THE BRAZILIAN ECONOMY

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years

The Brazilian economy in review

IBRE Economic Outlook

Public investment critical to Brazil's growth in 2013

Politics

Elections: What 2012 may tell us about 2014

Judiciary

More transparency

Interview

Brazilian Ambassador to China Clodoaldo Hugueney

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The BRAZILIAN ECONOMY

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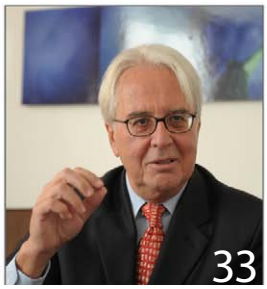
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THE BRAZILIAN ECONOMY









News Briefs

4 Another bank in trouble … Vale profits plunge … unemployment up a bit … Brazilian-French submarine partnership starts operating … more work permits for foreign professionals … Brazil and Angola meet on cooperation … tax exemptions costly … Brazil cuts spending

Politics

8 Elections: What 2012 may tell us about 2014

It is perhaps an omen that in last month's local elections most incumbent candidates and parties in major cities did not do well. For instance, in the majority of cities where the mayors were not seeking re-election, the candidate from the ruling coalition was defeated. João Augusto de Castro Neves analyzes the implications for the next national election.

Judiciary

10 More transparency

The Supreme Court has recently reasserted its independence by convicting former top government officials. However, the judiciary needs to become considerably more efficient itself to meet society's expectations of justice for all.

Cover Stories

12 Pages of history

Conjuntura Econômica, the parent of *The Brazilian Economy*, celebrates 65 years of publication this month. Luiz Guilherme Schymura, its editor-in-chief, introduces this special issue in which experts from the Getulio Vargas Foundation and its units trace the contours of the Brazilian economy over the years.

13 The interest rate roller coaster

For decades, Brazil had the highest interest rates in the world. Then in August 2011, the central bank began to bring the rate down to the current 7.25%. Why were the rates once so high and how does Brazil's current situation look comparatively?

16 No more gimmicks

Until 1998, when the Fiscal Responsibility Law was passed, Brazil was a fiscal spendthrift. After that all went well until 2009, when the government began to use accounting gimmicks to show budget surpluses.

19 Can Brazil control inflation?

In 1993 inflation was a staggering 2,708%. It took five economic plans to curb it. So why is there so much concern about inflation approaching 6.5%? And what path is inflation likely to take?

21 Industry: Back to the future

The economic growth of recent years that lifted Brazil to fifth place among world economies has failed to carry manufacturing along with it. Is this a normal evolution for a developing country? And how effective is the government strategy for addressing the lack of industrial competitiveness?

24 Agriculture on hold

After moving well along the path of growth, Brazilian agribusiness is now subject to both global developments and domestic policy decisions, plans, and investments in infrastructure and education to ensure more competitiveness despite uncertainties in international commodity prices.

26 Let's get down to work

In recent years the labor market has been overheated. Yet although wages have risen, the situation masks negatives in the rigidity of the labor laws and the high cost of hiring.

28 Education for all

Between 1950 and 1980 social inequality denied the poor access to education. Today, when policy is much more enlightened, Brazil suffers from the educational deficit caused by its history.

30 Ripple effect

In the past 20 years Brazil has greatly expanded its international economic presence. How did the country react to the ripples from the most recent worldwide credit bubble?

Interview

33 China: Sustainable growth ahead

Clodoaldo Hugueney, Brazilian ambassador to China, explains to Solange Monteiro that China is no longer pursuing growth at all costs but is concerned with *sustainable* growth, better income distribution, and environmental issues.

IBRE Economic Outlook

37 Because the September industrial output figures have frustrated hopes that the Brazilian economy will recover in late 2012, public investment will be critical to growth in 2013.

ECONOMY

Brazil central cank intervenes in BVA bank

Brazil's central bank has intervened in the operations of the financially compromised Rio de Janeiro-based bank Banco BVA SA. The bank, which provided financing for small and medium-sized businesses, reportedly had uncovered liabilities of US$276 million as the second quarter ended. The latest intervention comes as Brazil's banking system struggles in a sluggish economy to overcome loan delinquencies, which averaged a record high of 5.9% through August. (October 19)

Vale's third-quarter profit plunges

Giant mining company Vale reported net income of US$1.7 billion for the third quarter, a decline of 57.8% over the same period last year. The drop was driven by a 4.5% decline in the production of iron ore between July and September, and lower global iron ore prices, due to high Chinese stocks. (October 24)

Brazil September unemployment at 5.4%

Brazil's unemployment rate reversed two months of decline to rise slightly in September, and tight labor markets continued to push wages higher. Unemployment was 5.4% in September compared with 5.3% in August, according to the Brazilian Institute of Geography and Statistics (IBGE). Unemployment in September 2011 was 6.0%. The average monthly Brazilian salary was US$874 in September, up 0.1% from August and 4.3% from September 2011. (October 25)

Industrial production falls 1% in September

Industrial production interrupted three months of growth to decline 1% in September, an IBGE survey found. This is the worst result since January, when production shrank 1.8%. Compared to September last year, the drop in production was even larger at 3.8%. During 2012 manufacturing production has so far decreased by 3.5%. (November 1)

Inflation accelerated in October

CPI inflation (IPCA) accelerated in October to 5.45% year-on-year, from 5.28% in September, mostly driven by food and apparel prices. This is significantly above the government's 4.5% inflation target mid-point. (November 7)

ECONOMIC POLICY

Brazil's central bank signals end to rate cuts

The minutes of the most recent central bank monetary policy meeting suggest that the easing cycle has come to an end and the bank is increasingly confident of domestic recovery. Inflation is expected to eventually converge to the target. Analysts believe that the central bank will hold the policy rate at 7.25% until at least 2013Q4. Brazil's currency (+0.2%) outperformed peers against the US dollar. (October 18)

Brazil cuts spending to meet surplus goal

Brazil's government will subtract up to 42 billion reais (US$20.7 billion) in public spending from calculation of the primary budget surplus this year, Finance Minister Guido Mantega said, in an accounting maneuver aimed at meeting a closely watched budget target. However, Mantega reiterated that Brazil's government remains committed to fiscal discipline. He highlighted that the government's net debt as a share of gross domestic product, another widely watched gauge of the soundness of public finances, will keep falling this year. His remarks come a week after the central bank said the target for the primary surplus — the difference between total revenues and expenses excluding debt-servicing — would not be met. The accounting maneuver, last used in 2010, is not endorsed by multilateral institutions such as the International Monetary Fund. (November 6)



Photo:Valter Campanato/Agencia Brasil

Finance Minister Guido Mantega.

Tax exemptions to cost US$22.5 billion for 2012

Finance Minister Guido Mantega said that tax exemptions will add up to US$22.5 billion by the end of 2012, though he stated that the decision to take countercyclical measures does not compromise the government's fiscal stance. The minister also pointed out that the government forecasts GDP growth of over 4% next year. To achieve this, it will be necessary to raise investment by 8% to 10% more than this year. (November 12)

INTERNATIONAL

Brazil's IMF constituency shaken up

Large nations like Brazil often represent smaller countries on the International Monetary Fund's board. Colombia, one of the countries Brazil represented, has moved to Mexico's constitutency, a logical step as both Spanish-speaking countries already work together on a number of issues. Nicaragua, Cape Verde, and East Timor are now represented by Brazil, although together they do not equal the number of votes Colombia brought. (October 19)



Photo: Antonio Cruz/Agencia Brasil.

Foreign Minister Antonio Patriota (right) and Georges Chikoti, the chancellor of Angola, hold a joint press conference.

Work permits for foreign professionals up

In the first nine months of 2012, the Brazilian Ministry of Labor and Employment granted 55,000 work permits, temporary and permanent, for foreign professionals, an increase of 5% over the same period in 2011. Humanitarian visas granted to Haitians, work permits for foreign specialists and technicians installing imported machinery and equipment, and technical assistance or technology transfer contributed significantly to the increase. (October 26)

Brazil and Angola discuss areas of cooperation

Foreign Minister Antonio Patriota and Georges Chikoti, the chancellor of Angola, met recently to discuss cooperation in the areas of education, health, culture, agriculture, defense, information technology, combating transnational crimes, and immigration and consular matters, as well as the political situation in Guinea-Bissau. (November 13)

DEFENSE



Photo: Fabio Rodrigues Pozzebom- Ag. Brasil

Brazilian Defense Minister Celso Amorim

Brazilian troops in Haiti being replaced

On November 4, 130 Brazilian military personnel set off to join the United Nations Mission for Stabilization in Haiti (MINUSTAH). As leader of the military component of the mission, Brazil has more military personnel (1,878) in Haiti than any other country, though the number will gradually decrease. The UN Security Council has extended MINUSTAH operations through October 15, 2013. The phased withdrawal of the Brazilian contingent is in line with the strategy of Brazilian Defense Minister Celso Amorim who has reiterated that "there can be no permanent presence or irresponsible withdrawal" from Haiti. (November 8)

Itaguaí submarine base opens this month

The Prosub Metal Structure Fabrication Unit (UFEM) for conventional and nuclear submarine technology is scheduled to open in Itaguaí this month. In the 90,000 square-meter area, segments of submarines will be made for assembly in the shipyard. The Prosub operation is a partnership between the Brazilian and French governments which provides for transfer of French technology to Brazil for construction of submarines, particularly nuclear-powered. (November 7)

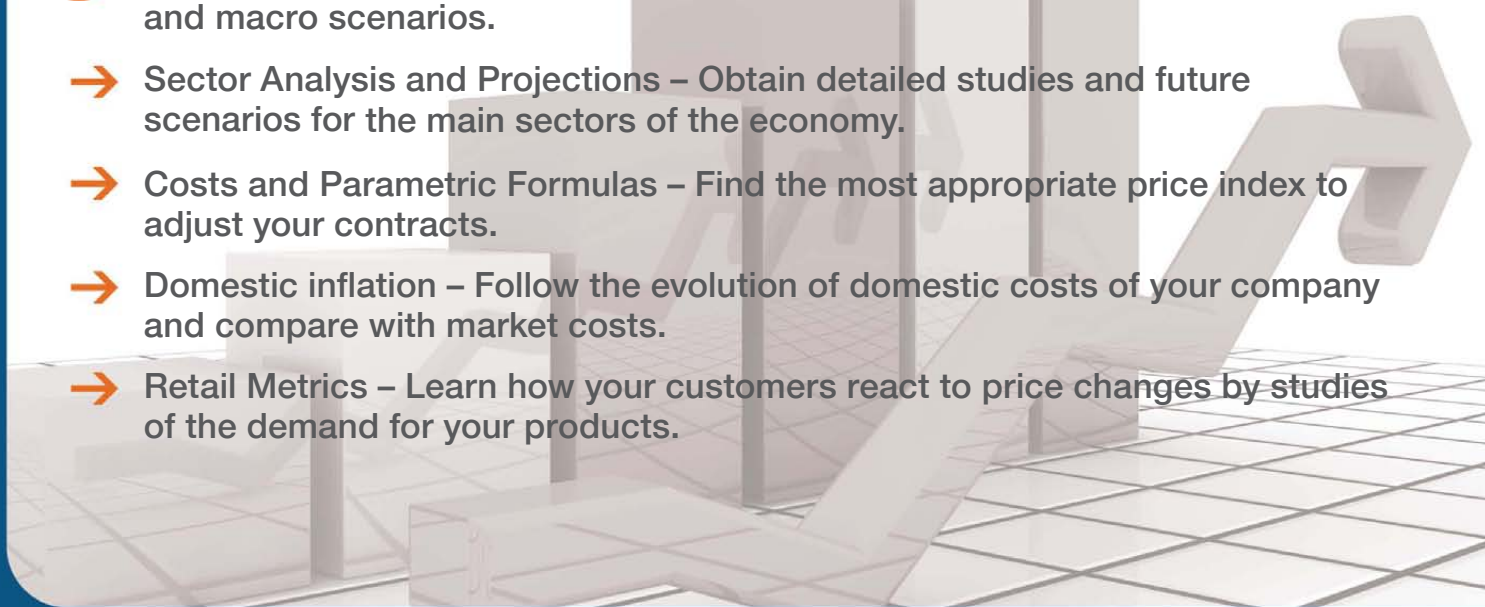
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April 2011

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Is Brazil starting to see real justice?

THE OTHER SHOE HAS dropped. When the Supreme Court found José Dirceu and many of his colleagues guilty in the mensalão trial that began in August, there was considerable enthusiasm for the ruling, but there was also considerable cynicism about whether the sentences would be meaningful. Now we know. On November 12 the Court announced that the former aide to former President Lula da Silva is being sent to jail for nearly 11 years. As Supreme Court President Carlos Ayres Britto commented about the importance of the trial, "The Supreme Court is changing Brazil's culture."

It's true that the culture of corruption is being changed, with help not only from the Supreme Court but also from the president, who has been adamant about clearing out members of her administration as soon as they came under a shadow. And the Court also allowed the trial to be broadcast live on television, a move toward transparency that could certainly be a model for a number of other areas of Brazilian governance. In recent years the Supreme Court has also been willing to take on a variety of other tough cases, as Kalinka Iaquinto spells out in her report on the judiciary in this issue.

But one area of the culture of the Brazilian judiciary needs some change of its own. It took seven years from the time the vote-buying scandal was exposed before Dirceu and his co-defendants went on trial. In the August issue, as the case went to trial, our political columnist, João Augusto de Castro Neves, called it 'just one example that justice moves more slowly where there is political and economic power." Although he also said that the trial "is part of a broader process of increased oversight and more accountability in Brazil's public administration," it is nevertheless true, as the old saying goes, that "justice delayed is justice denied."

Bringing accused parties to trial in a reasonable time is a more just way for the legal system to operate.

The Sixth Amendment to the U.S. Constitution guarantees to all persons accused of criminal wrongdoing the right to a speedy trial, but in the English-speaking world the right to a speedy trial is an ancient liberty that goes back to the Assize of Clarendon promulgated during the reign of Henry II (1154–1189). True, Brazilian law is based on the Portuguese civil law system, not the British common law tradition, but it's not too late to recognize that bringing accused parties to trial in a reasonable time is a more just way for the legal system to operate. In the U.S. a delay of one year in bringing a defendant to trial following arrest can trigger a presumption that the Sixth Amendment has been violated, although longer delays may be permitted to accommodate the schedules of important witnesses and to allow the lawyers in certain circumstances to prepare more fully.

The Supreme Court and the administration are to be commended for their clear commitment to dealing with the corruption problem. Now it may be time for the courts to also think about how to move more quickly so that not only will justice be done, but it will be seen to be done while the facts of a case are still fresh. Maybe, in fact, the courts can learn something from the president about moving faster.

Elections: What 2012 may tell us about 2014

João Augusto de Castro Neves, Washington D.C.

THE ELECTORAL CYCLE that ended last month did not change Brazil's political landscape at the national level much. At first glance, there were no major upsets or surprises salient enough to identify clear winners and losers among major parties; electoral spoils were fairly evenly distributed among them. While some gained control of more total districts, others lost control of capital cities. In the end, the PSDB, the PMDB, and the PT[1] retained their ranks as the three largest parties at the local level.

Perhaps more revealing, however, was the fact that most incumbent candidates and parties in major cities did not do well.

As growth slows and revenue dwindles, local governments must adjust to a more challenging economic environment while juggling the new political and socioeconomic challenges.

A sign of more competitiveness was the high number of run-off races necessary in capital cities: 17 of 26 state capitals, the highest number in recent years. Also, the success rate of reelection bids declined. In 2008, 65% of mayors of capital cities seeking reelection were successful (13 out of 20). In 2012, the rate fell to 50% (4 out of 8). Finally, in the majority of cities where the mayors were not seeking re-election, the candidate from the ruling coalition was defeated.

Even though there are numerous reasons that might explain the high turnover, one very plausible explanation is that several years of rapid economic expansion in Brazil have been accompanied by changes in the political sphere. To start with, economic growth in the past decade or so—and the rise in consumption it brought about—played a role in deepening a few urban problems, such as traffic congestion and pollution, that have generated dissatisfaction with local governments. More importantly, the economic growth has also led to the rise of a new middle class that has higher political expectations and demands.

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The challenge for local governments in these cities today is to respond to these rising demands for better public services. But as growth slows and revenue dwindles, local governments must adjust to a more challenging economic environment while juggling the new political and socioeconomic challenges. In the longer term, the message produced by local ballots this year may be a harbinger of a more profound shift of political behavior at the national level. In other words, a middle class with higher expectations can easily become frustrated with the status quo.

Going back to party performance, there are a few incipient trends from last month's local elections that may have important national implications. A strong showing by leftist PSB and center-right PSD may presage shifts in the governing and opposition coalitions heading into the 2014 presidential elections. The PSB will likely push for more space within the coalition; it will be challenging for President Rousseff to accommodate the party and its rising leader, Eduardo Campos. Ultimately, however, if the economy rebounds and Rousseff's approval ratings remain high, the PSB is not likely to be a real threat to the president's bid for reelection. As for the PSD, its strong showing reflects the fragmentation of conservative votes in major cities. This means that in 2014 the opposition could have a harder time coalescing around one party or one candidate.

In the longer term, the message produced by local ballots this year may be a harbinger of a more profound shift of political behavior at the national level.

Finally, Jose Serra's defeat in São Paulo city is noteworthy in terms of the fate of the opposition down the road. Although Serra's standing within the PSDB should diminish, he is likely to retain enough political capital to create some uncertainty that could make it hard for Senator Aécio Neves to consolidate support as the party's incontestable presidential candidate in 2014. The reason for this is that Serra still has high visibility as one of the main leaders of the opposition and that may steer support away from Neves. Fernando Haddad's victory over Serra serves as a reminder of former President Lula's resilience and the diminished impact of the Supreme Court trial of former PT officials on the party's overall performance.

[1] **Opposition parties**: Brazilian Social Democratic Party (PSDB), Progressive Party (PP), Democratic Labor Party (PDT), Democrats (DEM). **Governing coalition**: Workers' Party (PT), Brazilian Democratic Movement Party (PMDB), Socialist People's Party (PPS), Social Democratic Party (PSD), and Brazilian Socialist Party (PSB), Brazilian Labor Party (PTB)

More transparency

The Supreme Court has recently reasserted its independence by convicting former top government officials. However, the judiciary needs to considerably improve its governance and become more efficient to meet society's expectations of justice for all.

Kalinka Iaquinto

THE BRAZILIAN JUDICIARY is still very closed but it is becoming increasingly more relevant for society. The latest proof of this is the visibility the Federal Supreme Court (STF) and its justices have acquired as the court tried top officials of former President Lula on charges of diverting public funds to buy political support for his coalition government when it came into power (popularly known as the mensalão scandal). The Supreme Court opted to broadcast the trial live on TV to show transparency and assert the important role that the judiciary has among the three branches. However, the greater influence of the court, which has been building since 1988, brings with it a problem, says Joaquim Falcão, director of the FGV Law School: "There is a positive side to the [Supreme Court's] rising power, but it creates a social demand [for justice] that the judiciary is unable to respond to, generating a crisis of confidence and management."

The judiciary reform embodied in Amendment 45 to the Constitution (2004) created management tools such as the National Council of Justice (CNJ), which is intended to improve the work of the courts, especially with regard to administrative transparency and procedures. "From this starts a renewal that has two pillars, one that is ethical in terms of transparency, and one that deals with management efficiency," Falcão says. In coming years, issues involving the internal structure of the judiciary and the Supreme Court itself should be high on the reform agenda.

"Based on constitutional law, justices are to use their discretion. But when they are aware of Brazilian public opinion, the justices are closer to the citizen's sense of justice. That's good."

JOAQUIM FALCÃO

A major challenge, according to Falcão, is to end the corporatism of the judiciary, especially the hierarchical structure of the courts. "There is no internal consensus, and wages are sometimes excessive. Moreover, chief justices have only two-year terms. This rotation causes administrative discontinuity," he says.

José Antonio Maristrello Porto, professor at the FGV Law School, agrees with the need for change: "We could start by changing the way public employees are selected . . . or through changes in the academic education of lawyers." He believes that "court decisions based on the economic analysis of law . . . are far more concerned with the future behavior of individuals."

Falcão also thinks it would be advisable to review the concept of tenure for justices and judges, saying "We should keep the age limit at 70, but limit the term in office to 15 years." For him, the current system prevents renewal of the judiciary. "The National Organic Law of the Judiciary of 1970s is outdated and needs to be modernized. All concepts of management, efficiency, and ethical independence need to be strengthened," he says.

2012 A MILESTONE

If the 1988 Constitution gave the judiciary a new role and 2004 started it on the path to reform,

2012 will be remembered as the year when the Supreme Court drew closer to Brazilian citizens and their concerns. In recent years, the Supreme Court has ruled on such controversial issues as the requirement that electoral candidates have clean criminal records, same-sex marriage, authorization for stem cell research, legalization of the abortion of anencephalic fetuses, social and racial quotas for college admission, and demarcation of indigenous lands. The Supreme Court is making very important decisions that affect the everyday lives of Brazilians.

The very image of the Supreme Court justices is changing. Social networks and other media vehicles popularize their names and images to the point where they may be even better known than ministers and members of congress. Falcão says the live broadcast of the mensalão trial brings transparency to the judiciary that often does not exist in other countries: "It's a great educational process about how the justices arrive at their conclusions. This process is extremely positive for democracy because it undoes myths and shows the reality of justice."

According to Falcão, the voice of Brazilian public opinion has been heard. "Public opinion is crucial, because it is one of the factors that influence votes," he says. He points out that



Photo: José Cruz/Agencia Brasil.

Chief Justice Joaquim Barbosa

"Based on the Constitution, judges can form their decisions freely. It does not make sense to require that a magistrate take certain positions. Based on constitutional law, justices are to use their discretion. But when they are aware of Brazilian public opinion, the justices are closer to the citizen's sense of justice. That's good."

Carlos Pereira, professor, Brazilian School of Public and Business Administration FGV, points out that the punishment that will be applied to the defendants of the mensalão trial matters: "Brazilians feel that only the black and the poor are sent to prison. The mensalão has broken that belief." However, Falcão believes there may be conflicting expectations. "Part of society believes that only sending the defendants to jail is real punishment. These expectations are likely to be disappointed, since that will not happen with all defendants," but, he notes, "Whatever the sentences are, they will be applied and respected. The Supreme Court could not act otherwise."



Photo: José Cruz/Agencia Brasil.

Supreme Court Justices Rosa Weber, Antonio Dias Toffoli, Ricardo Lewandowski, Gilmar Mendes and Celso de Melo.

PAGES OF HISTORY



Luiz Guilherme Schymura
Chief Editor of *Conjuntura Econômica* magazine and Director of the Brazilian Institute of Economics (IBRE)

COMPLETING 65 YEARS of uninterrupted circulation is reason for pride for any publication, especially in the age of digital media. *Conjuntura Econômica* is the flagship publication of the Getulio Vargas Foundation (FGV), and parent of *The Brazilian Economy* Internet publication.

The 65th birthday of *Conjuntura Econômica* magazine in November 2012 illustrates the success of its dual mission: to act as a vehicle for dissemination of theses and ideas put forward by the staff of the Brazilian Institute of Economics (IBRE) of FGV, and to document developments in Brazil's economy. Launched in November 1947, *Conjuntura Econômica* has established itself as one of the most accepted business magazines in the country. Throughout its existence it has followed the major changes—even transformations—in Brazil from industrialization in the 1950s through the developmentalism of the 1960s to the "miracle" growth in the 1970s, the successive crises and attempts to stabilize the economy in the 1980s, and the long-awaited economic take-off that began in mid-1990.

This special issue attempts to trace the contours of Brazil from the perspective of today's experts at IBRE and FGV. The picture that emerges is of a more mature country that has had major successes over these six and a half decades, particularly in the last 20 years. The country has

- won the battle against hyperinflation and managed to stabilize its economy;
- attained a substantial fiscal consolidation;
- adopted a Fiscal Responsibility Law;
- gone from debtor to creditor of the International Monetary Fund;
- become a global exporter of grain and food
- substantially improved income distribution and social indicators; and
- overcome political and institutional instability to achieve a full democracy.

Not everything, however, is good news. Education remains deficient. Not only does inadequate education contribute to the low quality of labor and productivity, it also prevents Brazil from developing fully and affirming itself globally. Meanwhile, industry struggles to cope with growing foreign competition and poor infrastructure.

Brazil has progressed, but there is still considerable work to be done.

MONETARY POLICY
The interest rate roller coaster

Claudio Accioli, *Rio de Janeiro*

DEFENSE OF THE EXCHANGE RATE, the need to attract foreign capital, foreign crises, inflation control – these are all reasons that have been invoked to justify a policy of high interest rates. For decades, Brazil had the highest interest rates in the world. This changed only recently, in August 2011, when the Central Bank, contrary to market expectations and without ever signaling its intention, reversed the monetary tightening that had begun in January, when President Rousseff took office. Since then, the central bank's policy interest rate, which had risen to 12.5% in July 2011, has come all the way down to 7.25% today—the lowest level since the 4.5% recorded in March 1999.

"When the central bank began that move in August last year, I spoke publicly against it, but I was wrong. The policy rate fell 525 basis points and the world has not ended. Inflation did not explode," says Samuel Pessôa, consultant to IBRE/FGV.

Briefly reviewing the history of interest rates in Brazil, Pessôa notes that immediately after the Real Plan that stabilized the economy during the Itamar Franco and Fernando Henrique Cardoso administrations (1994–98), the government focused on building institutions and on constitutional changes, achieving price stability, privatizing state-owned corporations, establishing regulatory agencies, renegotiating the debts of state banks and restructuring the financial system. But this was also a period of fiscal imprudence that led to increased government borrowing, though that was necessary to prevent capital flight and to mitigate the terms of trade losses Brazil suffered in the aftermath of the Mexican and Russian crises.

After the Mexican and Russian crises, "The policy of very high interest rates . . . was the anchor that allowed government to put the house in order."

SAMUEL PESSÔA

PRICE OF STABILIZATION

"Facing this situation required a policy of very high interest rates. That was the price that had to be paid to stabilize the economy in an adverse environment with a history of hyperinflation, defaults on public debt, and a series of unsuccessful stabilization programs.

It was the anchor that allowed government to put the house in order. It left a negative inheritance, high public debt; but it also left a positive one, a better institutional framework," Pessôa emphasizes.

During the Cardoso administration, interest rates remained high to compensate foreign investors for relatively high country risk: "We suffered the effects of past errors and not-so-promising prospects," Pessôa explains. "The situation only began to improve when we adopted the current macroeconomic framework: floating exchange rates, high primary budget surpluses, and inflation targeting." Floating the exchange rate brought about a significant devaluation that helped to eliminate the external current account deficit: the current account deficit of about 4% of GDP in 1998 turned into a surplus of 2% in 2000 and 2001 without unemployment and deep recession.

The new monetary policy was tested during the transition from the Cardoso administration to that of leftist Luiz Inácio Lula da Silva. The central bank policy rate rose from 18% a year in July 2002 to 25% in December because of uncertainty about the new administration. "When it became clear that we had an elected leftist administration that was fiscally responsible and committed to respecting contracts, country risk plummeted," Pessôa explains. "However, interest rates remained high due to the strong increase in consumption demand generated by the policies of the Lula administration to improve income distribution, reduce inequality, and increase the purchasing power of the lower classes, supported by credit expansion."

OVERSIGHTS

These policies, according to Pessôa, had the merit of accelerating social change and opening up access to consumer goods for Brazilians in poorer classes. However, the Lula administration neglected public goods, leaving as a legacy rundown infrastructure and low-quality public services that retard growth. In the specific case of interest, this problem eventually led to the solution adopted by the Rousseff administration. "What led to the dramatic fall in policy interest rate in recent months has been the combination of two factors: the worsening of the international outlook, which should result in very low interest rates for longer than previously thought [possible] in major economies, and six quarters of negative growth in investments in Brazil. If the Brazilian economy resumes growth and investment recovers, interest rates will increase again," said Pessôa.

"The central bank will accept higher inflation to keep interest rates lower. Any inflation below the target ceiling of 6.5% would be acceptable."

SAMUEL PESSÔA

Silvia Matos, coordinator of the IBRE Economic Outlook, believes that "the challenge today is to maintain growth with controlled inflation and low interest rates. During the Lula administration, although the interest rate was higher, monetary policy achieved a better balance between these variables." Matos attributes current difficulties to an economic stabilization that was not completed. "Our real interest rates are effectively converging to international levels, but in a distorted way. Chile, for example has a real interest rate of 2%, the difference between a nominal interest rate of 5% and inflation of 3%. Brazil's real interest rate is close to 2%, but it is the difference between a nominal interest of 7.25% and inflation above 5%. Our situation is worse," Matos says. "When inflation does not approach the official target of 4.5% a year or even fall below it, we cannot say that our stabilization process is 100% complete."

Pessôa believes that if the choice is between growth and inflation the central bank will not hesitate: "President Rousseff has committed herself politically to a reduced policy rate and will resort to all available instruments to fulfill it in the coming years. The central bank will accept higher inflation to keep interest rates lower. Any inflation below the target ceiling of 6.5% would be acceptable. I hope the government seizes this moment to permanently reduce the cost of rolling over public debt."

Matos agrees. She adds that resolution of the puzzle of balancing growth, inflation, the interest rate, and the exchange rate exceeds the central bank's responsibilities and power: "The central bank has cut interest rates and tried to maintain a more favorable exchange rate to help industry, even sacrificing a bit of its own credibility with regard to curbing inflation, yet economic growth has not resumed, because the current consumption model is exhausted. You need to change the development strategy, prioritizing investments in infrastructure, increasing productivity, adopting microeconomic policies that improve the efficiency of markets, and clearly defining the roles of government and private enterprise."

"The central bank has cut interest rates and tried to maintain a more favorable exchange rate to help industry … yet economic growth has not resumed, because the current consumption model is exhausted."

SILVIA MATOS

FISCAL POLICY
No more gimmicks

SPEND LESS THAN YOU COLLECT. This universal principle guarantees orderly accounting. In Brazil, however, since World War II, the rule has usually been disregarded. The results have been expansionist policies, disproportionate investment in state-owned businesses, and ever-growing public debt, checked only by very brief periods of fiscal austerity.

The changes that were set off by the crisis of 1998, whose icon is the Fiscal Responsibility Act of 2000, marked a new chapter in the spendthrift culture that had characterized Brazil until then. From this new fiscal framework followed an improved profile of debt issued with longer maturities and lower interest rates, and budget surplus targets that make fiscal adjustment part of the tripod of macroeconomic policy along with the floating exchange rate and inflation targets. "Thanks to the Fiscal Responsibility Law it was possible to establish a system of consistent primary budget surpluses," says Gabriel Leal de Barros, IBRE researcher in applied economics.



January 2010

But since 2009, when the government began to resort to accounting gimmicks to show budget surpluses, the 2000 fiscal framework has been eroding. "It was an expedient adopted in response to the international economic crisis in 2008, but since then these adjustments have continued," says de Barros. This year, low GDP growth and use of a series of tax incentives to stimulate the economy considerably reduced tax collections and the government turned again to creative accounting. De Barros explains that "From January to August, revenues grew only 1.8% in real terms, while public expenditure grew by 6.5% a year. The government will need extraordinary revenues to reach the budget surplus target of 3.1% of GDP." He warns that these accounting gimmicks make it very difficult to assess the impact of public sector demand on the economy.

And the medium-term outlook is not promising. For de Barros, there is no more space for tax exemptions, and the government should decide what its fiscal policy goal is: "Today, it has several: meet the primary budget surplus, pay interest on debt, support monetary policy to fight inflation, increase investment in infrastructure . . . these goals are incompatible with our current policy

of expansion of public spending and compulsory expenditures." That is not even considering the spending on large infrastructure projects related to the World Cup and Olympics, as well as the impact of tax exemptions on industrial policy. "The policy to cut electricity costs alone will increase public spending by R$4.5 billion for the coming year."

Given current conditions, the government will not be able to cut expenditures until 2015 when the current policy of keeping minimum wages above inflation expires. Since pension benefits are currently linked to the minimum wage, that policy automatically increases public spending. Ceasing to index pension benefits to the minimum wage valuation would open up a huge space to cut spending. The minimum wage is already at international levels, and social policies other than raising the minimum wage could address income inequality, such as enhancing the Family Grant program for poor families and investing in education and health.

Meanwhile, de Barros argues that the government must reevaluate its accounting practices and their consequences for the credibility of fiscal policy. "Having a transparent nominal budget target (including all expenses and interest payments) for the public sector is the next step. . . . Communication with markets needs to be clear, and this implies not promising that there will be budget surpluses no matter what the cost."

THE TAX WAR BETWEEN THE STATES

If on one hand the future of Brazilian public accounts depends on returning to the previous spirit of fiscal discipline, on the other the country also needs to eliminate a problem no less serious: the regional imbalances that have intensified the tax war between the states.

"From January to August, revenues grew only 1.8% in real terms, while public expenditure grew by 6.5% a year. The government will need extraordinary revenues to reach the budget surplus target of 3.1% of GDP."

GABRIEL LEAL DE BARROS

Economist Fernando Rezende, professor, FGV Brazilian School of Public Administration, points out that the tax war originated because the federal government's policies to mitigate regional inequalities were ineffective. "At the time of the 1988 Constitution, states and municipalities demanded greater autonomy, which resulted in an increase in the State Participation Fund [FPE]," he says. The FPE receives a portion of the taxes on income and industrial products to make available to less developed states. However, the 1998 crisis and the need to ensure federal budget surpluses reduced the revenues available to the FPE, which diminished its importance

as a tool to promote economic balance between states. "The federal government has preserved the division of the pie that it had before 1988, with only some increase of municipal participation, and the conflict has worsened," he says. As poor states and municipalities depend more substantially on conditional transfers, their budget autonomy has been severely constrained. As a result, states have pursued a policy of attracting industrial activities by reducing VAT taxes, which has generated more conflict.

Although investors have identified the tax war as a factor in legal uncertainty, Rezende is optimistic about the possibility of change, particularly because many current legislators seem willing to discuss the matter. A special committee of the Senate has made suggestions for new rules for the FPE and ways to mitigate the tax war, including calculating the debt of the states and distribution of oil royalties. If successful, Rezende believes, the FPE reform could prepare the ground for the tax reform that is central to fiscal consolidation. This would be a huge step toward a more efficient tax system.

"The federal government has preserved the division of the [revenue] pie that it had before 1988 . . . and the conflict [between the states] has worsened."

FERNANDO REZENDE



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INFLATION
Can Brazil control inflation?

Claudio Accioli

YOUNGER BRAZILIANS did not suffer through one of the worst scourges of economic national life: the dreaded hyperinflation that haunted the country until the mid-1990s, unscathed by various economic plans to curb it. In March 1990 monthly inflation reached 80% as measured by the Brazilian Institute of Economics IGP-DI price index—almost 3% a day. In 1993 inflation was a staggering 2,708% a year. But now, two decades after adoption in 1994 of the Real Plan, a set of economic measures that included the introduction of a new currency, the *real*, the memory of hyperinflation has begun to fade.



May 2010

With this history, expressing concern about a single-digit inflation rate of about 5.5%, although it is above the official inflation target of 4.5%, may seem overzealous or even just plain odd. But Salomão Quadros, assistant superintendent, IBRE / FGV General Indices, warns that "Because we live in a much better situation today does not mean that we should stop pursuing lower inflation . . . . The issue is not just numbers. People become more flexible and accommodating with regard to inflation. It's a tricky situation."

In the 1980s Brazil carried out five economic plans to curb inflation, mostly based on freezing prices and wages: The cruzado currency (February 1986), the Bresser plan (July 1987), the Summer plan (January 1989), the Collor plan (March 1990), and finally the *real* currency (1994).

The first four initiatives were not able to contain the escalating inflation and stabilize the economy. Quadros believes, however, that all the plans helped in some way to forge the strategy that eventually succeeded. But not everything was resolved. "Although greatly reducing inflation, the insufficient fiscal consolidation in the Real Plan relied on an overvalued exchange rate. Between 1994 and 1998, the exchange rate anchor brought inflation down more than the fiscal stance would allow," Quadros explains.

The overvalued exchange rate brought about a serious external balance of payments crisis in 1998, which caused heavy losses of international reserves. Those forced the central bank to let the exchange rate float and adopt targeting to keep inflation at acceptable levels. "Inflation targeting had already been used for some years in countries like England, Chile, and New Zealand. As these countries had not had a brilliant record in curbing inflation, they sought a framework to commit to permanent control of inflation," Quadros said.

In Brazil, Quadros believes, the model was to some extent naive at first. In the first three years the authorities set the center of the target at 8%, 6%, and then 4%, with upper and lower limits within 2 percentage points, and the outcomes were 8.94%, 5.97%, and 7.67%. "They did not take into account the

fact that, when inflation was already lower, each percentage point decline had to be painstakingly conquered, mainly because at that time the country still retained habits acquired during the period of adjusting prices based on past inflation," he says.

CENTRAL BANK INDEPENDENCE

Now that more than 10 years have passed since inflation was first targeted, Quadros feels some disappointment with the results: "[They're] not exactly what we wanted after 20 years of the Real Plan. We have a target of 4.5% that has not changed since 2006. We could have been more ambitious." The comment refers directly to the performance of the central bank during the administrations of Presidents Luiz Inácio Lula da Silva and Dilma Rousseff. "The independence of the Central Bank of Brazil does not follow from any law but from the voluntary attitude of government. Lula realized that it was necessary to commit to controlling inflation . . . and assumed the political cost of handling control of inflation to the central bank. It worked, and the central bank gained credibility . . . . The central bank was absolutely committed to inflation targeting and was permitted to manage the policy interest rate," says Quadros.

"We have a target of 4.5% that is unchanged since 2006. I think we could have been more ambitious."

SALOMÃO QUADROS

In contrast, under Rousseff, Quadros says, the central bank since 2011 has used less conventional policy instruments: using more macroprudential measures to control rising inflation, such as increased capitalization requirements for financial institutions, rather than using interest rates. As this strategy did not curb inflation, the central bank raised its interest rate in the first half of 2011. In August, however, it suddenly reversed its policy, starting a loosening cycle that has reduced interest rates to the lowest levels in history. Quadros believes that given the still unfolding international crisis the central bank under President Rousseff is mainly concerned about economic growth.

Even if it is justified, Quadros believes that the current level of inflation generates uncertainty for the Brazilian economy. As he explained, "The problem is entrenching inflation expectations in sectors like services. Schools, for example, adopt annual contracts based on past inflation. The same goes for urban buses. Service inflation is little affected by the interest rate policy." The future of inflation is unknown because inflation expectations depend to some extent on the central bank making its medium-term goals clearer.

"I do not see a tranquil inflation outlook for the next few years, because among other reasons the government continues to stimulate demand, when it would be advisable to unlock supply, encouraging investment, productivity and the competitiveness of economy. The country has been helped by the exchange rate and the international deflation, but no one knows for how much longer. When the central bank governor declares that he is committed to fighting inflation, it is a sign that the policy does not speak for itself. Some things are not meant to be spoken, but to be understood."

INDUSTRY: Back to the future

Solange Monteiro

THE ECONOMIC GROWTH of recent years that lifted Brazil to fifth place among world economies has failed to carry manufacturing along with it. Together with external factors, such as the drop in global demand due to slow growth in the United States, Europe, Japan, and China's competition, a combination of domestic factors—the appreciation of the exchange rate starting in 2010, which raised labor costs and hindered exports, the fall in productivity, and continuing problems of competitiveness—prevented Brazilian industry from expanding with the rest of the economy.



August 2010

Average growth of manufacturing in the last decade did not reach 3%. "Between 1996 and 2003, Brazilian manufacturing export volumes grew by 8.4% on average, compared with 0.8% for imports but between 2003 and 2010 manufacturing export volumes increased only 4.4%, versus 13.1% for imports," Aloisio Campelo Jr., assistant superintendent of the IBRE/FGV Business Cycle, said by way of illustration. The cost of labor in foreign currency was 21% higher in 2004–10 than in 1996–2002. Productivity, measured using national accounts data, declined 0.8% a year in manufacturing for 2000–09, while it increased by 4.3% annually in agriculture and 0.5% in services.

However, the government strategy for addressing the lack of competitiveness of industry also raises concerns. Adoption of mechanisms to defend domestic industry—preferential tax treatment, and legal requirements to hire and buy parts locally—could eventually make domestic industry even less productive and competitive, undermine public finances, and aggravate income disparities.

"The problem with protectionist policies is that, after passing the critical period, it is hard to eliminate them. Although the authorities talk about innovating to grow . . . these policies may generate few results," says IBRE researcher Mauricio Canêdo. The protectionist policies carried out since the 2008 crisis and continued in the Greater Brazil Plan in late 2011 have also had an effect on the government budget. "Today we have fiscal tightening due to both low growth and the tax exemptions, and we cannot meet the primary budget surplus target without using accounting

gimmicks, like anticipating the payment of dividends by state-owned companies," says Regis Bonelli, coordinator of the IBRE Economic Outlook.

This deteriorating trend in public finances, according to Pedro Cavalcanti, professor of economics, FGV Graduate School in Economics (EPGE / FGV), has intensified since 2005. "Between 1995 and 2005, both the Cardoso and the Lula administrations undertook a series of economic reforms: privatization of public utilities, creation of regulatory agencies, the Fiscal Responsibility Law, and a successful macroeconomic regime. The Lula administration reformed social security pensions and passed a new bankruptcy law . . . . There was an understanding that the government does not need to produce but rather to be a regulator," he recalls. With the chaos of the 2008 crisis, this reform agenda was abandoned. The crisis was used as an excuse to reintroduce a vision of the state role in the economy that had prevailed in the 1970s. It had guaranteed growth for a number of years but has generated a series of distortions that ultimately hindered growth, Cavalcanti explains. "The policies adopted are a guide for how to reduce productivity: an industrial policy subsidized by massive transfers from the Treasury to the National Bank for Economic and Social Development (BNDES) . . . without performance goals and timeframes," he says.

USE IN MODERATION

"When we look at the experience of other countries and economic theory, we find that industrial policies to be successful should be used sparingly: they should have clear targets, a definite date to end, and protection should decline over time," Canêdo says. "Industrial policy is not a substitute for [dealing with] infrastructure problems, red tape for doing business, and an inefficient tax system. Reforms are always more efficient," he says. Cavalcanti argues that "the rapid growth that occurred between 1968 and 1973 (the economic 'miracle') resulted from economic and institutional reforms implemented between 1965 and 1967 by the Economic Action Plan of the Government during the Castello Branco administration."

"Industrial policies to be successful should be used sparingly: they should have clear targets, definite date to end, and protection should decline over time."

MAURICIO CANÊDO

IBRE researchers also point out that the concern about the relative loss of importance of industry since trade and foreign competition opened up in the 1990s should be considered in the context of structural transformation of countries. "When the economy grows, the proportional size of industry tends to decrease because people's needs and

demand shift to travel, education, etc. There is no doubt that we are moving to a model like the U.S., where services represent 80% of the economy," says Cavalcanti.

In Brazil, the share of the manufacturing sector in the economy peaked at 23% of GDP in 1974–1976, and had fallen to 16% by 2009–11. Elsewhere, the 2010 average was 10% of GDP for countries in the Organization for Economic Cooperation and Development (OECD) and 16% in Central Europe. "Today, more thinking in terms of a thriving industry, we should focus on policies to make the service sector more productive because our workforce is less skilled," Cavalcanti said.

For Bonelli, Brazilian industry should have better days in the near future because domestic consumption remains buoyant and the almost 20% exchange rate devaluation improves prospects for manufactured exports. "We see an increase in confidence in industry, but there are still uncertainties, because it is boosted by exceptional measures and a strong domestic consumer market, and we do not know what will happen when this is over," Campelo says. ""We need to focus on policies to increase productivity and competitiveness, especially those that encourage more and better spending on education and training."

The key question, however, is the quality of these policies and government ability to carry them out. For instance, "On the one hand, the government was right to seek a reduction in the electricity price, a key input for the industry. But this brought about insecurity [in the power sector]," says Campelo. The government's concessions program for transport infrastructure raises similar concern: "We need a pragmatic government that corrects its course when necessary."

"We see an increase in confidence industry, but there are still uncertainties, because it is boosted by exceptional measures and strong domestic consumer market, and we do not know what will happen when this is over."

ALOISIO CAMPELO

"With clear rules and few barriers and without changing rules of private contracts halfway through the game, incentives to invest in technology and innovation will be better than protecting industry from competition," Cavalcanti concludes.

AGRICULTURE
On hold

Solange Monteiro

COUNTRIES THAT EXPORT agricultural commodities are now becoming anxious about the future, watching what is happening in the big driver of world food demand, China. Brazilian suppliers try to assess how China's demand has been affected by the international crisis and the changes it is making in economic policy to stimulate the domestic market. Besides following global developments, Brazilian agribusiness is also awaiting domestic policy decisions, plans, and investments in infrastructure and education to ensure more competitiveness in the uncertain horizon for international commodity prices.



November 2011

Ignez Lopes, head of the IBRE Center for Agricultural Studies, points out that until now the path of growth adopted by agribusiness could not be better. The policies adopted in 1990 and the dedication of farmers to assimilate technologies without subsidies in recognition of the new reality of the global market allowed Brazilian agribusiness to take advantage of increasing world demand for food. In less than 20 years agribusiness has moved beyond the context of a fixed exchange rate and tariff protection to become a leading world exporter of such products as sugar, coffee, orange juice, ethanol, beef, tobacco, and chicken. "Previously the sector was badly affected by trade policy and the fixed exchange rate. During that period, if farmers increased production, prices would fall because there was nowhere to sell the surplus," says Lopes.

Agribusiness also benefited from the 1996 Kandir Law which eliminated the VAT on exports, and the creation of Mercosur in 1991, which made the country face direct competition from neighbors with strong agricultural traditions, like Argentina. "This forced Brazil to adjust," Lopes explained. "Argentina's corn and wheat came in very cheap. Initially with no tariff protection and a low dollar, the first impact of the opening was to import more. Only after farmers adjusted to the new conditions did Brazil become an exporting powerhouse."

Mauro Lopes, CEA project coordinator, notes that the Brazilian Agricultural Research Corporation (EMBRAPA) came up with a successful model of regional research centers in specific products, as well as other initiatives, such as investment in genetic research, to replace trial and error. "The result was that while grain production grew at an average annual rate of 5.9% between harvesting seasons

1999/2000 and 2009/10, the planted area increased only 2.3% annually," he says. This represents a jump in 10 years from 83 million to 147 million metric tons, thanks to annual productivity growth of 3.5%.

These productivity gains, however, reflect a countryside very different from the popular bucolic perception. Today, Brazil's grain production involves half-million-dollar harvesting machines with GPS, and computers that automatically analyze soil quality and spell out the exact amount of fertilizer needed. To invest in new technologies, however, agribusiness demands a skilled work force that is in short supply. The National Service of Rural Training recently hired IBRE to conduct a survey to identify worker training needs for each region. The first results are worrying. "The needs are vast—from specialists in field supervision and machinery maintenance and fighting pests to salesmen to market products," Mauro Lopes says.

What matters greatly for the sector in the medium term is the lack of logistics infrastructure to meet agribusiness needs. When logistics costs are high, producers earn less. For Mauro Lopes, initiatives like the concessions program to unlock investments in transportation infrastructure are needed urgently. For example, the 1,700-km BR-163 interstate highway is designed to be a major route for transporting grain. "It will benefit 23 municipalities whose crops account for 18 million metric tons a year," he says.

FOR ALL

"Investment in infrastructure is also important for small farmers; today without the scale of the large producers, they can see the comparative advantage of their products dissipate because of the logistical cost," says Mauro Lopes. According to the 2006 Agrarian Census of the Brazilian Institute of Geography and Statistics, the 3.9 million small farms account for 7.6% of total agricultural production. Of these, about 2.2 million generate only half the minimum wage per month, accounting for only 0.9% of total production value. At the opposite extreme, 300,963 farms account for 78.8% of total production value. "Policies of land distribution will not solve the rural poverty problem," says Daniela Paula Rocha, an IBRE researcher. She and colleagues estimate that about 1.4 million small farmers would be able to expand production if they had access to technology and were assisted by appropriate public policies. The other small farmers would require more targeted polices and social programs to improve their income, and might have to move beyond the agricultural sector.

"In the 1960s and 1970s, policy focused on increasing agricultural production. It has had no effect among small farmers because it benefitted only those that have access to bank financing and minimum price," says Lopes. For her, the only way to get results is to give active technical assistance to the producer. In June this year, President Dilma Rousseff announced a plan for creating a national agency for assistance and rural extension that would disseminate best practices using protocols and technology packages, with direct assistance to small farmers. "Access to technology as well as microcredit is the way we must ensure the inclusion of small farmers . . . . There are many small farmers perfectly incorporated into the market, and this is a frontier we can expand," Mauro Lopes concluded.

LABOR MARKET
Let's get down to work

Thais Thimoteo

IN THE LAST few years, the labor market has been overheated. The monthly Employment Survey (PME) of the Brazilian Institute of Geography and Statistics (IBGE) in October 2012 recorded unemployment at 5.4% of total working population in the six main metropolitan areas (Recife, Salvador, Belo Horizonte, Rio de Janeiro, São Paulo and Porto Alegre)—the lowest unemployment rate since 2002, despite slow GDP growth. Eight years ago, the economically active population (PEA) had 2.8 million unemployed. Today, the number has dropped to just 1.3 million.



August 2011

Not only do Brazilians today find it easier to get a job to support their families, but income also has been rising: between October 2004 and October 2012 the average real wage increased 30%, from US$682 to US$886. The reason for the good news essentially, according to Fernando de Holanda Barbosa Filho, an IBRE researcher, is that the economy has been doing very well especially since the first term of former President Lula "Economic activity explains 70% of the fall in unemployment and education 30%. When the economy is growing consistently, it reassures employers that, despite high labor costs, they can hire more to meet demand for their product," says Barbosa Filho.

But it was not always so. Brazilian workers began to have important rights guaranteed by the Labor Code Laws as early as 1943. However, the problem today, as before, another IBRE researcher, Leandro Rodrigo de Moura, points out, is the rigidity of the labor laws and the high cost of laying off workers, which makes hiring extremely costly to the company. "It forces companies to opt for outsourcing services or hire the worker without a contract," de Moura says.

The government has lowered the payroll tax for some economic sectors of the economy, especially industry, but Barbosa Filho is skeptical about other changes to make labor laws more flexible: "I support reforms of the labor code; however, I do not believe that reform will occur . . . . With unemployment very low, it will be difficult to pass these proposals since there is nothing with which to pressure the government."

INFORMALITY

The buoyant job market has brought in workers without formal contracts.

"Informal work declined from 43% of the total employed population in 2002 to 32% in 2011. The addition of 22 million people, who were educated between 2001 and 2011, according to National Household Sample Survey (PNAD), accounts for 64% of this decline," says Barbosa Filho. Moura explains that part of the decline of informal work is related to a reduction in outsourcing: "When there was trade liberalization, companies began to outsource their services because of the high cost of labor and periods of crisis. Now we are going through a process of retention of skilled labor (with the fall in unemployment) and employers are taking the opportunity to hire those without contract or outsourced."

"When the economy is growing consistently, it reassures employers that, despite high labor costs, they can hire more to meet demand for their product."

FERNANDO DE HOLANDA BARBOSA FILHO

However, this absorption of labor does not occur in the same proportions in all regions of the country. Even though there was improvement in the North and Northeast, 50% of the total employed population is outside the formal economy. In the Southeast, 25% of workers are informal. "There are two Brazils," Barbosa Filho says.

It is true that most workers prefer to have a formal contract, the guarantee of a salary every month, and the benefits of labor rights. But there is a specific group that has to strive further to achieve that. It is that portion that has not finished high school, although they have studied about nine years. They are the ones who are halfway through education, and yet they have an important role in the labor market. Among this group the unemployment rate is 14%, the highest of all. "They have a hard time finding jobs. Unemployment only starts to fall when they complete high school [8%]. At the college level, unemployment is almost nonexistent," Barbosa Filho says.

WORK-SHY

But if there are some who run after work, there are others who do not. A survey by the Institute of Social and Political Studies at the State University of Rio de Janeiro (UERJ) found that 5.3 million young people between 15 and 25 fit that profile. The challenge for the government is great, because "The truth is we do not know why someone quits study and work, as the labor market is overheated. They may be discouraged; they may despair, "says Barbosa Filho. The increase in household income may also have caused some young people to quit work.

EDUCATION
For all

Thais Thimoteo, Rio de Janeiro

BETWEEN 1950 AND 1980 social inequality denied the poor access to education. Today, when policy is much more enlightened, Brazil suffers from the educational deficit caused by its history. The shortage of human capital hinders economic development. For example, according to a survey by the National Confederation of Industry (CNI), there is a shortage of 150,000 engineers. Quite simply, the root of the shortages of skilled labor, in this and other areas, is that Brazilian basic education—from preschool through high school—does not prepare students to go to college. According to IBRE researcher Fernando de Holanda Barbosa Filho, because thousands of young people are not learning "they feel discouraged and drop out to get any job. Enrollment in high schools reaches only 51% of those eligible," he says. The goal, according to the National Education Plan (PNE) 2011–20, is to increase high school enrollment to 85% by 2020 and get more 15- to 17-year-olds into school by 2016.

The root of the shortages of skilled labor . . . is that Brazilian basic education—from preschool through high school—does not prepare students to go to college.

The task is arduous. Since the 1990s under the Cardoso administration, Brazil has significantly expanded elementary education—currently, according to the National Household Survey of 2011 (PNAD), 98.2% of children between 6 and 14 are in school. This expansion was partly due to investments made by the Fund for the Maintenance and Development of Fundamental Education and Valorization of Teachers (Fundef) begun in 1996, which pooled resources from states, municipalities, and the federal government. In 2007, it was renamed the Fund for the Maintenance and Development of Basic Education and Valorization of Teachers (Fundeb) and now also covers preschool and high school. Another important step was the creation of tools to assess student performance and define policies for improving education. The main ones are the Evaluation System of Basic Education (Saeb), the Brazil Exam, and the Index of Basic Education Development (IDEB). "The Brazilian educational system has not kept pace with demographic changes . . . . In the 1990s, there were major improvements. This does not mean that education has changed dramatically, but an institutional framework was built. Progress will take time; some is already happening," says IBRE researcher Fernando Veloso.

Despite clear progress, the changes so far are not enough. Brazil still faces enormous challenges. Brazil is currently ranked 53rd by the Program for International Student Assessment (PISA) of the Organization for

Economic Cooperation and Development (OECD), behind such neighbors as Mexico (49th), Uruguay (47th), and Chile (45th). Topping the list is China. "Brazil has been one of the three countries that have improved their evaluation the most since 2000—but that is because there is still such huge scope for progress," says Veloso.

As for other regions of Latin America trying to catch up, the key to progress is to find ways to improve the quality of education in order to train a large cadre of skilled workers, technicians, engineers, and scientists to meet labor market demand. "It's very hard to expand both the supply and the quality [of education services]," Barbosa Filho says. "If the system is very good, it is easy to replicate it. But if it has only a few islands of quality, as shown by the results of the National High School Exam (Enem), you need to rethink what should be done."

According to these experts, deficiencies are related to empowerment and training of teachers, resource management, and high dropout rates. "Maybe it's time to work on tracking each student, identifying their problems and trying to resolve them. The worst students are simply abandoned," says Veloso, who also argues for increasing school hours and dramatically changing pedagogy courses. Teacher training, he says, "is pure ideology with hardly any practical experience in the classroom." Barbosa Filho points out that "The majority of teachers did poorly in college. Obviously, teachers' low pay and prestige also explain why we cannot produce schools that offer good education."

INVESTMENT VERSUS MANAGEMENT

OECD's *Education at a Glance*, published in September 2012, shows that Brazil is investing more in education. In 2009, it spent 5.5% of GDP on education compared to 3.2% in 2000. Nevertheless, quality may not be related to the resources allocated for a particular purpose. The formula for success is good management. "Money and quality do not necessarily go together," Barbosa Filho observes. "Take, for example, states where per student spending is much higher than the national average, like Roraima and Rondônia states, in the northern region; even with those resources, education in these states is not the best education in the country. They are throwing money out of the window. In Brazil, we spend too much and spend it badly," says Barbosa Filho. Veloso agrees. He argues that resources should follow successful programs: "We have to use successful initiatives, such as those increasing school hours, maybe apply those experiences in schools with weaker performance and then expand them."

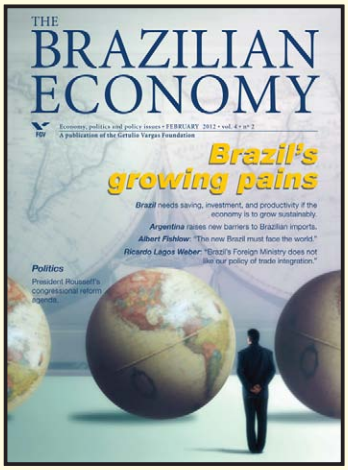
EDUCATION COMES FROM HOME

However, it takes more than management and resources to encourage learning. It is also up to parents, especially the lower middle class, to motivate their children in terms of the importance of a better education ," says Veloso. Lack of awareness of the relevance of education is a cultural problem, but there are signs this is changing, thanks to the increase in schooling, and consequently incomes. "Studies show that the socioeconomic environment directly affects student performance. Learning is more difficult in areas where families have lower per capita income," Veloso explains. He points out that young people often need to get a job early in life to help support their families. The good news is that this problem will tend to diminish over time. "There is nothing more convincing of the importance of education than what we feel in our pocket. I believe this new generation is already feeling it and they will pass it along to their children," he concludes.

EXTERNAL SECTOR
External ripple effect

Claudio Accioli

WHEN THEN-PRESIDENT LULA declared that the severe financial crisis that swept the world in 2008 would come to Brazil as a "small wave," he reflected the feeling of a country that had expanded its international economic presence over the past 20 years but still was not recognized as an integral part of a world whose transformations are crucial to its future.



February 2012

Sebastião do Rego Barros, former Brazilian Ambassador to Argentina and chairman of the IBRE Advisory Board, points out that if the effects of the 2008 crisis were indeed not felt much at home, they also cannot be ignored. "It was a disastrous event for much of the world, which was having a period of unprecedented growth. Brazil was taking advantage of these favorable winds when it faced the crisis . . . . But I think we weathered the crisis fairly well. We are not Switzerland, but we achieved some stability," Barros says.

EXTRA MONEY

Armando Castelar, IBRE coordinator of applied economics, highlights that in the last two decades, the dynamics of the Brazilian economy were influenced by a world that has become particularly "busy," especially with the dramatic increase in the speed and amount of capital flows between countries. In Castelar's opinion, though, at the same time the frequency and the virulence of international crises also increased. "Since at least Japan's crisis in early 1990, speculative asset bubbles have been moving from one country to another, bringing about boom periods followed by disasters that take time to be resolved, because they involve both financial systems and households," Castelar explains.

In the last two decades Brazil has endured a variety of international crises. "We had the Mexican crisis in late 1994; the Asian in 1997; the Russian in 1998; our own currency crisis in 1999, which caused significant capital outflows and a fall in reserves; the Argentinean, in 2001; and finally, the global crisis in 2008, resulting from a credit bubble that started in the United States and then spread over the Euro region."

For the Brazilian economy, the main change observed in this period was the way the external crisis affected the country. Before, says Castelar, because the government was a net borrower in U.S. dollars and its domestic bonds were linked to the U.S. dollar, any international

crisis resulted in a steep exchange rate depreciation, followed by increases in domestic interest rates and rash fiscal adjustments to keep public debt solvent.

That began to change in late 2002 and early 2003 with the increase of prices for export commodities that enabled Brazil to achieve large trade balance surpluses and build up its international reserves—which increased by more than ten times, reaching US$352 billion in 2011. "That's not to say that Brazil is immune to crises forever. The reserves make a difference because they give some security to foreign investors that Brazil will in the short term have cash to pay its debts in dollars," says Castelar.

"Not only has the presence but also the reputation of Brazil in the international arena greatly improved, compared to the 1980s and early1990s."

SEBASTIÃO DO REGO BARROS

REVAMPED IMAGE

Ambassador Barros notes that the period of economic recovery from the early 2000s until the 2008 crisis coincided with the improvement of Brazil's image among its peers. "Not only has the presence but also the reputation of Brazil in the international arena greatly improved compared to the 1980s and early1990s. At that time, we were ending 20 years of military rule, and then we plunged into a period of great economic instability and rampant inflation. During the Cardoso and Lula administrations (1995–2010), the country became more organized and predictable. I would say that Brazil got on the right path of human rights; political, economic, and legal stability; better income distribution; and concern for the environment."

Besides good economic performance, Barros credits the improvement in Brazil's international status to the diplomatic skills of the two former presidents, Cardoso and Lula. "We are a country that enjoys good relations without facing major problems with neighbors or trading partners," he said.

Despite progress, however, Barros believes that Brazil still has a long road ahead if it is to occupy a prominent position on the world stage: "We must not only maintain domestic stability but also move toward the technological frontier, increasing the added value of our products. For this, we have to address major structural issues that prevent us from joining the modern world, such as education, infrastructure, the so-called Brazil cost, and reducing the inefficiency caused by the bureaucracy."

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China: Sustainable growth ahead



Clodoaldo Hugueney

Brazilian Ambassador to China

Solange Monteiro, *Rio de Janeiro*

CHINA, THE SECOND largest economy in the world, no longer pursues growth at all costs. Now, the concern of its government is sustainable growth, better income distribution, and prioritizing environmental issues. The 2012 GDP growth forecast is 7.5%. That is how Clodoaldo Hugueney, Brazil's ambassador to China, views the situation. He believes China's approach has advantages for Brazil. "We should not forget that imports from China are worth about US$2 trillion, and most of them are manufactures," he says. The ambassador approves of the development of Brazilian supply chains in China and elsewhere in Asia and the Pacific region.

***The Brazilian Economy*—Recently, the World Bank revised its estimate of China's 2012 GDP. What are the implications of that?**

Clodoaldo Hugueney—The change means that the country is making an effort to reorganize and grow its economy on a more sustainable basis. This implies less investment and more domestic consumption, changing the relationship between wages and capital. Quarter on quarter, the growth rate has been falling since the end of 2010. In China's 12th Five-Year Plan, projected GDP growth is about 8%, and Prime Minister Hu Jintao announced 7.5% for this year . . . . Now, it is not so much about just growing, but about growing with improved income distribution, promoting household consumption, reducing investment, prioritizing environmental issues, and changing the energy consumption matrix.

These changes in the economy coincide with major changes at the top of government. What should we expect?

Of the nine members of the Politburo Standing Committee, seven will be leaving. There is also a debate whether the committee will continue with nine members or be reduced to seven. There will also be significant changes in the central committee. The changes in government will be completed in March next year in the National Assembly, which will choose the prime minister, the members of the Council of State, and minis-

ters.... Not only are public officials changing, but there is a transition from the fourth generation of leaders to the fifth.

The expectation is that the new leadership will address three major challenges. The first is domestic politics: there need to be changes in how the government is organized, the party's relationship with the government and society, and [public sector] transparency. On this, there is a great expectation that the new leadership can move forward. The second is the economy, where the strategy is well-defined: the current five-year plan focuses on changing the growth model. And third are the challenges in the international arena. China is the second largest economy in the world, with increasing international responsibilities. So China needs a foreign policy that reflects this new dimension.

What about external impacts?

China is also passing through an external rebalancing, which has to do with its external balance surplus and its exchange rate policy. Lower growth means fewer imports, which is already happening. At the same time, however, the government has adopted a policy of increasing imports to reduce the trade surplus, which reached almost 10% of GDP and now stands at about 2.8%. In 2008, the surplus was close to US$300 billion, this year it should be about US$200 billion. The relation of the Chinese currency to the dollar has also varied. The latest IMF report shows a small depreciation in the exchange rate with the dollar, estimated at about 7%. Chinese exports were also significantly affected by the fall in growth in Europe, China's largest export market.

How will the international financial crisis and less Chinese growth affect China's trade with Brazil?

Brazilian exports to China are very concentrated; raw materials and agricultural products account for over 90%. Three account for something like 80%: soybeans, iron ore and oil. Soybean sales increased in January-August compared with the same period in 2011 because of higher prices resulting from problems with crops in the United States and Argentina. Brazil failed to expand oil exports because production of new deep-sea oil was less than expected. As for iron ore, with the reorganization of the Chinese economy, there was a significant reduction in the share of heavy industry, particularly the steel industry. China can produce close to 900 million tons of steel per year, but ... demand for steel was affected because there were fewer Chinese infrastructure and construction projects. ... Through August, Brazil's total 2012 exports to China were US$30 billion, but the fall in iron ore and oil exports was about US$3 billion. It is significant ....

Imports, on the other hand, continue to grow because the Brazilian economy is recovering. Chinese exports to Brazil are extraordinarily diverse. The eight major products, all manufactures, account for 13% of the total, compared to more than 90% in what we export there. From China we import industrial inputs, capital goods, telecommunication equipment, electronics, computers . ... These imports are important for Brazilian

China is making an effort to reorganize and grow its economy on a more sustainable basis.

growth. I expect hopefully that Brazil's trade balance surplus with China will decline to a reasonable level. Now, we have to make a serious effort to diversify Brazilian exports to China. We should not forget that imports into China are valued at US$2 trillion, most of them manufactures.

Not only are public officials changing in China, but there is a transition from the fourth generation of leaders to the fifth.

A 2011 IPEA study said that one of the problems in the progress of relations between Brazil and China is that the Chinese clearly know what they want from Brazil, but Brazilians do not know what they want from China. Do you see strategic advances in this relationship?

I think so. The first international trip President Rousseff made was to China, which demonstrated the importance she attributes to repositioning Brazil in relation to China and Asia. This involves many things, but certainly in trade relations it involves, first, a concerted effort to diversify and increase the value-added of Brazilian exports. We count on China's goodwill, and this year Chinese authorities are scheduling missions of businessmen led by the government to increase imports of Brazilian products.

Do changes in demographics and population in China open up opportunities for Brazil?

The rapid process of urbanization … will radically change the appearance of China in 15 years. At the same time, the aging population and reduction in the work force will have an impact on labor supply. Wages are growing at accelerated rates. The one child per family rule established 30 years ago will have more significant impact starting in 2015. The third change is that during the period of rapid growth there was a pronounced process of income concentration. The [income] disparity between rural and urban areas and between coastal and inland areas has grown. Today, China has about one million millionaires. Some of the largest fortunes in the world are here. You have income concentration in large cities like Beijing, Shanghai, and Guangzhou, and creation of a middle class estimated at 200 million people. From the standpoint of marketing, that has several consequences. As Ignez Lopes and Mauro de Rezende Lopes pointed out, there will be fewer workers in agriculture and prospects of increased consumption of protein, like meat; Brazil is positioning itself to capitalize on this growth. Since I arrived in China I have been working with the Ministry of Agriculture in an effort to open the Chinese market for Brazilian meat. Brazil is among the largest exporters of beef and chicken. What we have to do now is export not only frozen but also processed meat. The opportunities are immense. Coffee consumption in China is growing at 20% a year. And Chinese demand for wine is the fastest-growing in the world. We are not yet taking advantage of it.

Should Brazil be making efforts to export more quality than quantity?

We have to intensify the effort to improve quality. [We also have] to show Brazil that China is not only a matter of niche products. There is opportunity for just about everything. … European manufacturing companies are increasingly devoting

themselves to developing markets in China's countryside, with great success. There is where you will find great dynamism as well as income.

How can Brazil improve its competitiveness?

Brazil must look to the long term and seize the opportunities that China presents. Brazil should invest in China, developing production chains. People are no longer thinking about classic trade, but about production chains. We need to develop supply chains in Asia and the Pacific region, which is where globalization is moving to. We need an exercise that involves short-, medium-, and long-term strategy. Brazil is doing this. With the new industrial policy begins a new dialogue with China, putting on the table clearly what are our goals and the problems we have to solve.

China is the second largest economy in the world, with increasing international responsibilities, so it needs a foreign policy that reflects this new dimension.

In your opinion, what is the role of the BRICS (Brazil, Russia, India, China, and South Africa)?

There are three important dimensions. One that has been growing is dialogue: at first it involved only economic issues; now it is expanding to policy issues such as the situation in the Middle East and North Africa. Dialogue between Brazil and China is increasingly seeking to coordinate positions and identify common policies that can help resolve problems. This is also occurring in environmental issues.

The second area is BRICS coordination. They identify topics on which they have a common position, such as reforms of the IMF and World Bank and economic issues within the G-20, and take them to international forums.

The third area is cooperation. In agriculture, for example, ministers have been meeting to identify areas of cooperation in trade, investment, science, and technology. The Brazilian Enterprise for Agricultural Research (Embrapa) has just opened a laboratory in China and the Chinese Academy of Agricultural Sciences has opened one in Brazil to strengthen cooperation in science, technology, and agricultural innovation. The Brazil-China program to build satellites is being expanded to encompass nanotechnology and biotechnology. Last August the Minister of Science and Technology, Wan Gang, signed a cooperation agreement to expand the China-Brazil Center on Climate Change.

What can we expect from the relationship in 2013?

For China, Brazil has been a priority for years, and vice versa. That will not change. The second thing that will not change is that we still have a lot of areas of cooperation that we can develop. And finally I think Brazil and China have growing prospects of cooperation at the international level. Both are emerging countries with a rising profile in international relations and therefore capable of exerting influence on the course of world order. Therefore, they must have a more comprehensive and increasingly global relationship.

Public investment critical to Brazil's growth in 2013

THE SEPTEMBER INDUSTRIAL output figures have frustrated hopes that the Brazilian economy will recover in late 2012. Our view, like the views of other analysts, has stressed the consistency of the evidence that economic activity will resume only slowly and gradually.

However, in view of September's weak industrial production the odds now are for even more modest growth in the last quarter of the year. We estimate GDP growth of 1% in the third quarter compared to our previous projection of 1.1%. Underlying the less optimistic outlook is stagnating investment that casts doubts on GDP growth in 2013. We estimate that gross investment fell 1% in the third quarter, the fifth consecutive quarterly decline.

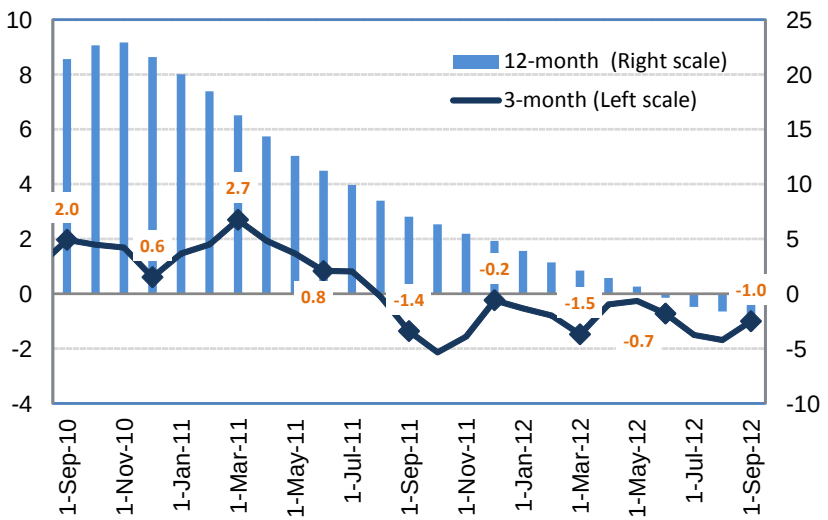
IBRE confidence indicators suggest some sobering of expectations in October, reflecting the concerns of businesses and consumers about the pace and strength of economic recovery at the turn of the year. In light of the latest indicators, especially stagnated investment, GDP growth of 3% in 2013 is a more plausible expectation than our previous projection of 3.4%.

The poor performance of the U.S., Europe, and Japan and the slowdown in China's growth will negatively affect international trade and finance. Investment and exports should be especially affected, and Brazil, as well as the other countries of South America and Mexico, will not be spared. Yet Brazil's poor performance also has domestic roots, as indicated by the fact that for 2012 most other countries in the region are expected to grow more than Brazil.

Why does investment not take off? It is clear that the federal government's investment in infrastructure has been far less than is necessary, but business is also hesitant to invest. This is certainly related to the protracted international crisis and the uncertainty generated by multiple government interventions in the economy. Under the circumstances, the strength of growth in 2013 will depend critically on whether the government will significantly increase public investment.

Brazil: Monthly Investment Indicator, Sept. 2012–Sept. 2012

(Percent change quarter-on-quarter, and 12-month moving average seasonally adjusted)



Sources: IBGE, Funcex staff projections.