# THE BRAZILIAN ECONOMY

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***Foreign policy***
Submerging Brazil?

***Regional economic climate***
Expectations of improvement in the Latin America economy.

***Interview***
**Edmar Bacha:**
Protectionism is bad for growth

***Industrial policy***
Recurrent mistakes




# What to expect next year

**IBRE staff and experts from various sectors of the Brazilian economy see a year clouded by uncertainties.**

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The BRAZILIAN ECONOMY

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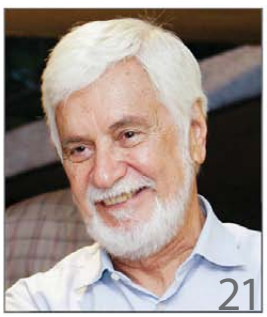
# THE BRAZILIAN ECONOMY











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## ECONOMY



Photo: Embraer

Embraer's Legacy 500 jet

**Embraer's new business jet**

Embraer's business midsize Legacy 500 jet made a successful first flight, marking the beginning of its test flight program. Deliveries of the first aircraft are expected in 2014. (November 27)

**Doing business more difficult in Brazil**

Brazil sank two places on the World Bank's 2013 Doing Business Report ranking, from 128th place for 2012 to 130th. (November 29)

**Vehicle production and sales fell in November**

Brazilian vehicle production fell 5.3% in November compared to October, to 301,700 units. From January to November, production is down 2.1% over the same period of 2011. Even with extension of the discount on the industrialized products tax on vehicles to the end of the year, moreover, sales of new vehicles fell 8.7% compared to October, to 311,800 units. (December 7)

**Inflation surprisingly high, up 0.6%**

Brazil's inflation rose faster in November than previously due to higher transportation prices, which suggests that the central bank has little room to cut interest rates further. Brazil's official consumer price index rose 0.60% in November, government statistics agency IBGE said. Food, housing, and transportation items were the main drivers. (December 7)

**Economy growth again anemic**

Gross domestic product grew only 0.6% in the third quarter, government statistics agency IBGE said. The disappointing result feeds a likely 2012 growth rate of less than 1%. (December 8)

**Retail trade increases in October**

In October retail sales increased 0.8% by volume, according to IBGE. Sales volume grew 8.5% for January-October compared to the same period a year earlier. It was the fifth consecutive monthly increase. (December 13)

**Industry more optimistic on 2013**

Despite poor performance in 2012, the expectations of Brazilian industry in 2013 are better than those seen in late 2011 to 2012, according to the October-to-November Investment Manufacturing Industry Survey by the Getulio Vargas Foundation. Of the 936 companies surveyed between October 15 and November 30, 50% reported budgeting more investments for next year; only 15% planned fewer. Also, 71% predicted sales growth, and only 6% expect sales to decline. The survey also reveals, however, that hiring expectations for industry are less favorable for 2013: the share of companies planning to hire fell from 36% to 32%. (December 13)

## POLITICS

**Will Lula run again?**

At a conference discussing the global economic crisis, the Forum for Social Progress, in Paris, former president Luiz Inacio Lula da Silva denounced new allegations that he was involved in the *mensalão* corruption scheme, criticized the press for double standards with regard to politicians—and hinted he would run again. (December 12).

## INTERNATIONAL



Photo: Wilson Dias/Agencia Brasil.

Presidents Donald Ramotar (Guyana), Evo Morales (Bolivia), Jose Mujica (Uruguay), Dilma Rousseff (Brazil), Christina Kirchner (Argentina), Rafael Correa (Ecuador), Dési Bouterse (Surinam), and Minister for Mines and Energy Rafael Darío Ramírez Carreño (Venezuela) at the Mercosur Summit in Brasilia, December 6–7.

### Mercosur summit

Mercosur continues to expand: President Morales has signed up Bolivia as a full member, subject to ratification. President Correa has asked for more time—negotiations with Ecuador were less advanced. However, there are still tariff issues that have not been resolved. Presidents Ramotar (Guyana) and Bouterse (Surinam) attended the summit as guests and have expressed interest in joining. Uruguay now takes over as chair for the next six months. (December 6-7)

### Brazil the largest foreign investor in Mozambique

Brazilian companies have rediscovered abundant natural wealth: With projects exceeding US$770 million, Brazil this year became the largest foreign investor in Mozambique, surpassing Portugal. Vale do Rio Doce company is mining coal in Moatize, and the Camargo Corrêa company will install a hydroelectric dam on the Zambezi River; the Mphanda Nkuwa dam will be the second largest in Africa. Odebrecht is building Nacala international airport in Nampula. Agribusiness is becoming the newest front for Brazilian business: Mozambique has 36 million hectares of arable land, of which only 5 million are being cultivated. Brazilian farmers have submitted projects for a 10,000 ha concession, and agribusiness companies have pledges for 100,000 ha, according to the Brazil-Mozambique Chamber of Commerce, Industry and Agriculture. (December 11)

## ECONOMIC POLICY

### New plan for ports announced

The Brazilian government plans to invest US$26 billion in ports across the country and expand private participation in managing ports. Brazil's ports are among the slowest and most costly in the world due to poor infrastructure, high taxes, excessive red tape, and deficient road and rail access. It costs US$200 on average to handle a single container in Brazil, compared to US$110 in European ports like Rotterdam, Hamburg, and Antwerp and US$75 in Asian ports. The government expects investments in ports, roads, and railways to eventually reduce transportation costs by 20%. (December 6)




Photo: Wilson Dias/Agencia Brasil.

President Rousseff participates in the ceremony to launch the new plan for ports.

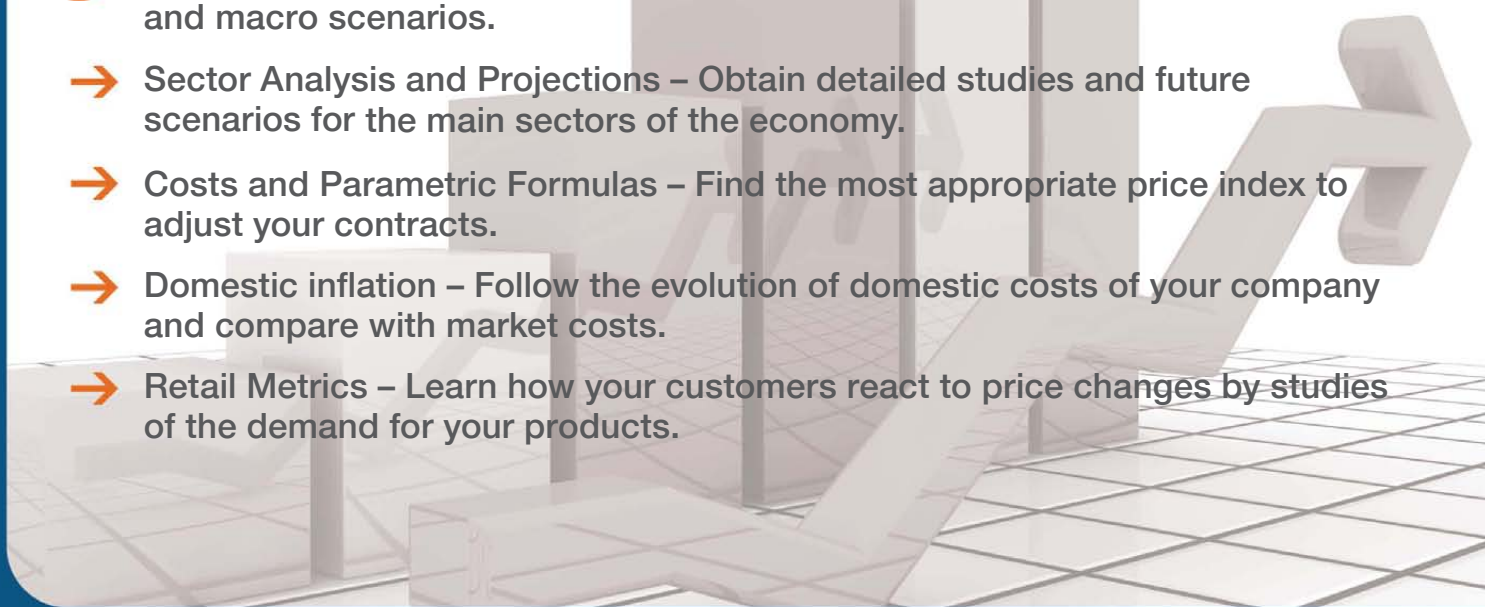
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# Brazil's competitiveness challenge

YES, PRESIDENT ROUSSEFF is a member of the Workers Party, but lately her administration's efforts to keep some workers in their jobs in, for example, the auto industry may be threatening jobs in other Brazilian industries. Take the electricity industry. In September the administration announced Provisional Measure 579, which among other things reduced electricity rates. The result? Immediately recognizing that power company revenues would plunge, investors pulled away. Since August, major power companies listed on the Bovespa stock exchange have lost US$34.6 billion in market value. Is this any way to grow the economy? Growth depends on investment. A policy that clearly reduces return on investment can only discourage investors.

Protectionism and red tape are pushing Brazil off a competitiveness cliff.

Agriculture and manufacturing are both desperate to get their goods to market more cheaply so they can compete with countries that have decent roads and ports. But instead of investing in infrastructure, the administration has been giving tax incentives for consumption—which may help the auto industry, at the cost of crippling the rest of the economy. Local content rules prevent companies like Petrobras from buying the best equipment and expertise from abroad. Not exactly a recipe for competitiveness. Or, for that matter, a model of sound management.

The government's social policy of transfers and subsidies to low-income households limits the amount of money the government has available to invest in infrastructure, and unquestionably its minimum wage and pension decisions have been decidedly generous—some might say profligate. It's great that 35 million more Brazilians are now considered middle class—but the new middle class would probably appreciate an economic policy that helped them stay there rather than sliding back again.

Brazil desperately needs higher productivity. That depends on a facilitative business environment, skilled labor, and innovation. Instead, according to the World Bank Doing Business indicators, Brazil has regressed two points, to 130$^{th}$ out of 150 countries. In other words, it's getting harder, not easier, to do business in Brazil.

Innovation, which in turn often depends on skilled labor, can be a powerful way to increase productivity and cut costs. Take General Motors in the U.S. as an example: In the 1990s GE outsourced is production of appliances to China in the 1990s. In the last 10 years, it's been bringing production back to the U.S. Today, GE does US$5 billion; 55% comes from its U.S. factories and by the end of 2014 that will be 75%. How can US workers possibly compete with the low-cost Chinese? The answer is innovation. GE put together teams of design and manufacturing engineers, line workers, and sales and marketing staff to redesign both products and assembly lines. The result was spectacular: made in China, its Geo Spring Water Heater costs US$1,599; made in the US, it costs US$1,299.

Meanwhile, Mexico is making it easy for companies like Embraer to invest there. There's a reason it will soon take over from Brazil as the most prosperous economy in the region.

The lessons are there: Protectionism didn't work for Brazil before (except to send production costs soaring) and it won't work now. Red tape never works. These policies are pushing Brazil off a competitiveness cliff.

# Submerging Brazil?

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

AFTER A FEW YEARS AS ONE OF the darlings of the new global economic order, the tide seems to have turned against Brazil. Two consecutive years of disappointing economic growth have been sufficient to sour the expectations of both commentators and market participants and all but demote the country as an emerging power. In policy circles in Brasilia, the fact that the country deserved not one mention in US presidential debates was widely perceived as a sign of disregard. Attempts to rekindle an illusive rivalry by pointing out Mexico's inevitable overtaking of Brazil as the region's main economy have also fueled concerns.

Is Brazil reliving a not-so-distant past and entering the bust phase of yet another boom-and-bust cycle?

Much of what is driving the general pessimism is the recurrent habit of many international relations pundits of viewing the world in terms of inexorable—and ever faster—power transitions among major powers. The problem has less to do with power transition itself than with the excessive expectations that followed the global financial meltdown of 2008–09. While the US and other developed economies were in a downward spiral, emerging countries like the BRICS kept growing and shouldered the weight of the global economy. To many, this process was a harbinger of a tectonic shift in geopolitics: the "rise of the rest."

Is Brazil reliving a not-so-distant past and entering the bust phase of yet another boom-and-bust cycle?

Brazil was never at the center of this process, at least from a geopolitical perspective, but several years of sustained economic growth gave more international visibility to the "B" in BRICS. Despite persistent social inequalities, its general domestic situation (political, economic, and social) has improved considerably, and like other large emerging powers Brazil has become more assertive regionally and globally. In doing so the country started to redefine its own national interests in ever-expanding terms. Brazilian multinationals conquered markets, more and more immigrants flocked to Brazil for a better life, and decision-makers started to flex their muscles on the global stage.

But two years of disappointing economic growth have deeply dampened expectations, not only toward Brazil but also with respect to other emerging countries. As a result, broken BRICS—the "*demise* of

castroneves@eurasiagroup.net

the rest"—has become the newest fad in pundit-land jargon.

One of the many problems with these premature assessments is that they tend to view international relations as a fundamentally zero-sum game: If one is down, the other has to be up. Not a lot of attention is given to the fact that some (not all!) economic challenges that emerging markets have endured in the past two years were influenced by continuing difficulties in developed economies. Furthermore, part of the frustration has to do with misperceptions and excessive expectations. The BRICS never represented a new and emerging world order. What glued these countries together was not shared viewpoints about what the world should look like but a slight overlapping of individual strategies aimed at better enhancing each country's international standing.

The economic situation in Brazil today is unarguably less favorable than before and is likely to remain so for some years, at least compared to the first decade of this century. And for a country with limited military resources situated in a relatively nonstrategic region (from a U.S. perspective), projection of Brazil's global power is predominantly a function of long-term economic activity. Thus, the Japan of the 1980s and even the Brazil of the early 1970s serve as cautionary tales about seeking a path to great power.

But while it is always prudent to talk about rising powers with a grain of salt, there are reasons to believe that the current pessimism toward Brazil is overstated.

While it is always prudent to take talk about rising powers with a grain of salt, there are reasons to believe that the current pessimism towards Brazil is overstated.

While growth is at the moment lackluster, unemployment is still very low. Furthermore, the growth of the middle class is a sign of a structural shift in Brazil's demographics, which will have many repercussions in policymaking — including foreign policy. Finally, beneath the chatter created by some (overly) aggressive policy responses to the economic downturn (pressure on the banking sector and power utilities, to name a few), important structural reforms have begun to take shape (in public pensions, savings accounts, payroll exemptions, and concessions for transport infrastructure, among others). Of course, many challenges lie ahead and Brazil's place in the world will depend greatly on the longer-term impact of these reforms — and whether the government will continue to pursue them.

For a country for which international prestige has always been one of the goals of its foreign policy, to be excluded from headlines may feed an alleged "inferiority complex" in Brasilia. But when one thinks of China and the Middle East, no mention is certainly a good thing when it comes to U.S. presidential debates.




# What to expect next year

**IBRE staff and experts from various sectors of the Brazilian economy see a year clouded by uncertainties.**

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

IN DECEMBER 2011, most of the analysts interviewed by *The Brazilian Economy* did not hesitate to say that 2012 would be similar to 2011—that is, somewhat predictable and uneventful. And, in fact, there was no *major* turbulence in the domestic economy in 2012. But the year now ending did produce at least two surprises. The first is that estimates of gross domestic product (GDP) growth have been heading steadily downward and it is expected to hit only 1%—just a third of what even the most conservative projections expected early in the year. The second is the fact that economic activity has not responded to any of the government's efforts at stimulus, including investment packages, sectoral tax exemptions, and an unprecedented reduction in the central bank policy interest rate.

To try to cure the economic anemia, earlier this month the government ended the year as it began, by announcing yet another tax exemption initiative, this one for the construction industry, and a new US$50 billion package to stimulate investments. However, with inflation close to the official target ceiling (between 2.5 and 6.5), gross investment having declined for five consecutive quarters, and a very uncertain external environment, projecting scenarios for 2013 is a highly risky business.

## IBRE BASELINE SCENARIO

The Brazilian Institute of Economics of the Getulio Vargas Foundation (IBRE-FGV) announced its scenarios during a recent seminar on Perspectives for the Brazilian Economy in 2013. Speakers were economists Regis Bonelli, Silvia Matos,

and Samuel Pessoa, all from IBRE; José Júlio Senna, managing partner of MCM Consultants and member of the FGV Board, and Affonso Celso Pastore, former governor of the Central Bank.

With regard to growth, the most sensitive point for current economic policy, the assessment of IBRE researchers is that, although the second half of 2012 performed slightly better than the first—despite the disappointing GDP results of only 0.6% for the third quarter—the recovery of economic activity is not enough to ensure growth of more than 1% for this year. For 2013, the forecast is 3.2% growth. Thus average growth in the first three years of President Dilma Rousseff's term would be 2.3%. "It's a significant drop compared to the eight years of President Lula, whose average was 4%. Of course the world is also growing less, but there is evidence that domestic factors have been more important in explaining the slowdown," said Silvia Matos, coordinator of the IBRE *Economic Outlook*.

Among those domestic factors is the plunge in gross investment, which should end the year with a cumulative decline of 3%. "This is a key variable that is very worrisome, because it puts at risk the country's growth potential not only in 2013 but also beyond," Matos said. For the next year, given the reduced real interest rate and other favorable factors, the IBRE researchers project a recovery in gross investment of 8.6%, but the risks to this projection are significant.

Given the projections for this year and next, the comparison again looks bad for the current administration compared to the previous one: average annual growth in gross investment would reach 3.4% for the Rousseff administration, compared to 8.9% in Lula's administration. "This difference is crucial to explain the deceleration of growth in Brazil," according to Matos.

Taking into account factors like productivity, hours worked, and capital stock used by the economy, IBRE researchers estimate potential 2013 GDP growth (growth capacity without increasing inflation) of 3.0% to 3.5%, primarily due to the lower rates of investment

**Brazil**
**IBRE baseline scenario. 2009-2013**

| | 2009 | 2010 | 2011 | 2012 Proj. | 2013 Proj. |
|---|---|---|---|---|---|
| Real GDP growth ( % change) | -0.3 | 7.5 | 2.7 | 0.9 | 2.9 |
| Inflation (% change) | 4.3 | 5.9 | 6.5 | 5.6 | 5.7 |
| Central Bank policy rate (end-period, %) | 8.75 | 10.75 | 11.00 | 7.25 | 7.25 |
| Exchange rate (average, reais per U.S. dollar) | 2.0 | 1.8 | 1.7 | 1.9 | 2.1 |
| Budget primary surplus ( % of GDP) 1/ | 2.1 | 1.9 | 3.2 | 2.3 | 2.6 |
| External current account balance (% of GDP) | -1.5 | -2.3 | -2.1 | -2.2 | -2.5 |
| Trade balance (US$ billions) | 25 | 20 | 30 | 18 | 16 |
| Export (US$ billions) | 153 | 202 | 256 | 244 | 268 |

Source: Brazilian Institute of Geography and Statistics. Central Bank of Brazil. IBRE staff projections.

1/ Excludes interest payments on public debt

**Economic activity has not responded to any of the government's efforts at stimulus, including investment packages, sectoral tax exemptions, and an unprecedented reduction in the central bank policy interest rate.**

and productivity observed during the current administration compared to its predecessor. "We have lived in a very different period since the onset of the global crisis. It seems difficult to achieve the much-desired growth rate of 4% or 4.5%," said Matos.

IBRE researchers estimate that inflation was 5.4% for 2012 and will be 5.7% in 2013—less than in 2011, which hit the target ceiling (6.5%) but still far from the target mid-point of 4.5%. In 2012, the main factors contributing to inflation were the service sector, at 8.2%, and food inflation, at 9.1%; in 2013, the first of these is projected to go up slightly, to 8.5%, and the latter to drop to 6.5%. Despite the expected decline due to a positive external supply shock, Matos emphasized that food inflation will still be high enough to make it hard to bring headline inflation to the 4.5% mid-point target. Also, administered prices were not raised in 2012 because it

## THE INTEREST RATE
### The pursuit of sustainability

**Claudio Accioli**

THE ECONOMIC VARIABLE that most attracted the attention of specialists in the current year—the central bank policy interest rate—declined 525 basis points from July 2011 to December 2012, from 12.5% to 7.25%. Samuel Pessôa, associate IBRE researcher, notes that the real interest rate differential, net of inflation expectations and sovereign risk,[1] has held at about 5% a year since 2003, for reasons that vary according to the period examined but usually because of movements in exchange rates.

The real interest rate differential has been high since 2006 as a result of the policies of supporting domestic industry, maintaining a more depreciated exchange rate, and lower absorption of foreign savings; the recent decline in interest rates is due mainly to the significant drop in Brazilian domestic demand, particularly the fall in investment in the last five quarters. "If investment grows back stronger, which is desirable, interest rates would increase. Is the country then condemned to have high interest rates?" Pessôa asks.

He argues that a high policy interest rate should not be viewed as by definition a nega-

[1] The real interest rate differential was calculated by subtracting from the interest rate the expected inflation given by the central bank's Focus Bulletin, the U.S. real interest rate, and the Brazil risk.

was a local elections year, and some prices, like that of gasoline, will be adjusted. Matos emphasized that "Projections for 2013 are a worrying combination of lower growth and higher inflation."

Despite the risk of higher inflation, Matos believes that the central bank will use macroprudential measures to curb inflation, holding its policy interest rate at the current 7.25% a year. "In a way, the central bank is accepting higher inflation as long as it does not exceed the target ceiling [6.5%]," Matos observed. "If there is a stronger recovery of the world and the Brazilian economies, it will certainly be necessary to adjust the policy rate. But as this is not likely, inflation is expected to remain reasonably controlled in 2013, making it unnecessary to tighten monetary policy."

Another important variable to contain inflation of tradable goods, according to Matos, is the exchange rate: "If the exchange rate had appreciated freely, without central bank intervention, the negative effects on domestic inflation from external shock would have been mitigated." IBRE researchers project an exchange rate at 2 reais per U.S. dollar by the end of 2013.

## PUBLIC BUDGET

Missing the budget primary surplus target (budget balance excluding interest payments) of 3.2% of GDP was not surprising, but the result of only 2.3% was certainly disappointing. IBRE projects a primary surplus of 2.6% of GDP for 2013. The shrinking surplus is mainly due to the combination of the steep drop in tax revenue, whose real growth fell from

tive indicator of the economy's health. "In Brazil, we tend to think that is so because high rates were generally the result of errors in economic policy or crises of confidence. In those situations we paid an exorbitant interest rate differential to keep investors from withdrawing their money from the country. But it must be clear that, in a normal world where there is no risk of capital flight or solvency problems, a high interest rate is a positive sign, because it is the variable that balances savings and investment," Pessoa explains adding that such was the case for the Brazilian economy between 2004 and 2008.

Pessôa draws three scenarios in which interest rates might stay low even after investment growth resumes. The first would be stagnation in total factor productivity. "That's more or less what has been occurring since 2008. When it ceased to grow, productivity knocked down investment, growth, and interest rates," he says. The second would be a resumption of investment growth, but accompanied by policies to ensure that domestic savings grow at the same speed so that there is a natural balance between savings and investment, which would eliminate the need to manage the interest rate. The third scenario assumes that, even before economic activity picks up again, the government does not interfere with the foreign exchange rate to protect industry. As Pessôa explains, "The interest rate does not necessarily have to rise. But if we keep everything as it is and productivity and investment growth come back, interest rates will surely rise."

**"[Investment growth] is a key variable that is very worrisome, because it puts at risk the country's growth potential not only in 2013 but also beyond."**

*Silvia Matos*

12.2% in January-September 2011 to 1.5% in January-September 2012, and public spending, which for the same period rose from 3% in 2011 to 6.2%.

Revenues shrank not only because of the economic downturn but also because of the tax exemptions the government granted to revive the economy. The increase in spending, according to Matos, was mostly due to the rise in the minimum wage. "The main thing is the quality of the surplus," she noted. "This year, the federal government contributed 1.5% of GDP to the total primary budget surplus, and regional governments, because of the elections, contributed less. Next year, we expect regional governments will contribute 1% and the federal government 1.6%. Once again, it is unlikely that the government will meet its primary surplus target. However, if the 2.6% is achieved in a context of increased investment, it will not be so bad."

## EXTERNAL SECTOR

IBRE researchers estimate a trade balance of US$19 billion for 2012 and US$16 billion for 2013: notably below the US$30

## EXTERNAL SCENARIO
### Unforgiving

**Claudio Accioli**

IBRE's EXTERNAL SCENARIO shows that the consequences of the international crisis that erupted in 2009 are far from over for the global economy. In 2013 the United States is expected to have a moderate slowdown in economic activity, with growth declining from 2.1% in 2012 to 1.8% in 2013. The Eurozone's economy shrank 0.4% in 2012 and is expected to stagnate next year, growing only 0.2%. Similarly, after growing at about 10% for the last three years, China is likely to slow down to 7.6% in 2012 and 7.8% in 2013.

For economist José Júlio Senna, managing partner of MCM Consultants and a member of the FGV board, the main consequence of this crisis scenario for Brazil is the absence of external demand to stimulate growth next year: "It's amazing the degree of synchronization of the downturn in the economies of many countries. Because countries did not buy from each other, global exports collapsed; they recorded negative 12-month growth for the first time since the acute phase of the global crisis . . . . At the moment, nobody is helping anybody."

China is different. Senna says that the slowdown there is caused by overinvestment, with gross fixed capital surpassing 40% of GDP for the last 10 years, and there is a decline in consumption, which is responsible for about 35%

billion recorded in 2011. The value of exports contracted slightly, from US$256 billion in 2011 to US$245 billion in 2012, while imports held steady at US$226 billion—which may indicate a retraction of investments.

"Imports depend on the exchange rate and the strength of the economy, for which investment is vital," Matos explained. An appreciated exchange rate encourages imports of machinery and equipment, which would be beneficial for the Brazilian economy. However, the current depreciated exchange rate does not encourage imports of machinery and equipment, although it does help to improve industry's export competitiveness. IBRE researchers estimate that the current account deficit for 2012 will be 2.2% of GDP, almost the same as in 2011, and in 2013 will go up slightly to 2.6%.

**The current depreciated exchange rate does not encourage imports of machinery and equipment, although it does help to improve industry's export competitiveness.**

What is expected in agriculture, industry, trade, construction, and energy sectors of the Brazilian economy is forecast separately in the articles that follow.

of GDP—though that is not much by international standards. With 10 years of extremely low interest rates reducing the cost of purchasing foreign currency to keep the exchange rate competitive, the Chinese have chosen to invest their savings in real estate; theirs has been the fastest-growing market in recent years. "With the loss of dynamism, China is preparing to rebalance its economy in order to increase consumption [and reduce investment], but there are interests in conflict with this, such as the construction industry. Even if there is a rebalancing of the economy, losses may occur because a possible drop in the value of real estate, which has great importance in the Chinese economy, could hurt growth," Senna says. "It's a complex situation."

The positions of the U.S. and the Eurozone, Senna adds, are also complicated. In the U.S., the concerns are about inhibition of private investment, with consumers still reducing their debts, and fiscal issues, particularly with regard to the timing of the fiscal adjustment that is necessary. "The damage that fiscal policy will cause to U.S. economic growth in 2013 will be higher than this year," he says. With regard to the Eurozone countries, Senna expects the situation to worsen before it gets better: "Employment takes time to recover, bank loans are frozen, and there are signs that the crisis is spilling over to central European countries. In Germany, exports to the region have stagnated, and the business confidence index is not positive."

# INDUSTRY
## A year to forget

**Solange Monteiro**

DESPITE THE EXPANSIONARY FISCAL policy of the Rousseff administration and the improved macroeconomic environment for industry, 2012 is a year that industry would prefer to forget. The National Confederation of Industries (CNI) estimates that manufacturing GDP will close the year with a contraction of 0.6%.

There were positive changes in the economy that may help industry in the medium term. Between August 2011 and October 2012, the central bank cut its policy interest rate by 5.25 percentage points, to 7.25%. The exchange rate devaluation registered after July 2012 was also favorable to industry, yet there was no significant increase in Brazilian manufacturing exports, due mainly to depressed demand in Europe and protectionist measures imposed by the Argentine government.



"Brazil's export volumes to Argentina fell by about 20%, and there is no guarantee that the situation will improve next year," says Paulo Francini, director of the Department of Studies and Economic Research of the Federation of Industries of the State of São Paulo (Depecon-Fiesp). On the other hand, until October imports of consumer goods kept pace with 2011 because domestic demand was still strong.

The government also granted exemptions from payroll taxes for some industrial sectors and reduced electricity rates. "All these good deeds will carry over into 2013," Francini said. "They will take time to bear fruit." The reduction in the cost of energy, for instance, does not go into effect until February.

If industry is to recover in 2013, however, Robson Braga, president of CNI, believes other measures are needed to address the main problem: stagnant productivity and high production costs: "The renewal of the Reintegra program [which enables exporters to recover some tax costs incurred in producing for export], and the National Bank for Economic Development's Program for Supporting Investment are very important, but we also need to see the end of the fiscal war between the states—the competitive reduction of state VAT to attract investments—and reduced state VATs to reduce the cost of investing."

To improve the contribution of the private sector, industry executives point out that it is not enough to have a thriving consumer market. Today, Brazilian public investment is about 1%, in China it is 4%. Higher investment results in better infrastructure and a better quality of basic education, which are vital for attracting investment, Braga explains. CNI projects that, if in 2013 the measures to stimulate competitiveness take effect, GDP grows 4%, and investment grows 7%, industrial GDP can expand by 4.1%. In a less optimistic scenario, if the economy grows 3% and investment 4%, industry would grow only a modest 2.3%.

# ENERGY
## Uncertain future

**Solange Monteiro**

THE BRAZILIAN ENERGY SECTOR ended 2012 amid a cloud of uncertainties. Since September, when the government announced Provisional Measure 579 (MP 579), which anticipates renewal of contracts for generation and transmission of electricity that expire through 2017 and reduces electricity rates, electricity utilities have had no clear horizon for future investments. Previously considered an option for conservative investors, generating companies listed on the Bovespa stock exchange were the first to feel the impact. In December it was estimated that power companies Eletrobras, Cesp, Cteep, Cemig, Copel, and Celesc had lost US$34.6 billion in market value since August, before the government announcement.

To meet demand, which is expected to grow 5% a year, the energy sector will need to add about 5,000 MW of power a year. The insecurity generated by the MP 579 for new investments is not restricted to operators of large hydropower plants. Charles Lenzi, president of the Brazilian Association of Clean Energy Generation (Abragel), also questions the rules that will govern the contracting environment, because reduction of prices in the regulated market reduces options for the free market. "Today," he says, "we cannot sell energy in the long term, which also takes away the ability to obtain financing from the National Bank for Economic and Social Development, which requires as collateral contracts for at least 10 years."

Among other question marks there are small hydro projects that have had concessions since 2002, but owing to the difficulty of obtaining a license from the Environmental Protection Agency have not yet left the drawing board. For these, a proposal presented to lawmakers resets the concession period as starting not in 2002 but in March 2013. "With that we could recover the economic and financial balance of the power plants, which are aimed at self-production and also at independent production and sale," says Mario Menel, president of the Brazilian Association of Investors in Self-Production of Energy (Abiape).

Menel highlights the efforts of Abiape to amend MP579 to simplify the participation of foreign investment in the self-production segment: "We have received proposals for partnerships, which would bring in foreign capital . . . . When it comes to selling energy to large companies like Votorantim, Gerdau, Vale, the perception of risk that we see today would be reduced." Abiape proposes that 30% of the energy generated by self-producers be directed to the regulated market. Also, it suggests promotion of a model for a company that would launch special-purpose shares of energy production, with 50% of preferred shares for foreign investors, and 50% held by the self-producer group. "Thus, though investors would not have a right to the energy, they would have preferential remuneration of their investments," Menel explains, adding, "If the idea behind all these policy changes is low electricity rates, we need to ensure increased supply and not generate a risk of shortages.".

# AGRICULTURE
## Infrastructure bottlenecks

**Solange Monteiro**

WHILE FOR SOME SECTORS of the Brazilian economy the big challenge in 2013 is to improve productivity, for agriculture it is how to manage its production gains until investments in logistics infrastructure improve sales abroad. According to the Ministry of Agriculture, agricultural production is forecast to rise in 2013, thanks to a record grain harvest and increasing exports. The favorable harvest of 2012–2013, which was sown in September, may reach 180 million metric tons, according to the National Supply Company (Conab)—8.4% more than the previous harvest. The production value of major crops is expected to rise 24%, to US$149 billion.



"In 2013, demand for and prices of agricultural commodities should continue to be buoyant," says economist Luiz Antonio Fayet, consultant to the National Confederation of Agriculture and Livestock of Brazil (CNA). "The exchange rate at 2 reais per U.S. dollar will especially benefit meat exports that have higher added value," he says.

The problem of the sector is not potential for growth. About 86% of soybeans and 70% of corn traded on the international market in 2011 were exported from the United States, Brazil, and Argentina. Of the three, Brazil is in the best position to expand its agricultural frontiers. "The Organization for Economic Cooperation and Development (OECD) estimates that Brazil will supply half of the additional world demand for grain. Today, however, we have a serious problem in expanding production in the new frontiers of Mato Grosso, Maranhão, and Piauí states because of the poor transport infrastructure," Fayet says. This year, therefore, the largest expansion in the production of major crops will be concentrated in the Midwest, with expected growth of 30%, followed by the Northeast with 14%; production in the South and Southeast will decline.

"As we expand the agricultural frontier, we are moving it away from export ports. Currently we spend four times more [than we should] in managing and transporting production from the farm gate to the port," said Fayet, pointing out the need for investing in ports in the North. "We spent the last few years giving tax incentives for consumption when we should have invested in infrastructure and maintained a sound economic policy. Instead, we … may lose a spectacular market opportunity," he says, hoping that the recently announced program of investment in transport and ports will address the bottlenecks.

# COMMERCE AND SERVICES
## No turbulence

**Solange Monteiro**

THE COMMERCE AND SERVICES sector will end 2012 with a positive balance, and "We estimate that retail will grow 8%, against 6.7% last year," says Mariana Halson, economist for the National Confederation of Commerce (CNC). These favorable expectations, however, are not true of all segments. Among the beneficiaries of the extension of the exemption on industrial products tax are furniture and household appliances, which have had sales growth of 10%. Vehicle sales were affected by the credit crunch caused by rising defaults.

"Sectors that rely more on income, such as supermarkets and nondurable goods in general, also exceeded the average growth of the sector," says Halson. Sales were helped by a buoyant labor market and rising real income as the minimum wage was adjusted by 9.2%. However, according to the Budget Guidelines Law passed in July, the minimum wage is expected to increase only 7.3% in 2013. Halson explains that "Income and credit are the components that move the sale of goods and services, and without good prospects of increased income, we hope the development among consumers to renegotiate debts is reflected in a credit recovery." She finds it difficult to assess the impact of a possible end of the tax exemption, but she does point out that the impact diminishes over time because it implies the anticipation of purchasing decisions.

The services sector has benefited by continued improvement in the Brazilian standard of living, which resulted in an increase in average spending per consumer. Shielded from foreign competition, the sector could pass on increased costs to service prices, pushing service inflation above headline inflation. The rising cost of labor due to heavy demand is a major factor putting pressure on prices, which is exacerbated by low productivity. "Productivity in services is low mainly because most workers in this sector are low-skilled. Moreover, Brazilian labor legislation does not help improve workers' skills and productivity because it encourages high turnover," Halson says. "It's a non-cooperative relationship between employer and employee, where the employer does not invest in training employees because of fear they will leave the job, and employees feel encouraged to search for jobs, especially when the unemployment rate falls."

Halson estimates that growth in household consumption is expected to continue to support growth in the economy but "We noted in 2012 that we cannot sustain growth only with consumption, and for retail the central issue is economic activity as a whole. If there is no investment, commerce and services will hardly continue to grow at this pace."

# CONSTRUCTION
## Going ahead

**Solange Monteiro**

FOR THE CONSTRUCTION industry, 2012 left much to be desired. Nevertheless, the programs and packages the federal government announced in the second half of the year have rekindled optimism in the sector, which in 2013 is expected to grow between 3% and 4%, compared to an estimated 2.5% in 2012, according to the Brazilian Chamber of the Construction Industry (CBIC).



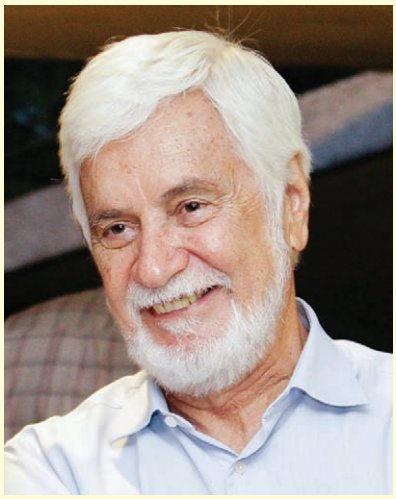
"This year could have been better, but considering factors such as the decline in investments, the temporary stoppage of work at the National Department of Transport Infrastructure (DNIT) due to its restructuring, and the performance of the Growth Acceleration Program (PAC) below what was expected, we cannot complain," said José Carlos Martins, CBIC vice president, pointing out the momentum that characterizes this industry and ensures some level of activity despite the slowdown in hiring.

The measures announced, however, suggest that in 2013 the construction industry will have a better year. The initiative to accelerate the pace of concessions for construction of transportation infrastructure; the changes last October in the government housing program, such as the higher ceiling for real estate financing and the reduction in interest rates; and the stimulus packages for investments [in the construction industry], including the reduction in the payroll and working capital credit line, justify optimism," Martins said. All the government signs are that it will be stimulating investment, and almost half of investment is devoted to the construction sector.

For Martins, the sector may also benefit from an improvement in the qualifications of labor: "Since 2007, we have increased employment from 1.3 million workers to about 3.1 million. When you hire more workers, inevitably [at first] productivity suffers. But businesses are investing in technology and training, and we're getting to the point of reversing this situation."

Martins also said that the major challenge is to improve the business environment. "Today that's what increases costs and delays works. I'm talking about what happens in the city halls, registries, environmental licensing. Today, our production process has changed a lot, and public agencies have not changed at the same speed."

# Protectionism is bad for growth



## *Edmar Bacha*

Member, Business Cycle Dating Committee

**Claudio Accioli,** *Rio de Janeiro*

With exhaustion of the boom of rising commodity prices and labor surpluses that gave it a small economic miracle between 2005 and 2010, the Brazilian economy now faces a harsh new reality, in which growth can only be achieved if there is more investment and higher productivity. But the government's difficulties in carrying out public investments and the rules for hiring and buying parts locally can undermine investment and growth. So warns Edmar Bacha, the former president of the Brazilian Institute of Geography and Statistics (IBGE) and member of the Business Cycle Dating Committee of the Brazilian Institute of Economics (Codace IBRE). He is finishing a book on deindustrialization in Brazil. "We are . . . closing the country to the world, which is absurd. We will not ever grow, because the government has no capacity to invest and prevents the private sector from buying better technology and more productive assets from elsewhere in the world," he says. To boost industry, Bacha advocates a radical program that would double the share of foreign trade in GDP and halve the tax burden on companies, regardless of sector: "That would be a genuine industrial policy!"

***The Brazilian Economy*—The government has lowered interest rates, granted tax exemptions for certain industries, and announced packages of investments, but Brazil's GDP growth rate was only a disappointing 0.6% in the third quarter and may be less than 1% for the year. Why is the economy not taking off?**

*Edmar Bacha*—I think this is the end of the growth cycle that we had between 2005 and 2010, followed by two years of very low GDP and investment. In the first period, there was a very specific combination of good things that produced a small "growth miracle," but now a new reality is knocking at our door.

**What would this reality be?**

In 2005, investment was very low, which meant there was huge room for recovery. In fact, that's what happened: Investment increased from 15.5% of GDP in 2004 to 19.5% in 2010—in my view, in large part because of a huge external bonanza in terms of both higher prices for our exports and abundant external financing . . . . We also had a high unemployment rate in 2004, about 12%, which came down to just 5.3% in October 2012 . . . . Now, the boom has ended, commodity prices have

stabilized or are falling, the availability of external financing has declined, and the labor surplus has disappeared . . . . Brazil's sustainable growth pattern today is different from the growth cycle in 2005 –2010. Growth now will depend heavily on investment and productivity.

**But investment has declined for five consecutive quarters. How do we revive it?**

The main problem is the current government's interventionist bias, but it is also unable to execute planned investments that have been budgeted. The government makes one announcement after another promising to invest, but nothing materializes. Even President Rousseff, in a recent interview, admitted the problem is not money but execution. The delays have been due to a number of factors, such as uncovering corruption in public works that paralyzed investment in transport, unqualified people in key positions, public procurement laws, a dilatory Court of Audit, and problems getting environmental permits. The whole system is poorly articulated and badly managed. Given these difficulties, one would expect that the federal government was willing, as many state and local governments are doing, to call on the private sector to carry out infrastructure works. The government does call on the private sector, but everything goes slowly and, when a plan finally comes, it is inadequate — as has been dramatically illustrated in the case of airports. Now the government has announced measures for ports but does not dare to touch the state-owned dock company . . . . The entire process is entirely lethargic. Similarly, changes in the rules of the game interfere in decisions, discouraging some and encouraging others who have privileged access to the National Bank for Economic and Social Development.

**What about productivity?**

The primary reason [for low productivity] is the fact that our economy is one of the most closed in the world. In the rankings of the World Bank and Penn World Tables, we are the 169th economy with the lowest share of foreign trade in GDP. This deprives us of imported products that would add productivity and creates domestic monopolies and oligopolies that are not favorable to productivity growth, because there is no innovation without competition. The current highly protectionist policy goes totally against what the country needs to increase productivity, which is to integrate competitively into international trade flows.

**Traditionally Brazil also has low domestic savings. To what extent does this affect performance of the economy?**

It would be good to save more. But the bigger problem is that prices of capital goods in Brazil are very high in interna-

***"The government makes one announcement after another promising to invest, but nothing materializes."***

tional terms. So . . . we have to acquire capital goods produced locally at prices much higher than if the economy was exposed to more international competition.

**IBRE estimates potential GDP growth of between 3% and 3.5%. Which sectors should be prioritized to increase growth?**

It all starts with infrastructure [which] provides the logistics of ports, airports, and roads. And that is going badly, for the reasons I mentioned. The government should focus its action on providing good infrastructure for the country and let the private sector compete for the rest.

***"The government calls on the private sector, but everything goes slowly and, when a plan finally comes, it is inadequate—as has been dramatically illustrated in the case of airports."***

**You are editing a book on deindustrialization in Brazil. Since industry has been replaced in GDP by the service sector worldwide, what is unique to our local reality?**

The share of this or that sector in GDP depends on specific situations related to history, geography, the economy, and consumer preference. The problem is not the share of industry in GDP, but its quality. In Brazil, the government wants to produce all parts for all products, adopting an import-substitution industrial policy. For example, the new policy for the health sector the Ministry of Health has proposed is to reduce to zero the trade deficit of US$11 billion of medicines and hospital equipment by decreasing imports. For this, the government proposes to pay 25% more to those who produce these items in Brazil . . . . This model extends to other sectors, such as exploitation of deep-sea oil and the automobile industry, in which if companies meet the government's requirements they are protected by a 70% tariff. Our policy has become to close the country to the world, which is absurd. We will never grow, because the government has no capacity to invest and is preventing the private sector from accessing better technology and more productive assets from elsewhere in the world.

**What are your views on the government's recent measures to grant relief to some industry sectors in an attempt to boost growth?**

I find it absurd to select who will receive this or that favor. I would advocate a radical program to redefine Brazilian industry with two basic measures: double the share of foreign trade in GDP, from 12% to 25%, and halve the tax burden on businesses, from 60% to 30%. That would be a genuine industrial policy, with the goal of raising productivity to make the Brazilian economy grow.

**Besides growth being low, inflation is high because of services inflation. Is this worrying?**

Yes, the combination of high inflation and low growth is very worrying because it shows that the Brazilian economy has a disease . . . . Fundamentally, what is at issue here is low productivity. When productivity is low, in theory it is possible to have full employment with zero growth . . . . Growth and expansion of employment was led by commodities exports, which generated growth of services and construction—more labor-intensive sectors.

***"The current highly protectionist policy goes totally against what the country needs to increase productivity, which is to integrate competitively into international trade flows."***

**The international crisis is far from ending. How could it affect Brazil in 2013?**

The international situation is bad, but it appears the risk is decreasing. News from Europe is not so bad, with the search for solutions to Greece. In the United States, employment is a little better. Probably external factors will not help [Brazil]—there will be no new commodity boom or abundant external financing—but they also will not hurt. Our risk is not a new large international financial crisis but a continuation of our domestic problems. That is the cause of our low growth and high inflation, which compare poorly to our Latin American neighbors.

**What do you expect for the Brazilian economy in the next year?**

Growth will have to recover to some extent because it is hard to imagine it will be as bad as 2012. I expect GDP to grow between 3% and 3.5%. Inflation should decline, benefitting from moderate food prices and the government policy of controlling energy prices. If it continues controlling gasoline prices, it is possible to create conditions for slightly higher growth, keeping inflation at current levels. The scenario will be a bit better than this year, but nothing that will do justice to the potential of our country.

***"I would advocate a radical program to redefine Brazilian industry with two basic measures: double the share of foreign trade in GDP, from 12% to 25%, and halve the tax burden on businesses, from 60% to 30%."***




Regis Bonelli (insert) participated in the discussions on industrial policy. (Photo: David Venturini)

# Industrial policy: Recurrent errors

## Experts criticize the government's policies for stimulating the economy and industrial activity

**Solange Monteiro,** *Rio de Janeiro*

A DISCUSSION AMONG a group of economists gathered at the Brazilian Institute of Economics, Getulio Vargas Foundation (IBRE-FGV) in November, made it clear that there has been no shortage of studies and diagnostics on the Brazilian economy in the last 40 years exploring possible paths to growth. But ultimately the experts participating in the seminar, "Patterns of Industrial Development in Brazil: Past and Future"—in honor of the 70th birthday of Regis Bonelli, economist and IBRE researcher in applied economics—concluded that the tendency to repeat past mistakes is recurrent in Brazil.

The criticism had a clear target: the protectionist trend apparent in the industrial policy of President Dilma Rousseff and her government, which was compared to the policy of incentives adopted in the 1970s to boost domestic industry. "There is some difficulty in dealing with a proper understanding of our not-so-distant past,

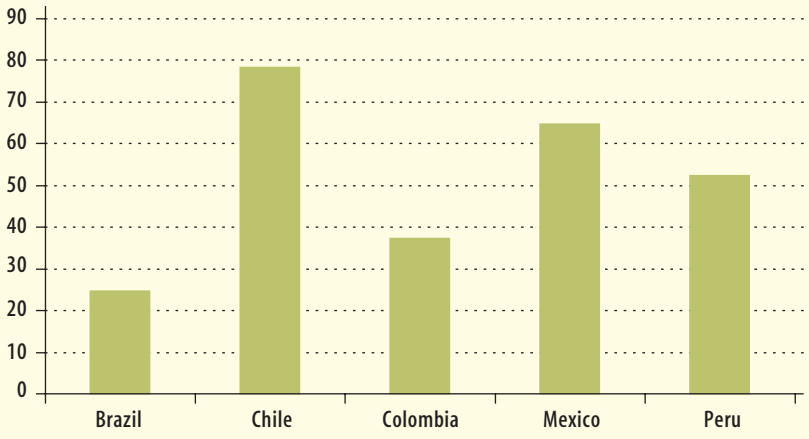
and the nostalgia for a past that is not coming back," said Pedro Malan, former Minister of Finance. Eustaquio Reis, researcher at the Institute of Applied Economic Research (IPEA), added that "Even though previous experience has demonstrated that type of growth to be unsustainable, despite two decades of stagnation and reconstruction, including the scrapping of domestic industries that received subsidies in the 1970s, those policy strategies are still echoing today. From the past to the present, the myth of the great Brazil is an illusion."

> ""We know that such [industrial] policies have worked only in countries that conducted preparatory studies, identified performance goals, and set deadlines . . . The Brazilian public bureaucracy is not ready to do the same."
>
> *Luiz Schymura*

Marcelo de Paiva Abreu, professor of economics, Catholic University of Rio de Janeiro (PUC-Rio), noted that the recent roll-backs in trade openness are made obvious by the increasing prominence of preferential tax treatment and legal requirements to hire and buy parts locally. He also underscored "the increased direct and indirect government presence in the economy, particularly in oil and gas and electricity, and interference in the management of private companies by means of the pension funds of state-owned companies. That is not even to mention the credit subsidized by the National Bank of Economic and Social Development [BNDES]." Luiz Guilherme Schymura, IBRE director, pointed out that the requirements to hire and buy parts locally and the tax benefits granted by the current administration to protect domestic industry rest on a shaky foundation: on one hand, due to high public spending and greater difficulty in meeting the budget primary surplus target, there is little room for fiscal maneuvering, and on

**Brazilian economy is not as open as its neighbors.**

(Total imports plus exports, % of GDP)




Source: Armando Castelar, FGV/IBRE.

**Brazil invests less than its neighbors.**

(Average 2005-11, % og GDP)

| | |
|---|---|
| Brazil | 18.7 |
| Chile | 22.5 |
| Colombia | 22.7 |
| Mexico | 25.2 |
| Peru | 22.8 |

Source: Armando Castelar, FGV/IBRE.

the other, there is a lack of clarity in evaluating these policies to confirm that they are worth their high cost. He added, "We know that such policies have worked only in countries that conducted preparatory studies, identified performance goals, and set deadlines . . . The Brazilian public bureaucracy is not ready to do the same."

> "Countries that have advanced more in dismantling the state and in trade liberalization have clearly performed better. Our recent policy measures undermine investment and increase its cost."
>
> *Armando Castelar*

## THE IDEAL INDUSTRY

Evaluating the actions the government has taken to encourage industrial activity means addressing another equally controversial issue: What should be the ideal weight of industry in the Brazilian economy considering the growing participation of the service sector, falling export competitiveness and industrial investments, and a difficult business environment. "Brazil has become an efficient producer especially in agribusiness, mining, and forestry, and is about to do the same in oil. When these types of exports grow faster than GDP, it is natural to have to import more manufactured goods," said Rogerio Werneck, professor of economics, PUC-Rio. Added to this is the growth in domestic consumption, which has to be fed by imported products. Werneck emphasized, "The political resistance to this increased share of imports has been exacerbated by the loss of competitiveness of the manufacturing industry, which only recently ceased to be exclusively associated with the exchange rate." He argued that the situation should not be corrected by restricting imports. In fact, Sandra Rios, Center for Integrative and Development Studies (Cindes), added, if there is any correlation between the level of imports and industrial competitiveness, it is positive. A recent Cindes study, she said, "indicates that the sectors that performed worse were those with low exposure to imports."

IPEA's Reis warned that this combination of factors in the current situation is a sign that the task of economic recovery is still to be accomplished. "We need to restore public sector savings," he said. For Samuel Pessôa, IBRE associate researcher, trying to build up industry without giving priority to domestic saving is contradictory: "If we cannot save more, how can we support industry, which is capital-intensive?" He pointed out that "Asian countries that escaped the trap of average income in the last sixty years adopted a model with a high share of industry in total production [but also] very high savings by Brazilian standards." Pessôa referred to a paper co-authored with Silvia Matos and Regis Bonelli that demonstrates the association between the share of industry in GDP and the savings-to-GDP ratio, based on an analysis of 88 countries. "China saves 35% of GDP more than Brazil," he said, "and I would explain the difference between the two countries by the difference in the savings rates." He underscored his argument by saying, "Saving economies export more than import, have to compete more, and consequently have larger industries. That may explain the high participation of industry in East Asian countries."


Photo: David Venturini

Sandra Rios, Rogerio Werneck, Luiz Schymura, and Samuel Pessôa.

Despite supporting the call for greater trade openness, Edmar Bacha, director of the Institute of Economic Policies Casa das Garças, a "think tank" in Rio de Janeiro, minimized the influence of domestic savings on the competitiveness of Brazilian industry: "Our historical experience is not a high savings-to-GDP ratio; we are like the United States—only without their productivity [but] today our capital accumulation is half what was registered through 1980 due to the increase in the relative price of investment." According to Bacha's studies, the current purchasing power of domestic savings for investment goods is 25% lower than the historical average. In other words, "our problem is not saving less, but that the same savings are buying fewer capital goods." Among factors responsible for this, he said, is that labor productivity in the construction industry grew only about 1% a year between 1950 and 2008, while productivity in the economy as a whole rose 2.3% a year. Also adding to the problems were factors such as exchange rate and pressure to reduce imports, which meant increased costs when machines from abroad are 40% cheaper.

## MORE OPEN TRADE

Abreu of PUC-Rio pointed out that "Countries that have advanced more in dismantling the state and in trade liberalization have clearly performed better. Our recent policy measures undermine investment and increase its cost." Armando Castelar, IBRE coordinator of applied economics, suggested there is a need to admit that Brazil's low growth and steady decline in investment have domestic



Photo: David Venturini

Former Finance Minister Pedro Malan

causes. According to a paper Regis Bonelli presented in early November in Beijing, Brazil, Mexico, Colombia, Peru, and Chile together account for 70% of the population, 73% of GDP, and 83% of foreign direct investment in the region. "If we compare these countries," Castelar said, "only Brazil's growth slowed in 2011 and 2012." The reason, he explained, is that Brazil has the highest tax burden—34% compared to 15%–22% in the other four countries—the lowest trade openness, and the worst business environment. On the World Bank ranking of Doing Business, while the other four countries rank between 37th and 48th, Brazil ranks 130th.

Castelar went on to say, "Brazil also has the lowest investment-to-GDP ratio: 18% for 2005–2011—four percentage points of GDP less than the rest of the group. And they do not have a BNDES." He questioned how effective BNDES actually is in inducing private investment, since in recent years, though BNDES disbursements had risen substantially, private investment has not increased. "And we still have more inflation—an average of 5.5% over the past five years, while Chile, Colombia, and Peru recorded between 2% and 3% — and we are not paying attention to the fact that inflation raises uncertainty about return on investment and investment itself."

The consensus was clearly that, without a course correction, repetition of past mistakes may have serious consequences in the present.

## Payroll tax reduction: Wrong medicine

THE GOVERNMENT CLEARLY must make an effort to address the difficulties of the industrial sector to make it more competitive in an economy that is overtaxed. Diagnosing the disease correctly, however, does not necessarily mean that the Rousseff administration has found the right way to treat it. One example is the decision to reduce the payroll tax from 20% to no more than 2% of sales in 15 sectors, which will be extended to 40 sectors in 2013.

To Rogerio Werneck, professor, Department of Economics, Catholic University of Rio de Janeiro, the measure will have little effective impact—only 0.17% of GDP in 2012, US$3.6 billion—and it simply underscores the government's fiscal problems. "Unable to reconcile its political program with a program of effective and substantial reduction of the tax burden," he said at the roundtable, "the government has been manipulating a showy but not transparent policy that reduces costs very little and causes new distortions to the tax system. Moreover, the rapid growth in the number of sectors included in the program only confirms the fears that the already problematic tax system will become even more disfigured."

Werneck noted that the arrangements entail increased spending, in a scenario where public spending is already high, which will limit the possibility of a substantial reduction in the tax burden. In his view, the ideal tax reform would be a reduction in the payroll tax offset by an increase in the value-added tax (VAT). Greece, Portugal, and Spain are discussing this option. By taxing final consumption rather than investment and exports, it would stimulate competitiveness.

Citing former Argentine Economy Minister Domingo Cavallo, who supports this type of tax reform, Werneck also argued that it corresponds to a devaluation of the exchange rate without any inflationary effect on domestic prices and corporation balance sheets, and it would promote formal employment and private savings. He admits, however, that it is difficult to carry out this tax reform in Brazil where the VAT is already close to 34% and would have to rise to 40% to offset a reduction in payroll tax. The government's choice, he concluded, "is a paradise of populist fiscal management—and a tremendous setback."

# Regis Bonelli: A factory of ideas



Photo: David Venturini

**Solange Monteiro**

TO STUDY THE ECONOMIC and industrial development of Brazil over the past 40 years, it is inevitable to consult the work of economist Regis Bonelli. With 46 years of academic activity and more than 125 works, including books, book chapters, articles, and theses, Bonelli, currently researcher at the Brazilian Institute of Economics (IBRE) and coordinator of the *IBRE Economic Outlook,* has been a privileged observer of Brazil's economic history and has been generous in sharing his observations.

Bonelli participated in the group that started the Institute of Applied Economic Research (IPEA) in the 1960s, with economists Albert Fishlow, Pedro Malan, Edmar Bacha, and Marcelo de Paiva Abreu. At the Catholic University of Rio de Janeiro in the early 1990s, Bonelli lectured and did research on income distribution and economic transition in Brazil, "More than being topics treated in isolation, these different dimensions combine to compose a historical and analytical framework of the Brazilian economy that is very rich and diverse," said IPEA's Paul Levy at the roundtable held in November in honor of Bonelli's 70th birthday."

One of Bonelli's most prominent works is "The Limits of the Possible: Notes on the Balance of Payments and Industry in the 70s," which he co-authored with Malan. Published in 1976 in the *Pesquisa e Planejamento Econômico Journal* published by IPEA, the article, which became required reading for college entrance exams, criticized the government strategy at the time, which culminated in Brazil's debt crisis in the 1980s. Malan, who with Bonelli studied both engineering at Catholic University and economics at the University of California, Berkeley, said that "He believes the quality of our understanding of risks and future opportunities depends on the quality of our understanding of the developments that have brought us to the current situation. And Bonelli has made an invaluable contribution to this understanding."

On the long list of his activities—including his service as executive director of the National Bank for Economic and Social Development and as general director of the Institute of Geography and Statistics—Bonelli recalls some favorite works, such as the 1988 *Debt and Deficits: Medium Term Projections*. "One of the merits of that study was to quantify public sector flows and stocks in the context of high inflation and confusion in public accounting," said Eustaquio Reis, co-author of the paper.

The turbulent decades that Bonelli observed, which included protectionist industrial policies, hyperinflation, a series of economic plans, and privatization of state-owned companies, have refined Bonelli's judgment but not shaken his optimism. "Brazil makes many mistakes by insisting on solutions that were used when the problems were different. The economy changes, the world changes, I have changed my opinions many times since I started my career, and governments do not have that flexibility," he said. "I think as growth resumes, industry will also take off. As for investment, we know that uncertainty and changes in regulation are the major obstacles."

Bonelli has persevered in exploring a theme that has directed him since the 1960s, when he earned his doctorate at Berkeley: Understand productivity better. That job is still to be done, he believes. "The origins of productivity are linked to investment and growth itself, but we know little about its causes. Productivity is also related to investment, and we still do not understand this nexus—what determines productivity and the role of innovation," he says. "We assume that productivity is exogenous, a given. But I believe there is a relationship between growth and productivity. Silvia Matos mentioned recently that productivity is procyclical. Because we do not really know why, we continue to say that it is exogenous. That's something that bothers me. We need to look into it."

*The latest economic climate survey indicates expectations of improvement in the Latin America economy.*

**Lia Valls Pereira**

Center for International Trade Studies, IBRE.

THE ECONOMIC CLIMATE INDICATOR (ECI) for Latin America recorded an improvement in October after having worsened between April and August. The two indices that constitute the economic climate — the current situation and the expectations indexes — in October were back in the favorable zone above 100. The improvement was more pronounced for South America. The increase in ECI of 17% was mainly due to improved expectations, which had a positive variation of 26%.

The economic climate improved in Bolivia, Chile, Colombia, and Paraguay. In Peru and Uruguay it declined, but the winds remain favorable. In other countries there was an improvement in the indicator, but the winds continued to be unfavorable for Argentina and Venezuela and held steady for Mexico and Ecuador, which are in the neutral zone (100).

Brazil's results track the indicators for South America. There was marked improvement in expectations (from 118 points to 146 points) and a moderate improvement (from 90 points to 98 points) in assessing the current situation, though it remained slightly negative. The ECI for Brazil thus went up from 104 points to 122 points, a 17% increase. The experts surveyed considered the current situation of investment to be unfavorable and consumption favorable, but they expect improvements in both components by March 2013. However, Brazil's poor growth of 0.6% in the third quarter could lead to a downward revision of expectations in the next Ifo survey in January 2013.

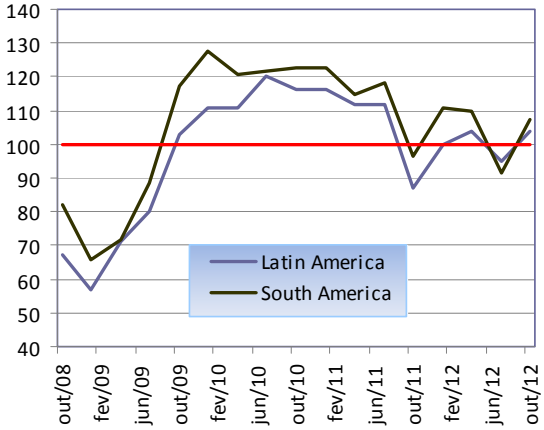
Lack of competitiveness and a shortage of skilled labor are the main obstacles to growth in Latin American countries. (A similar result was observed in the Ifo survey last April.) That is also true for Brazil, although the weight given to the issue of competitiveness has decreased because a depreciation of the exchange rate has improved competitiveness: Between April and October, the real effective exchange rate declined by 5% against the dollar.

Inflation is a very relevant issue for Argentina (24.5% projected for 2012 by the experts consulted), Uruguay (8.1%), and Venezuela (23.9%). Unlike what has happened in European countries and the United States, unemployment is considered highly important in Colombia and Mexico.

The Economic Climate Indicator is a quarterly survey conducted by the Getulio Vargas Foundation and the German Ifo Institute for Economic Research—Ifo World Economic Survey (WES). The ECI is an average of the current situation and expectations for the next six months based on experts' answer to questions on key macroeconomic data (consumption, investment, inflation, trade balance, interest and exchange rates). The indicators are weighted by the share of trade of each country in the region. http://portalibre.fgv.br/main.jsp?lumChannelId=402880811D8E34B9011D92BBCC431F08

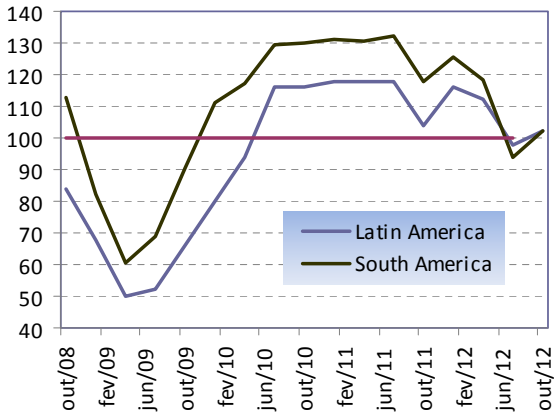
**Economic climate indicator**

**(Above 100 favorable)**



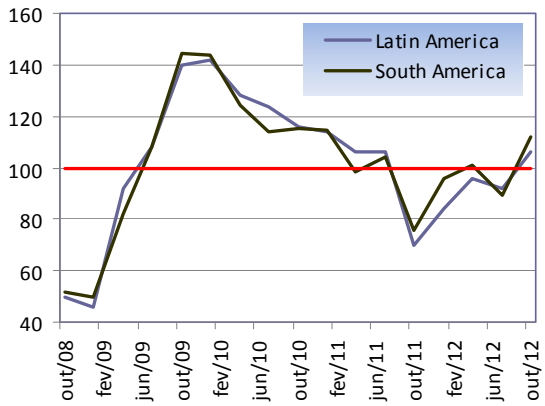

**Current situation indicator**

**(Above 100 favorable)**




**Expectation indicator**

**(Above 100 favorable)**




Source: Ifo, World Economic Survey (WES)