insists on the need for long-term planning, adding "We also need commitment from the government and Congress that the infrastructure sector will remain open to private initiative in coming years." Frischtak cites the energy sector as an example not to be followed, explaining that "The pricing policy today is highly distorting. By controlling fuel prices the government is damaging the prospects of investment in the energy sector."

Even with a discouraging outlook for 2012 and delays in the works for the major sporting events Brazil will host, Gabriel Leal, IBRE, thinks that today the government has a unique opportunity to reverse the outlook for next year: "We must recognize that the Rousseff administration demonstrates the intention to improve. The President is articulating international agreements and working groups to develop a metric for evaluating public policies, has created a supersecretariat for public management, and gathered big businessmen in a committee to assist in the evaluation of projects (Committee of Management Policy, Performance and Competitiveness) based on the model developed in 2001 by former British Prime Minister Tony Blair." Frischtak adds, "The political decision to get something done is positive. The media, the pressure of civil society, and the Court of Audit can help the government to improve the quality, design and implementation of projects." IPEA's Mansueto warns, however, that we cannot lose more time. "Granting concessions in infrastructure to the private sector was held up for half a decade, and the result we now see in the hustle and bustle for sporting events," he says. "Moreover, the entrepreneur is rational and moves by profit, not by kindness," he adds, suggesting that mishandling and delays of new concessions could leave the government alone in investing in infrastructure.

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Brazil: Back to a more conventional economic cycle?



Arminio Fraga Neto

Founding partner of Gávea Investments and former central bank governor

Claudio Accioli, Rio de Janeiro

ECONOMIST ARMINIO FRAGA NETO knows the nuances of the financial system nationally and internationally, as both market participant and policy maker. After six years in New York managing the investment fund of financier George Soros and serving as vice-president of Salomon Brothers, Fraga headed the Central Bank of Brazil in the second term of President Fernando Henrique Cardoso. He is a founding partner of Gavea Investments, an asset management firm with a net worth of R$13 billion, and chairman of the board of the Stock Exchange, Commodities & Futures of São Paulo (BM&F Bovespa). He points out the need for government to increase investment, especially in infrastructure, calls for more rational and less emotional debate on the reduction of bank spreads, and speaks of the fall of domestic interest rates as a factor to induce growth and alignment between Brazil and the global parameters. "Chile has had a long-term real interest rate of about 2%. Although we are an economy that does not save much, we must go along the same path.

***The Brazilian Economy*—A principal problem Brazil faces today is low economic growth, lower than the other BRICS and even some Latin American countries. Why is this so?**

Arminio Fraga—It is important to separate long-term growth factors, which are linked to investment, productivity, and education, from cyclical factors. The long-term factors are always present. As for cyclical ones, for the last five years, they have been the result of the American and European crises.

We must also consider that the domestic economic cycle in Brazil has normalized. The economy had been growing above its potential, unemployment had been declining, credit went through a period of accelerated expansion . . . , and inflation went up . . . forcing the central bank to react. Soon after came the global crisis, which led the central bank to reverse its policy, but it had already signaled that we would live a more conventional cycle, partly because Brazil does not yet have the problem of excessive debt seen in most of the world. Regarding 2% growth in 2012, you must be very cautious [reading this number] . . . . How exactly Brazil is growing

on average is always difficult to measure. Perhaps it is around 3.5% or 4%. However, Brazil's potential growth rate is higher . . . I see with hope the comprehensive debate in this country about growth beyond the cyclical aspect. It underlines the importance of having a more efficient government.

How do you assess the Rousseff administration approach to the efficiency of public management?

President Rousseff has made it clear that this is a priority. . . . Of course the government still has to deal with a difficult political environment, a government supported by a party coalition with more than 30 ministries. There is a long way to go in this area, but at least the debate is in the air and is growing.

Another important aspect relates to education . . . Today, for public opinion, education is second only to employment . . . . This is a significant change. It also gives hope that families will call for better schools. I have a positive view of Brazil. I know there are many challenges ahead, we are suffering a bit with the current situation—but we should take advantage of the moment and seek solutions.

In a recent report on Brazil, the International Monetary Fund was optimistic about growth but warned of the lack of savings and investment and high household debt. What did you think of the report?

Overall, it seemed well balanced. With regard to investment, it is somewhat natural that in recent years consumption has led domestic demand. There was repressed demand, and access to credit, better income distribution, and poverty reduction played an important role in meeting it. However, the supply side is lacking. This disparity is most visible today almost everywhere in infrastructure: airports, ports, railways, highways, energy, and sewage. It has become a national emergency. The government invests very little because it was designed to transfer income, not to invest, and it has difficulties in mobilizing private capital. . . . In my view, some very positive things are happening in this area, including the fall in interest rates. Currently, the long-term interest rate is about 4.5% a year. That is still high, but well below the 6% or 7% of the not-so-distant past. Another important fact is the change in the government's attitude about partnerships, granting concessions, and so on.

Brazilian industry has suffered from the crisis. Is this a temporary situation or does it arise from structural changes in industry?

I think it is more structural than cyclical. One part has to do with the so-called Brazil cost, which includes aspects such as taxes and red tape, as well as the infrastructure problems already mentioned. Another part is related to an almost global trend where industry has an ever-smaller weight in GDP

Today, for public opinion, education is second only to employment . . . . This is a significant change. It also gives hope that the families will call for better schools.

. . . But I do not minimize the problem; it is relevant. I think that the answers [for this problem] should be more comprehensive—it is very rare to see a well-based industry response. Usually, what happens is the product of lobbying and ends up being an income transfer: the resources come from somewhere and are finite; benefitting a particular industry means burdening others in some way. There is no magic.

Infrastructure has become a national emergency. The government invests very little because it was designed to transfer income, not to invest.

Do the falling profits of the three largest private banks in the country indicate a risk to the health of the banking system?

Overall, our financial system is going well. Brazil, given its history, should never fall into the illusion that a fully free but highly leveraged financial system is good. There is still much discussion about the fact that the banking spread is very high, but this is due to many causes. Some will improve over time, with increasing competition and transparency; others, like the tax on financial transactions, the IOF, depend on the government. The IOF is one of the worst taxes; it is a wedge that affects both savings and investment. Undeniably, the world today has an enormous antipathy toward the financial system. Part of that, in my view, is deserved . . . there was much folly and irresponsibility, with [financial institutions] leveraging 60, 80, and 100 times their equity. It is therefore natural that the pendulum is going against the banks, but I fear that there is an exaggeration, because the economy needs a healthy and efficient financial system. I support reducing banking spreads, but I think it has to be done comprehensively, without turning banks into villains. We must rigorously examine the real causes of these spreads.

Turning to the international scenario, the crisis in Europe has dragged on for months without signs of a solution. What can we expect?

Europe is experiencing a very serious and deep crisis. With the advent of monetary union, which was incomplete, suddenly European nations saw the chance to borrow money very cheaply, which led to a large increase in debt, of not only governments but also businesses, families, and banks. One day the music stopped. Now, these countries have to deal with large debts and very low growth. In the past, if a crisis happened in one of the five economies now in the spotlight, it would generally be resolved by depreciating the exchange rate. . . However, because they no longer have their own currencies, the cost of adjustment is greater . . . It seems that Greece will restructure its debt again, but it is not yet clear whether it will leave the euro. As to the others, I am sure they would like to stay, even though the lack of a floating exchange rate entails a huge sacrifice and requires administration of political pressure. On the other hand, it is not that simple to deepen the monetary union. Germany and France may not want or may be unable to assume this burden. Other countries have difficulties in making the necessary adjustments and do

not want to give up their sovereignty . . . .

Americans need to make a large fiscal adjustment, and the case of Japan is very serious: in the next 30 years, the workforce will fall by half while public debt—already significant—tends to increase. I see all this within the larger context of a phase of deleveraging of the global economy, in contrast to the period of high leverage between 1980 and 2008. History shows that these adjustments are tense and prolonged.

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How immune is Brazil to the crisis?

Although Brazil does not have a very open economy, it will certainly be affected. As I stressed earlier, in recent years the country enjoyed a long period of falling unemployment, rising debts, and improving export prices. Export prices may become less favorable. That somewhat reduces our room to maneuver and can last several years, but it is cyclical. Uncomfortable, but it does not kill.

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Abrazpe

Export Processing Zone in Teófilo Otoni, Minas Gerais state.

The reinvention of the EPZs

Kalinka Iaquinto, *Rio de Janeiro*

AFTER STANDING STILL for 24 years, in the second Lula administration and now under current President Rousseff Brazilian Export Processing Zones (EPZs)—areas that serve as a type of industrial park, tax-exempt areas mainly for facilities that export and import inputs and raw materials — have gained new momentum. Some are considered them as a mechanism for averting the recent crisis in the industrial sector, since they can give impetus to exports and boost local economies.

However, advocates warn that EPZs should be recognized as just one component of a broad industrial policy, not as the answer to all of industry's problems. "We must think of the scheme as an alternative. I do not believe that it is a panacea," says Gustavo Fontenele, executive secretary, National Council of Export Processing Zones (CZPE), which is an agency of the Ministry of Development, Industry and Foreign Trade. There are certainly questions, such as how this solution, which has been around for quite a long time, can in a scenario of international crisis support a model that is based on exports.

Changes coming?

Questions like these have led to a proposed revision of the legal framework for EPZs in order to bring new life to states,

Brazilian EPZs



Incentives
Companies in EPZ are exempted from:
☐ Tax on Industrial Products (IPI),
☐ Contribution to finance the Social Security (Cofins),
☐ Contribution to Social Integration Program and Public Servant Fund (PIS and Pasep),
☐ Import Tax,
☐ Cofins on imports, and
☐ Freight Surcharge for Renovation of Merchant Shipping.

EPZ's objectives
☐ Attract foreign investments directed to exports,
☐ Level the playing field for national companies and foreign competitors,
☐ Create jobs,
☐ Increase the value of exports and strengthen the external balance of payments,
☐ Disseminate new technologies and best management practices, and
☐ Correct regional imbalances.

EPZs should be recognized as just one component of a broad industrial policy, not as the answer to all of industry's problems.

municipalities, parliamentarians, and businesses. "The EPZ is a kind of production paradise. It is the place where you can work and produce without the constraints the government otherwise imposes on businesses," says Peter Pedrossian Neto, professor of economics, Catholic University of São Paulo and business director of the management company of the Export Processing Zone of Bataguassu (Egezpe) in Mato Grosso do Sul state. Encouraged by discussions about the bill in the Senate to amend a few points in the current legislation, Pedrossian highlights the advantages provided in the EPZ model as the main attraction for businesses, since the tax exemptions greatly reduce the Brazil cost.

"It costs about 40% less for a company to acquire or improve capital goods," agrees Germano Augusto Pereira e Silva, AS Pontes Construtora, who is president of Egezpe. He says that current EPZ rules allow companies to buy industrial plants in other countries and reassemble them in Brazil without having to pay import duties. That is also true for acquiring software and parts: "This, coupled with the exemption for inputs purchased to make the final product for export and the benefits granted by states and municipalities, also reduces operating expenses."

Even if markets are shrinking, the partners are optimistic: they see the crisis as a challenge that, if addressed, can drive development. "With the dollar reaching a reasonable level for the Brazilian exporter, it makes us more competitive," says Pereira e Silva.

However, according to Helson Braga, president of the Brazilian Association of Export Processing Zones (Abrazpe) and a proponent of EPZs since the late 1980s, sluggish global demand makes it harder to fulfill the current rule requiring export of four-fifths of EPZ production (the remaining 20% can be sold in the domestic market but suspension of taxes and duties is revoked). "Today, it is very difficult for you to commit to export 80% [of production] when the global economy is stagnant and there is a violent struggle for market share," Braga says. He also says that the high export requirement is not attractive to investors: "Few Brazilian companies are able to export so high a share of their production."

Senator Lídice da Mata (PSB-BA), author of the bill to amend the current legislation (Senate Bill [PLS] 764/11), advocates reducing the export requirement from 80% to 60%, and even to 50% in some cases. "Many countries have eliminated this requirement, provided all taxes due on domestic sales are paid in full, which already happens here," she says.

Some segments of industry criticize reducing the EPZ export requirement and expanding domestic sales as unfair competition. Proponents of EPZs feel strongly, however, that this is not a danger. "When the company sells in the domestic market, it pays all taxes that have been suspended. Sale from an EPZ to the domestic market has exactly the same treatment as a normal import from China, Korea, or Germany. The notable difference is that when you buy from those countries, you create jobs there, when you buy here, you are creating jobs here," Braga emphasizes.

Another change under discussion in Congress is to allow service providers to set up operations in EPZs, which now may only support manufacturing companies. "The EPZ model of the 1970s, exclusively dedicated to manufacturing, has evolved. Today, it covers services, hospitals, even universities. Brazil needs to adjust to these new times. In the case of IT services, several studies have shown that Brazil has the potential to gain a significant share of the market, which is currently dominated by China and India," says Senator da Mata.

Cost avoidance?

While EPZs are just now taking off in Brazil, the initiative is not new in the rest of the world. The earliest EPZs date from the 1960s in Ireland, India, and Taiwan. In the 1970s, South Korea and China adopted the model to expand markets and further increase their savings. Currently, according to a World Bank 2009 survey, there are about 3,500 EPZs in 135 countries; they account for 68 million jobs and turn over about US$500 billion annually.

> For state and local governments, which must apply to set up EPZs, the possibility of reducing regional imbalances and boosting local economies is very attractive.

Here, EPZs have been seen as a way of avoid the Brazil cost, much of it attributable to the bureaucracy, and to circumvent the difficulty of accessing funding and logistical problems. "The EPZs have a special tax regime where the suffocating tax burden does not exist," Pedrossian says.

Another difference has to do with the foreign exchange freedom afforded to EPZ producers, which have the right to retain abroad all the revenues from exports. Pedrossian explains, "There is no commitment to bring in foreign currency and the paperwork is less. Producers are exempted from licenses to import and export."

"All these advantages are valid for 20 years, and renewable for the same period," says Braga, which he believes is reassuring

According to a World Bank 2009 survey, there are about 3,500 EPZs in 135 countries; they account for 68 million jobs and turn over about US$500 billion annually.

to potential investors. "Whoever enters will know that no one will change the rules mid-game. This is critical, especially for foreign companies, because Brazil has a rocky history of noncompliance with rules."

Attractive to governments

For state and local governments, which must apply to set up EPZs, the possibility of reducing regional imbalances and boosting local economies is very attractive. Braga noted that in some countries formation of EPZs has in turn triggered formation of new industries in regions around the EPZs, which were established to supply raw materials and supplies to companies in the EPZs.

"Small and medium businesses can benefit in several ways," Senator da Mata says. "They may use incentives and conditions to grow by selling to foreign markets, or they can exploit opportunities to become suppliers to companies located in EPZs. Furthermore, EPZs stimulate the development of urban centers."

Egezpe president Pereira e Silva agrees: "It's a program that can make Brazil stronger by encouraging the export features that we do not have today. . . . With exports, the country becomes more competitive, it can compete in the global market. We interact with the world, and we are not left behind just buying imported manufactures."



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Economic activity is still so weak that even if recovery picks up in the second half of the year, GDP growth is likely to hover around only 1.5%. Long neglected structural weaknesses are weighing on markets, leading to a more sober view of the Brazilian economy.

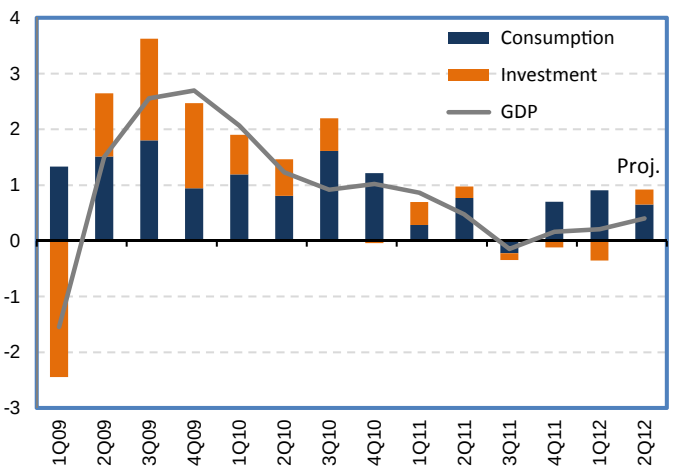
THE UNFORGIVING GLOBAL economy is hardly enough to justify the poor performance of the Brazilian economy lately because almost all the other countries in South America, some of which are as much or even more dependent as Brazil on production and export of commodities, grew more than Brazil did in 2011 and are expected to outpace us again in 2012. Also, the shift to a less positive perception about Brazil can hardly be attributed to a sudden change in the mood of the markets, considering that the shift could have been identified some time ago. Signs of dissatisfaction among markets and investors about how much the Brazilian administration was intervening in the economy—and certainly not always in the right direction—began to emerge not too far into 2011. As a result, foreign investors reduced their purchases of stocks and bonds by 40% in the first half of 2012 compared with the same period of the previous year: from US$12.4 billion to US$7.5 billion.

There is little doubt that the darkening in how markets are viewing the Brazilian economy is based on a number of neglected structural weaknesses, among them low savings, investment, and productivity; the high tax burden, which at 36% of GDP is suffocating the private sector; a notoriously complex tax system; the lack of adequate infrastructure; a shortage of the skilled human capital demanded in the labor market; political interference in how regulatory agencies and public enterprises are operated; and the failure of the government to carry out, efficiently and completely, its own investment programs.

Recovery continues fragile

Data released in July confirm that second-quarter economic activity was feeble, although there was a slight recovery over the first quarter. Our forecast for GDP growth for the second quarter is 0.4%. The low expected growth is largely due to a fall in manufacturing production by 1.4% over the previous quarter, mainly in production of consumer and intermediate goods. Our forecast incorporates the expectation that domestic demand rose by 0.9% in the second quarter compared with 0.6% in the first. Even if quarterly growth gets up to 1.0% in the second half of the year, GDP is likely to grow by only 1.5% in 2012.

GDP is growing slowly as consumption and investment recovers.
(quarter-on-quarter % change)



Sources: IBGE, IBRE staff.