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The BRAZILIAN ECONOMY

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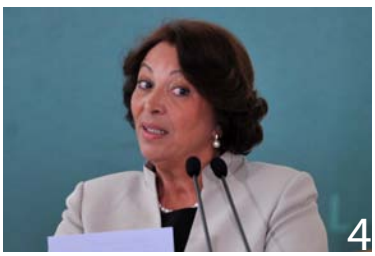
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Latin America is no longer seen as monolithic, as João Augusto Neves demonstrates. More pragmatically, some countries are seen as liberal, others as quite conservative. Different countries have different attitudes toward the U.S. military presence and U.S. policies. Brazil's emerging power status is making a difference, as are attitudes toward China.

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Rousseff's projections for the real interest rate have been unrealistically optimistic. In fact, the real interest rate is probably high simply because demand is far outstripping supply. There is need for a countercyclical fiscal policy: To make up for the increase in private consumption and investment, public spending must be dramatically reduced.

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The service sector — ranging from retail to telecommunications — is responsible for almost 70% of the wealth generated in Brazil, and it is changing the structure of the economy. Claudio Accioli and Solange Monteiro define the current situation and identify vulnerabilities that need to be dealt with. They also explain how demand for services is exerting more influence on Brazil's economy and raising concerns about inflation, and discuss the implications of the fact that many services have been provided outside the formal sector.

INTERVIEW

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Murilo Portugal, the president of the Brazilian Federation of Banks (Febraban), which represents one of Brazil's fastest-growing sectors, describes to Claudio Accioli what he sees as the mission of banks in this phase of economic stabilization and growth; the challenges facing banks, such as keeping credit expanding at a higher rate than GDP without degrading its quality or endangering the financial system; and what Febraban and its members are doing to make bank fees more transparent.

POLITICS



Photo: Fabio Rodrigues Pozzebom/Agencia Brasil.

Minister of Institutional Relations Ideli Salvatti must mediate coalition demands.

Rousseff works to rebuild her coalition

President Roussseff has recognized a need to negotiate consensus and has been emphasizing that "the government is not only the executive branch, but a broad coalition." Today, the government depends on 15 other parties. She has said the continuity of major changes depends on "negotiation, articulation of interests and ability to identify similarities and convergences." Coalition congressmen are pressuring the new Minister of Institutional Relations, Ideli Salvatti, demanding government positions, funding for pet projects, and a greater voice in Rousseff's decisions. (June 13)

ECONOMY

Prices fell by 0.22% in June

The General Price Index (IGP-10) declined 0.22% in June, after rising 0.55% in May, according to the Getulio Vargas Foundation, mainly because agricultural and industrial prices have been falling. Cotton, ethanol alcohol, poultry, beef, and orange products recorded significant declines. (June 17)

Moody's raises Brazil's rating

The rating agency Moody's has raised its rating of Brazil from Baa3 to Baa2, citing the fiscal effort, the brake on credit, and the inflation fight. Brazil is still eight steps below the top rating, Aaa. The top-ranked country in Latin America is Chile at Aa3. (June 20)

Unemployment again at historic lows

The unemployment rate in six of Brazil's largest cities was unchanged at 6.4% in May, according the Brazilian Geographic and Statistics Institute (IBGE). That is the lowest rate for May since the current survey started in March 2002. With employment strong, companies must pay more to keep workers, passing on the cost to consumers and pushing up inflation pressures. Cimar Azeredo, who manages the report, expects the trend to continue. (June 22)

Domestic credit growth still robust

In May credit rose 1.8% month-on-month in May, to US$1.1 trillion, 47% of GDP, but slowed slightly year-over-year to 20.4% from 21.0% in April. Credit growth is expected to slow because of hikes in the central bank benchmark interest rate and the effects of other recent measures. The delinquency rate also edged up, to 5.1% in May from 4.9% in April. (June 28)

INFRASTRUCTURE

Lower House fast-tracks infrastructure projects

Brazil's lower house of Congress voted to speed up public works projects for the 2014 World Cup; delays have plagued plans to build new stadiums and expand airports. The Senate has not yet acted. The bill would streamline government tenders for infrastructure projects. The government had prioritized passage of the bill, dismissing criticism that it could fuel corruption. FIFA President Sepp Blatter in March had criticized what he called Brazil's "day-after-tomorrow" attitude to the World Cup preparations, saying that political infighting was delaying the work. (June 16)

NATIONAL SECURITY

Brazil "the main transit route for cocaine" into Europe

The UN World Drug report cites Brazil as the main route for traffickers transporting Andean cocaine to Europe, reporting that cocaine shipments originating in Brazil and intercepted in Europe rose from 25 (339kg) in 2005 to 260 (1.5 tons) in 2009. The World Customs Organization was quoted as saying Brazil, Venezuela, Ecuador, and Argentina were among the most important centers for global distribution of cocaine. (June 23)

TRADE

U.S. Senate votes to open up the country for ethanol

A bill passed by the U.S. Senate would end subsidies for the domestic ethanol industry and abolish the tariff on imported ethanol, to the satisfaction of the Brazilian Sugarcane Industry Association (UNICA). The amendment, approved 73-27, was introduced by Senators Tom Coburn (R, OK) and Dianne Feinstein (D, CA). Leticia Phillips, UNICA Representative in Washington, commented that "Ending the 30-year-old tariff on imported ethanol will help lower fuel prices and provide Americans with greater access to clean and affordable renewable fuels like sugarcane ethanol." (June 17)

FOREIGN POLICY



Photo: Antonio Cruz/Agencia Brasil.

Peruvian President Ollanta Humala meets President Rousseff in Brasilia.

Brazil "a model of economic growth with social inclusion"

After meeting in Brasilia with President Rousseff, Ollanta Humala, Peru's president-elect, said his government should take Brazil's economic and social model as an example. In Peru, 30% of the population live in poverty. "A country cannot be considered rich when there is so much poverty," said Humala. He added that Brazil was an important strategic partner to Peru. (June 9)

Graziano da Silva to head UN food agency

Brazil's former food security minister, Jose Graziano da Silva, yesterday became the first Latin American to head the Rome-based UN Food and Agriculture Organization, edging out Spain's former foreign minister by 92 to 88. The election was applauded by aid groups and the U.S. (June 27)

Mercosur Summit concludes in Paraguay

Concluding the 41st Mercosur Summit, Brazil, Argentina, Paraguay, and Chile signed nine agreements. The summit committed to more economic cooperation between members and new electoral rules for the Mercosur Parliament (Parlasur). A working group was created to oversee elimination of double charging of the Common External Rate (AEC), and the deadline for reviewing the Protocol on Government Procurement was extended to year-end. The intent is to open up opportunities for businesses and service providers in the region. (June 29)

Brazil and Japan campaign to expand the UN Security Council

The foreign ministers of Brazil, Antonio Patriota, and Japan, Takeaki Matsomoto, have committed to finding new supporters for the campaign for the September UN General Assembly to reform the United Nations Security Council. Expanding from the current 15 seats —five permanent and ten rotating — already has the support of more than 100 countries. (June 30)

ECONOMIC POLICY

Decision on carry-over expenses

Soon after Institutional Relations Minister Ideli Salvatti reiterated that President Rousseff would not extend the period for carry-over spending from last year's budget, the government backed down and extended it for three months. Finance Minister Guido Mantega said that the extension will not affect the government fiscal outcome and pointed out that R$50 billion in budget cuts will be retained. (June 30)

Central bank inflation report expected

The Central Bank's more gradualistic approach to curbing inflation seems to align with Rousseff administration views urging that side effects on economic activity and employment should be minimized. The Central Bank is projecting that inflation will not converge to the 4.5% taret midpoint until 2013, assuming a constant benchmark interest rate of 12.25%. Risks to the projection are that growth will not moderate, commodity prices will rise, and wage increases will outstrip labor productivity growth. (June 29)

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

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Removing barriers to greater success in services

Services are changing the structure of the Brazilian economy — and that's not a bad thing. As our cover story makes clear, once people have a home and a car, they begin to spend more not only on retail goods but also on intangibles like entertainment, health, and education. Clearly, the fact that Brazil is moving in that direction means that for more and more Brazilians the basics are already taken care of so they can, for instance, get a computer to go online and take courses to brush up their skills.

It's easy to think of services in terms of traditional areas like transportation, retail, and personal services like haircuts, but in economics the word means far more: tourism, for instance, but also finance, telecommunications, and information technology. This is where the services picture gets a little cloudy.

Large segments of these areas have long been dominated by the government, there is a shortage of workers with the skills these areas need, and there are archaic restrictions on foreign investment. That may explain why, as GFV economist Pedro Cavalcanti tells us, when Brazil is compared to the U.S. and Korea, there are clear productivity gaps but the worst is in the services sector, not agriculture or industry. Cavalcanti finds an old problem to be the main culprit: education. Even though literacy levels are rising and Brazilians are spending more years in school, he says, "The workforce in this country is still not well qualified."

One of the main forces holding the service sector back from success is thus the inadequacy of Brazil's educational system. True, there begins to be some recognition of the problem by both public and private groups. The National Competitive Development Policy, which was once focused solely on manufacturing, now incorporates services. Regarding engineering services, the Federal Council of Engineering, Architecture, and Agronomy is launching a national census of the skills of engineering and architecture professionals as the basis for discussion on how to improve technological and technical education — particularly important given huge and urgent infrastructure demands in areas like international sports and deep sea oil. There is a draft bill to introduce subsidized loans for the training of workers (though it has yet to pass). But until we make education a true priority rather than just a verbal one, the services sector, which is responsible for almost 70% of the wealth generated in Brazil, will survive on its potential rather than fully actualizing its success.

One of the main forces holding the service sector back from success is the inadequacy of Brazil's educational system.

Education may be the biggest problem for the sector, but of course it is not the only one. Another is the extensive informality in certain areas, particularly personal services such as cosmetics and health, where the barriers to entry are low. The Individual Entrepreneur law has helped here, bringing more than 1.2 million small businesses into the formal economy, from bars to beauty salons. What would also help, according to lawyer and banker Murilo Portugal, is for the government to "adopt negative incentives" to raise the cost of informality, and to reduce the excessive cost of labor by exempting payroll from taxes.

The services sector is going strong. But it could contribute even more to Brazil's economic success, not to mention the well-being of Brazilians, if the hurdles it must surmount were dismantled.

Latin America: A region in flux

Latin America seems relatively cohesive culturally, politically, and economically. A closer look, however, reveals a significantly diverse political landscape, consisting of countries with more liberalized economies and countries that are not receptive to U.S. overtures such as the Mercosur members and the countries that side Venezuela's brand of leftism. Brazil's emerging power status and China's increasing presence have also had a tectonic impact in the region. All these factors call for a different and more sophisticated U.S. approach toward Latin America and Brazil.

João Augusto de Castro Neves

The fact that in the race for the International Monetary Fund's top job Agustin Carstens lost to Christine Lagarde came as no surprise to the international community. However, the fact that two Latin American powers, Argentina and Brazil, opted to support a European candidate instead of Mexico's central banker is revealing. Somehow, despite the persistent clamor of both countries for more opportunities for the developing world in the top echelons of the global architecture, confirmation of the status quo in the IMF seemed like the best strategy.

The recent election of the new IMF managing director may be yet another example that reinforces tangible changes that have been occurring in the region in the past decade or so. For most of the world (especially the United States), Latin America seems relatively cohesive culturally, politically, and economically. The abundance of regional initiatives and institutions — regardless of their practical results — bolsters that perception. It can seem quite reasonable to think of Latin America as a single entity.

A closer look, however, reveals significant cracks in the idea of a monolithic Latin American political landscape. For Brazil, those fissures began to surface in the 1990s when Mexico decided to join the North American Free Trade Agreement (NAFTA) and the Organization for Economic Cooperation and Development (OECD). Mexico's rapprochement with the developed world seemed to give Brazilian officials an opportunity to rethink Brazil's regional boundaries. As a result, the notion of a uniform Latin America began to lose strategic substance; it was replaced by a more pragmatic attitude toward South America.

What followed was in a sense a diplomatic strategy of concentric circles. Brazil's reconciliation with Argentina in the 1980s created what was to become the axis of Mercosur in the 1990s. When Paraguay and Uruguay joined in, the regional bloc became a regional and

diplomatic priority for Brazil. A second concentric circle encompassed all of South America. In practical terms, Brazil's approach centered on a trade agreement between Mercosur and the Andean Community and a cluster of regional infrastructure projects. The Latin American and Caribbean circle, although given lip service in diplomatic discourse, was paler.

Another cause of these transformations was U.S. policies toward the region. On the economic front, the failure to complete the Free Trade Area of the Americas triggered a U.S. hub-and-spoke trade strategy. After NAFTA the U.S. aggressively pursued free trade agreements (FTAs) with Chile, Peru, Colombia, and most of the countries in Central America. As a result, the regional economic framework today consists basically of more liberalized economies — countries that have FTAs with the U.S. — and economies that are not receptive to U.S. overtures, mainly the Mercosur bloc and the Bolivarian countries that side Venezuela's brand of leftism (the Bolivarian Revolution) .

Although it may be prudent to view the sustainability of Brazil's rise with a grain of salt, it is impossible to ignore the increasing asymmetry between Brazil and the rest of the region.

On the political and strategic fronts, U.S. policies also stir different reactions in the region. Many leaders in Central America and parts of South America (Colombia) see a U.S. military presence as essential for dealing with domestic and regional problems, such as natural disasters, violence, and drug trafficking. But it is precisely the U.S. military presence that other leaders in the region (including Brazilians) see as part of the problem. Many view U.S. use of military bases in Colombia and the reestablishment of the 4th Fleet by the U.S. Naval Forces Southern Command a few years ago with concern and suspicion.

If these regional trends have been evolving for some time, why should they matter now? Two reasons: First, China. In 2010 China became not only Brazil's — and Latin America's — main trading partner but also an important source of investment. The increasing Chinese presence is seen not only as a threat to U.S. exports but also as a sign of diminishing U.S. influence in the region. After all, China's presence gives countries in the region the possibility of bargaining with two great economic powers.

The second reason is Brazil's emerging power status. Although it may be prudent to view the sustainability of Brazil's rise with a grain of salt, it is impossible to ignore the increasing asymmetry between Brazil and the rest of the region. With or without a diplomatic strategy, Brazil's economic expansion is exerting a growing gravitational pull on neighboring countries. Without some sort of coordination or deeper engagement, more friction might arise between Brazil and the United States when the interests of both countries differ.

During President Lula's administration (2003-2010), for example, Brazil's rising power

status led the country onto a rocky path with the United States not only on regional affairs (Cuba, Colombia, Honduras) but also on global issues such as nuclear proliferation, climate change, and human rights. Since President Dilma Rousseff's inauguration early this year, this situation seems to be changing. Rousseff's early comments and decisions on human rights so far have been interpreted as positive gestures aimed at reestablishing favorable relations with the United States. A state visit to Washington in the near future would reinforce the idea of rapprochement and possibly set a new framework for engagement.

That said, the two reasons — China's presence and Brazil's emergence — combined call for a different and more sophisticated U.S. approach toward Latin America and Brazil. Although Latin American countries obviously have some common political, economic, and cultural grounds, today the dynamics in the region have changed considerably. In some sense U.S. policies already capture some of these nuances, despite the tentative and persistent efforts of recent U.S. administrations to forge a broad (though fuzzily defined) Latin American agenda. In fact, the region was originally defined by exclusion (the United States and the rest). Now, it is time to reconsider that idea.

> China's presence gives countries in the region the possibility of bargaining with two great economic powers.



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The real story of the real interest rate

After the euphoria that dominated the end of President Lula's administration, the first six months under President Rousseff can be described as a reality check. It's amazing that on the eve of her inauguration, her advisors were projecting that the real interest rate would fall to 2% at the end of her first term, although some did see the forecast as overly optimistic. Today, with inflation still high and real interest rates around 7%, that projection has quietly faded away.

Inflation above the official target, a much appreciated exchange rate, persistently high real interest rates, and the prospect of annual growth in 2011–2012 that does not exceed, and may even drop below, 4% — the scenario sounds very frustrating for those who succumbed to the developmentalism enthusiasm of the Lula administration grand finale.[1]

Of all the afflictions that continue to trouble the Brazilian economy, none seems so uncomfortable, or generates so much astonishment, as the soaring real interest rate. The feeling is that Brazil cannot escape from this trap. Yet this may well be a false perception. As Brazil's risk has declined, the real interest rate has dropped from double digits, which dominated for a considerable stretch of time in the aftermath of inflation stabilization in 1994, to single digits today.

Since 2004, once it became apparent that the arrival in power of the leftist party did not mean abandonment of fiscal responsibility, the Brazil risk has been falling. The ratio of net public debt to GDP, which reached more than 60%, is now 40%, and the prospects are for that downward trend to continue.



A persistently high real interest rate is probably the expression of a much simpler fact: demand is far outstripping supply.

The proportion of the real interest rate that is related to sovereign default risk has vanished. Today, country risk does not explain more than 20% of the differential between domestic interbank interest rates and the 360-day Libor, the equivalent rate for developed economies.

It is thus clear that solvency risk related to public debt is not the only explanation for high Brazilian interest rates. There is in fact no shortage of causes, among others the peculiar indexing

of most public debt to short-term interest rates and the large share of administered credit (credit earmarked to agriculture and National Bank for Social and Economic Development credit) that is immune to monetary policy

But the high real interest rate is probably the expression of a much simpler fact: demand is far outstripping supply. In Brazil, when the economic situation improves, pulling up business confidence and investment, domestic savings do not react. The excess of investment over domestic saving, therefore, produces inflation, appreciation of the currency, or both as the external balance deficit increases. In essence, we are simply importing savings from other countries.

Also, when businesspeople are more confident and willing to invest, consumers feel equally encouraged to consume. Thus the increase in consumption, reducing domestic savings, occurs just when domestic savings are most needed to finance business investment. The external deficit fills the gap between growing consumption and investment. In recent years, both consumption and investment have been firmly procyclical, but part of this procyclical aspect of consumption may be "once and for all" growth as Brazil's credit-to-GDP ratio increases to a level consistent with its development.

Still, the evidence is that in Brazil growth spurts lead quickly to rising inflation and a rising external deficit. So not only are domestic savings low, they do not rise much when the economy speeds up.

There is a need for a countercyclical fiscal policy, and it can only be based on public spending.

There is a need for a countercyclical fiscal policy, and it can only be based on public spending. To sustain higher rates of growth without generating imbalances, public spending must be reduced much more intensively than is done today in order to make up for the increase in private consumption and investment.

Whenever growth seems likely to accelerate, the primary surplus would have to grow much more intensely, so that increases in public savings offset the reduction in private savings and higher investment. That way surging expansion will not bump into resource limitations, and the side effects of higher inflation and a higher external deficit can be avoided. With less inflationary pressure, the real interest rate may fall, cutting the vicious circle of attracting speculative capital with the resulting currency appreciation.

The alternative, surely worse, would be to accept that growth brings a huge increase in the external deficit — that is, absorption of foreign savings. If that is the case, there is no way to avoid a major appreciation of the currency and deindustrialization.

[1] Developmentalism is the theory that the best way for Third World countries to develop is through government intervention to foster a strong and diversified domestic market.

ARE YOU BEING SERVED?

Responsible for almost 70% of the wealth generated in Brazil, the service sector is changing the structure of the economy and increasingly attracting foreign investors. But there are problems with productivity and quality.

Claudio Accioli and Solange Monteiro, Rio de Janeiro

The service sector has become indispensable to the future of the Brazilian economy. In 2009 it contributed 72% of all new jobs, in 2010 it contributed 67% of gross domestic product (GDP) exclusive of the public sector, and in the first quarter of 2011 it grew 4.0% over the same period last year (industry grew 3.5%.) From January to May, it received 60% of total foreign direct investment, compared with 29% in 2010.

Yet experts and sector leaders are beginning to recognize vulnerabilities in this heterogeneous sector. Services comprise not only the dynamic financial, telecommunications, and information technology sectors but also such traditional sectors as transportation and retail and all activities, often informal, that cover personal services. Productivity is low because large segments have long been dominated by the government, there are old restrictions on foreign investment, and there is a shortage of skilled workers.

Industry's problems

In general, as a country becomes richer and its people can afford more goods, demand then moves into services: someone who already has a home and a car can invest in entertainment, education, and health. Moreover, as technological development makes production of industrial goods more efficient and thus cheaper, it reduces the share of industry in a country's GDP.

In Brazil, "Until the 1980s … the country had too many industries,'" recalls Samuel Pessoa, consultant to the IBRE. Today, however, industry's share in Brazil's GDP is surprisingly falling to the levels of industrialized countries. "I think we have a structural trend — not reasonable, given our per capita income — for industry to reduce its share," Pessoa says. Two factors explain this situation. First, savings are low (17% of GDP) even though Brazil has an economically active population. Low savings are related to the huge welfare state that reduces risks for individuals but also reduces incentives to save. "Ample social insurance produces a huge tax burden. Now, with a huge tax burden on one side and substantial social insurance on the other, why should anyone save in Brazil?" Pessoa asks. He also points out that in the last 15 years, with the minimum wage rising an active worker's retirement benefit grows faster than his earnings, so "It just does not make sense to save in those conditions."

The second factor Pessoa cites is Brazil's privileged position as a supplier of commodities to the world, especially Asia, where a third of the world is becoming rich but which is poor in natural resources. The upward trend in prices for agricultural commodities encourages Brazil to produce primary goods. Pessoa says, "In this scenario, I cannot see much future for industry."

A natural progression?

For some experts, however, the current predicament of industry does not imply confrontation with the service sector. "It's not a zero-sum game," says André Rebelo, advisor on strategic affairs to the Federation of Industries of São Paulo (FIESP). He points out that in part the service sector is growing because certain activities previously done within companies, such as cleaning or computer support, have migrated out.

As a country becomes richer and its people can afford more goods, demand moves into services.

Similarly, Ernani Torres, head of economic research, National Bank for Economic and Social Development (BNDES), argues that the structural growth of the service sector due to changes in the production chain is normal. "Sectors change, leave, and start other processes . . . . It is part of the market economy," Torres, says adding that industry and services have their own logic and operate independently.

While agreeing with FIESP's Rebelo's views, Torres notes, however, that in some situations industry and services benefit from each other's progress. In 2010, BNDES channeled nearly R$47 billion in financing for infrastructure services. In Torres's view, there are significant opportunities for services growth.

Productivity is low because large services segments have long been dominated by the government, there are old restrictions on foreign investment, and there is a shortage of skilled workers.

Today the demand for services is exerting more influence on Brazil's economy, prompting the government to intensify efforts to correct growth deviations. It is also raising concerns about inflation. With overheated demand and an expansionary minimum wage policy, service sector inflation has been exceeding average inflation. "In 2011 and the beginning of 2012, we will be on the alert," says Salomão Quadros, IBRE coordinator of economic analysis. "This year, it seems Brazil's growth rate will be half of last year's rate, which, along with a good harvest and imports of consumer goods, will generate some balance between supply and demand."

For FIESP's Rebelo, services are not worrisome for inflation targeting: "We have to separate the effects of inflation due to high demand from those due to a structural correction. Incorporating more than 30 million new consumers takes time — but it is a good kind of problem."

Pessoa underlines the structural factor: "Brazil has good institutions and good business opportunities and is attracting investment. If investment increases but savings do not, the difference has to be paid by foreign savings, but you cannot import services." That is, foreign savings, which can only come in the form of goods, generate inflation of services. And "expensive services mean an overvalued exchange rate," Pessoa says.

Quality and productivity

The supply of services suffers from low productivity in some sectors and poor services quality. Humberto Ribeiro, Secretary of Trade and Services, Ministry of Development, Industry and Foreign Trade (MDIC), says, "We must look to those segments that induce competitiveness and support

The service sector has attracted more foreign investment in 2011

(Billions of U.S. dollars)

	Jan.-May 2010	2010	% of total	Jan.-May 2011	% of total
Agriculture and mining	2.6	18.1	34.5	3.3	12.7
Industry	8.6	19.3	36.8	7.14	27.0
Services	4.4	15	28.7	15.9	60.3
Telecomunications	0.6	0.9	1.3	5.9	22.5
Utilities	0.1	1.1	2.2	2.6	9.8
Commerce	0.6	2.5	4.8	2.0	7.7
Real estate	0.3	1.1	2.1	0.9	3.4
Financial services	0.7	1.8	3.5	0.8	3.3

Source: Ministry of Development, Industry and Trade.

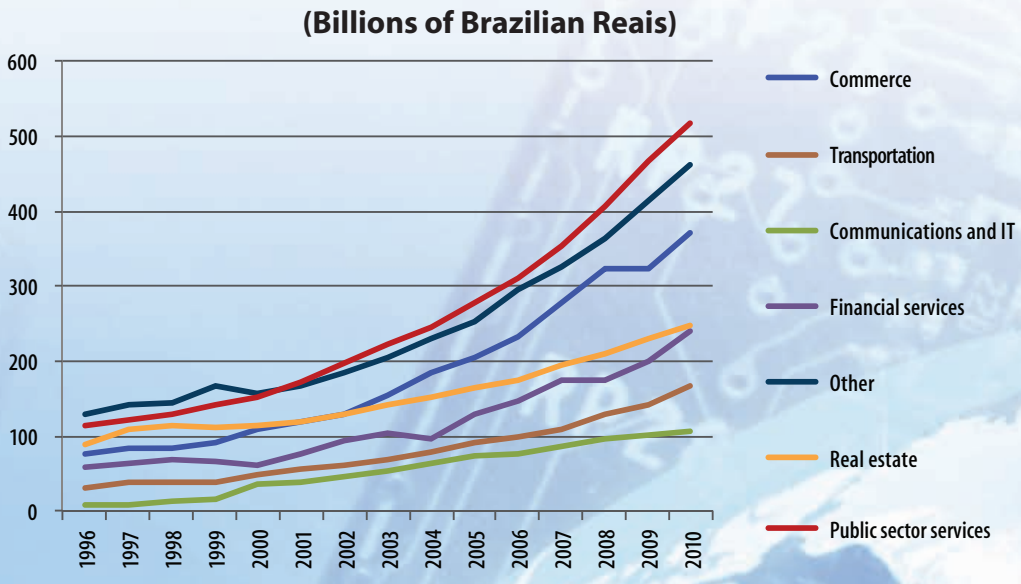
sustainable agriculture and a world class industry. We also have a policy aimed at strengthening traditional sectors such as retail; other segments, such as education, health, and leisure, that need to be better managed; and IT and telecoms, which can provide world-class services."

Pedro Cavalcanti, economist, FGV Graduate School in Economics, points out that productivity in the service sector in terms of its share of GDP is low. When the Brazilian economy is compared with those of the U.S. and Korea, Brazil's productivity gap is much worse in the services sector than in agriculture and industry. Why? Cavalcanti suggests that an important factor is education. Even with the drop in illiteracy and the increase in average years of study, he says, "The workforce in this country is still not well qualified."

Ribeiro agrees. As an example, he cites engineering services, which, after decades of timid demand due to low investment in major infrastructure and the dismantling of the heavy construction industry, now finds itself confronted with needs related to the Growth Acceleration Program (PAC), deep sea oil, and the World Cup and Olympics. The Federal Council of Engineering, Architecture and Agronomy, he says, will soon launch a national census of the skills and flexibility of engineering and architecture profes-

In part the service sector is growing because certain activities previously done within companies, such as cleaning or computer support, have migrated out.

Services have been growing since 2005.



Source: Institute of Geography and Statistics (IBGE).

"With a huge tax burden on one side and substantial social insurance on the other, why should anyone save in Brazil?"

Samuel Pessoa

sionals; the data should support discussion on how to improve technological and technical education. "Minister Pimentel [MDIC] has called for increasing the well-being of the Brazilian consumer, and we know that this requires better services — so much so that the Competitive Development Policy, which was once focused on manufacturing, now includes the service sector," Ribeiro says.

The extensive informality in certain services segments is stimulated by demand for personal services, such as cosmetics, health, and food. "These sectors have low barriers to entry and involve little initial investment; with the amazing growth in consumption, the provider of services can earn a much higher income than from a salary," says Carlos Alberto dos Santos, CEO of Brazilian Support for Micro and Small Enterprises.

Santos points out the good results from the law promoting the Individual Entrepreneur (annual sales of up to R$36,000), which simplifies business registration and payment of taxes. In the two years since the law was passed, more than 1.2 million businesses have registered, including small retailers, beauty salons, bars, and restaurants.

To make the movement toward formalization of service providers broader and more effective, Murilo Portugal, president of Febraban, recommends action on two fronts: "The first step is for the government to adopt negative incentives—measures that directly raise the cost of informality. The second, which is being actively discussed, is to exempt payroll from taxes to reduce the excessive cost of labor." However, the exemption has to be real, Portugal warns: "Providing a tax exemption for payroll in a labor-intensive sector and offsetting it with tax increases in capital-intensive sectors would be a mistake — the increased use of capital is what increases productivity."

Growing external deficit in services.

(Millions of U.S. dollars)

	1970	1980	1990	2000	2007	2008	2009	2010
Services	- 473	- 3,039	- 3,596	-7,162	-13,219	- 16,690	- 19,245	- 30,807
Transportation	- 185	- 1,936	- 1,644	- 2,896	- 4,384	- 4,994	- 3,926	- 6,406
International travel	- 130	-241	-90	2,084	- 3,258	- 5,177	- 5,594	- 10,503
IT services	- 5	- 14	- 51	-1,111	- 2,112	- 2,598	- 2,586	- 3,296
Leasing of equipment	-10	- 292	- 513	- 1,311	- 5,771	- 7,808	- 9,393	- 13,752

Source: Central Bank of Brazil.



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EXCEPTION TO THE RULE

Solange Monteiro



Marco Stefanini

Although services are least exposed to external competition, even with foreign competition advancing into their own backyard, several Brazilian information technology (IT) companies have managed to position themselves competitively in the international market. In June the Dom Cabral Foundation released its ranking of the largest Brazilian transnational companies: out of 46 companies, 12 were in the services sector, 6 of them in IT.

"Abroad, [our] strategy is to focus on building a serious brand ... and knowing the business culture and the country, [because] services have to be customized," says Marco Stefanini, president of Stefanini IT Solutions , which was second in the Dom Cabral rankings.

Stefanini has 67% of its assets, 37% of its employees, and 36% of its revenues outside Brazil. Fifteen years ago, it opened its first foreign operation in Argentina. Today, it operates in 27 countries, adding 10 in 2010 when it acquired American TechTeam, which had operations in China, Germany, and Australia.

Stefanini believes that Brazilian IT industry is quite mature. "We have good installed capacity to meet increased demand, even though we are not immune to growing pains," he says, referring mainly to the lack of skilled workers. He sees the government as sensitive to training needs in the sciences: "There is already a draft bill to introduce subsidized loans for the training of workers — but still nothing concrete."

He believes that, in general, the Brazilian professional "is more flexible, more creative, and participative than in other countries." That is one reason his company stays based in Brazil, from which it supplies contracted services in other countries, such as help desks. But he also recognizes the disadvantages: "The appreciated exchange rate, high labor costs, and the lack of bilingual professionals make operations more expensive."





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The role of banks in building the economy



Murilo Portugal

President of the Brazilian Federation of Banks

Claudio Accioli, São Paulo

Lawyer and economist Murilo Portugal, president of the Brazilian Federation of Banks (Febraban), jokes that he is more of a bank clerk than a banker. He has never been associated with any Febraban member — or any other private company — yet his new job launches a major change in how Febraban is managed. However, he has had a long and successful career in public service. Portugal was Secretary of the National Treasury during the time (1992–96) when the Real Plan was introduced, then executive director of the International Monetary Fund (IMF), where he represented Latin American countries (1998–2005). He came home to serve as deputy finance minister (2005–2006) but was then appointed deputy managing director of the IMF (2006–2011). Now he takes charge of the organization that represents one of Brazil's fastest-growing sectors.

***The Brazilian Economy* — What do you think should be the mission of banks in this phase of economic stabilization and growth in Brazil?**

Murilo Portugal — At every stage of development, banks have three important roles: First, they must run the payment system safely and efficiently. Second, they must mobilize, protect, and adequately remunerate the savings of firms and individuals. Third, they must allocate these savings effectively to finance production, consumption, and investment. Depending on the specific circumstances, there may at times be more or less emphasis on one or another role. Brazil's banking sector has always handled the first two roles well. But because of high inflation and the fiscal indiscipline that characterized Brazil until the economic stabilization phase that started with the Real Plan, banks focused mainly on government funding. This has begun to change in

Foto: Crédito das fotos

recent years with accelerated expansion of credit to the private sector. In this scenario, banks increasingly will be financing investment, which in Brazil still depends heavily on compulsory savings mechanisms led by the government. These mechanisms seem to be reaching their limits. They need to be complemented by funding from private banks and the domestic capital market.

At the moment, in addition to creating new types of long-term loans and complying with the new Basel rules, Febraban has been analyzing the rapid rise in the number of users of banking services. According to the Getulio Vargas Foundation study of the new middle class, between 2003 and 2009, 35.7 million consumers were added to the middle and upper classes. These are people who consume more and therefore need to better understand the financial products banks offer and the basics of how to handle money, credit, and savings. Another challenge is to keep credit expanding at a higher rate than GDP, but without degrading its quality or endangering the financial system.

How do we overcome this challenge? By offering cheaper credit with longer maturities?

The high rate of interest paid on government debt makes it less attractive to invest in long-term private paper, whose quality by definition is lower than that of government bonds. Part of the solution is for government to give corporate bonds a tax advantage, as was done last year. Private long-term bonds must also be of high credit quality; their risk should be classified by rating agencies. We also need a deep and liquid secondary market for private bonds as well as public bonds. This requires a small number of high-quality bonds, large trading volumes, regularity and predictability in their issuance, and market makers to keep the secondary market functioning. We are still discussing how to create those conditions.

Strictly speaking, the cost of credit has been declining for the past year as Brazil's macroeconomic fundamentals improve. But it is necessary to reinforce this process by reducing both the basic interest rate and spreads. For the former, the most important factor is a continued fall in expected inflation and reducing the gross financing needs of the public sector — Brazil's is the highest among emerging economies. At the same time, it is necessary to reduce subsidized credit because it increases the basic interest rate on nonsubsidized credit. As for spreads, it is necessary to reduce delinquency, especially the costs of collecting on collateral; lower the tax rates on financial interme-

It is necessary to keep credit expanding at a higher rate than GDP, but without degrading its quality or endangering the financial system.

Photo: ERJ-170, arquivo Embraer

diation, which are also higher in Brazil than elsewhere; reduce bank administrative costs; and promote further competition in the financial sector. The agenda is challenging. We not only need more progress in macroeconomic fundamentals, we need microeconomic reforms to break with the culture of the short-term, overnight markets, and certificates of deposit with daily liquidity. This may be the single most difficult task for government, banks, and society.

In countries with higher living standards, the services sector is usually the main generator of income and jobs.

The service sector has been growing fast in recent years. Why do you think that is happening?

This is normal when there is an improvement in per capita income. A person who has more resources does not necessarily consume much more food, clothing, or other manufactures. The additional demand ends up being channeled to services. In countries with higher living standards, this sector is usually the main generator of income and jobs.

Is this growth in line with Brazil's current stage of development or might it indicate problems in the structure of the economy?

This is a normal process. Like all large economies, Brazil depends mainly on its domestic market. As a result, a rise in incomes affects the domestic market, particularly growth in services. In exporter countries that depend on external demand, growth in other sectors becomes more evident. We will see this happen in Brazil because of our great wealth of natural resources available for export. We are world leaders in exporting agricultural commodities and have significant participation in mineral commodities, like iron. Now, we have these great oil and gas discoveries. Production will grow faster in these areas than in the rest of the economy.

Historically, financial intermediation has been among the segments with the greatest weight and growth in the services sector. In the first quarter, financial intermediation grew 6.4% over the same period last year but recorded a small decrease of 0.4% from the previous quarter, for the first time since 2008. Should we worry about this?

The setback is temporary and is normal. It responds to the Central Bank's tightening of monetary policy over time. But I think the factors that contributed to that faster growth in the past will continue to allow faster growth in the future. The financial sector has good levels of capital and liquidity, considerable technological sophistication, and a more active and innovative approach to offering its customers new products. Of course the

Foto: Crédito das fotos

level of credit to the private sector as a proportion of GDP, though it has lately increased greatly, is low compared with other countries. My view is that, if we sustain this macroeconomic scenario, credit to the private sector will continue growing faster than GDP, especially when monetary policy becomes more neutral.

A large numbers of complaints are related to bank fees, which are high compared to the rest of the world. How do you respond to these criticisms?

It is always important to reduce costs. Febraban has made a significant effort to make fees more transparent. Our website has an online tool that makes it possible to compare bank fees for different types of services, so there has been progress. A recent survey by the Consumer Defense Institute (IDEC), which was often only partially reported, shows that some banks did not increase their fees during the period evaluated and some even lowered them, especially public banks. Just one bank pushed one particular fee up by 124%. But the headlines said, "Bank fees increased 124%."

All complaints should always be looked into very carefully because they help to improve services. Yet the number of complaints is relatively small considering that in Brazil there are 141 million accounts and about 55 billion of transactions a year. As a proportion of total services provided, complaints, which are in the thousands, can be considered low.

As a proportion of total services provided, complaints about bank fees can be considered low.

The IBRE Outlook released in June cites inflation control and fiscal policy as major challenges for 2011 and 2012. How should these issues be addressed?

The Central Bank should continue to manage the benchmark interest rate to ensure a reasonable probability that inflation will converge to the official target by 2012. As for fiscal policy, the principal challenge is to keep current government spending below the rate of GDP growth. We need to take advantage of rising tax revenues to save more. I see no conflict between medium- and long-term growth and keeping inflation low and predictable, or keeping fiscal policy prudent and counter-cyclical. These are necessary conditions for sustained growth.

Inflation is more widespread in the services sector because it has been overheating and it is less sensitive to the effects of interest rate increases. How can we change this situation?

This, too, is normal, because prices in the service sector are stickier than in other sectors. After all, in most cases people cannot cut their hair or seek medical attention abroad. The point is that there is still a reasonable degree of indexation in the Brazilian economy, in wages or contracts, and because the government administers many of these prices,

they do not respond immediately to changes in interest rates.

The main external risk for 2012, according to the IBRE Outlook, is the possibility of a sharp contraction in global economic growth that could trigger a wave of pessimism that could affect asset prices and commodities. What do you think of this worst-case scenario?

The international outlook for the next year is for gradual recovery but with significant uncertainties. In particular, some countries on the periphery of the euro area are facing a difficult debt crisis, which might cause some imbalance in the European financial system. But there is also uncertainty about the fiscal position of most advanced countries, whose debt has grown significantly — Japan's is 200% of GDP. Germany, the United Kingdom, France, and Spain, among others, have adopted policies to address such problems. But the United States and Japan have not yet come up with plans.

For Brazil the important thing is that demand and commodities prices remain reasonably steady. Of course prices are always volatile, but the prospect of new consumers in China and other emerging markets helps to maintain demand. Brazil is also experiencing great financial inflows, which create short-term difficulties for managing economic policy. However, these flows are essentially good. We must organize ourselves to use them better, not only to build reserves but also to meet the great needs we have in infrastructure and other areas. In short, the external scenario is complex and uncertain but offers opportunities, such as high commodity prices, low interest rates, and large capital inflows. It is up to us to take advantage of these opportunities to increase production capacity and reduce vulnerabilities. ■

The external scenario is complex and uncertain but offers opportunities. It is up to us to take advantage of these opportunities to increase production capacity and reduce vulnerabilities.