THE BRAZILIAN ECONOMY

FGV
Economy, politics and policy issues • SEPTEMBER 2011 • vol. 3 • nº 9
A publication of the Getulio Vargas Foundation



Foreign Policy
Brazil's foreign policy: Moving backwards?

Roundtable
Brazil's new industrial policy frustrates expectations

Interviews
RIORDAN ROETT
"Rousseff is not powerful in her own party, the PT [Workers Party]; Lula is the PT."

ANTONIO DELFIM NETTO
"Financial innovations are not bad; these were misused."

Seminar
Transforming public security in the Americas

Can Brazil become a creative economy?

Today's economic success depends on ideas, not crops or machinery; Brazil has some catching up to do.

GETULIO VARGAS FOUNDATION

60 IBRE

The BRAZILIAN ECONOMY

The Getulio Vargas Foundation is a private, nonpartisan, nonprofit institution established in 1944, and is devoted to research and teaching of social sciences as well as to environmental protection and sustainable development.

Executive Board

President: Carlos Ivan Simonsen Leal

Vice-Presidents: Francisco Oswaldo Neves Dornelles, Marcos Cintra Cavalcanti de Albuquerque, and Sergio Franklin Quintella.

IBRE – Brazilian Institute of Economics

The institute was established in 1951 and works as the "Think Tank" of the Getulio Vargas Foundation. It is responsible for calculation of the most used price indices and business and consumer surveys of the Brazilian economy.

Director: Luiz Guilherme Schymura de Oliveira
Vice-Director: Vagner Laerte Ardeo

Directorate of Institutional Clients:
Rodrigo de Moura Teixeira

Directorate of Public Goods:
Vagner Laerte Ardeo

Directorate of Economic Studies:
Márcio Lago Couto

Directorate of Planning and Management:
Vasco Medina Coeli

Comptroller:
Célia Reis de Oliveira

Address
Rua Barão de Itambi, 60 – 5º andar
Botafogo – CEP 22231-000
Rio de Janeiro – RJ – Brazil
Tel.: 55 (21) 3799-6799
Email: ibre@fgv.br
Web site: http://portalibre.fgv.br/

Economy, politics, and policy issues

A publication of the Brazilian Institute of Economics. The views expressed in the articles are those of the authors and do not necessarily represent those of the IBRE. Reproduction of the content is permitted with editors' authorization. Letters, manuscripts and subscriptions: Send to **thebrazilianeconomy.editors@gmail.com.**

Chief Editor
Vagner Laerte Ardeo

Managing Editor
Claudio Roberto Gomes Conceição

Senior Editor
Anne Grant

Assistant to the Editor
Louise Ronci

Editors
Bertholdo de Castro
Claudio Accioli
Solange Monteiro

Art Editors
Ana Elisa Galvão
Cintia de Sá
Sonia Goulart

Contributing Editors
Kalinka Iaquinto – Economy
João Augusto de Castro Neves – Politics and Foreign Policy
Thais Thimoteo – Economy

THE BRAZILIAN ECONOMY







NEWS BRIEFS

4 Two more ministers leave the administration … inflation target threatened … economy down, consumption steady … problems with high-speed rail … fewer Brazilian soldiers for Haiti … new industrial policy … higher primary surplus … lower benchmark interest rate.

FOREIGN POLICY

8 Brazil's foreign policy: Moving backwards?

The president started out with some reasonable new foreign policy initiatives but seems now to have left pragmatism behind and fallen back on the policies of the previous administration. João Augusto de Castro Neves analyzes the constraints on the president's foreign policy and the implications of Brazil's recent actions, in the UN Security Council and elsewhere.

ROUNDTABLE

12 Brazil's new industrial policy frustrates expectations

Economists of the Brazilian Institute of Economics explain their disappointment and skepticism about the new industrial policy, questioning its short-term orientation and arguing that it is overly protective and insufficient to help Brazil recover its competitiveness. Claudio Accioli and Solange Monteiro report.

COVER STORY

20 Can Brazil become a creative economy?

Other countries have recognized that economic success today depends on ideas, not crops or machinery. Claudio Accioli, Kalinka Iaquinto, Solange Monteiro, and Thais Thimoteo describe what is happening at home and around the world, why Brazil is behind the curve, and what it might do to catch up.

INTERVIEWS

30 Caution: Pitfalls ahead for the Brazilian economy

Political scientist Riordan Roett discusses with Anne Grant the differences between the Lula and Rousseff administrations, concerns about Brazilian de-industrialization, Brazil's relationships with India, China's relations with other developing regions, the Belo Monte project, and the interplay of politics and economics in Brazil.

34 Financial innovations not bad, just misused

Antônio Delfim Netto was Minister of Finance between 1967 and 1974 and architect of the "economic miracle" when Brazil grew at rates above 10% a year. In a later round of government service he negotiated debt relief with foreign creditors and the International Monetary Fund. Still witty, still quotable, Delfim Netto gives Claudio Accioli informed opinions on such subjects as the world economy and the Workers Party.

SEMINAR

39 Transforming public security in the Americas

Numerous polls within Latin America and the Caribbean have identified citizen safety as the number one public concern. Eva Silkwood Baker reports on government responses discussed at the 14th Annual Western Hemisphere Security Colloquium in Washington, DC, including Brazil's civil-military collaboration to regain control of the *favelas*.

POLITICS


Photo: Antonio Cruz/Agencia Brasil.


Photo: Fabio Rodrigues Pozzebom/ Agencia Brasil.

Minister of Defense Jobim leaves after indiscretions; former top diplomat Celso Amorim takes over.

Amorim replaces Jobim at Defense

Minister of Defense Nelson Jobim has resigned over his indiscreet comments on the capacity of Intitutional Relations Minister Ideli Salvatti and Chief of Staff Gleisi Hoffmann. He was replaced by Celso Amorim, foreign minister in the Luiz Inácio Lula da Silva administration, once more showing Lula's continuing influence over the Rousseff administration. Jobim is the third minister to leave since the new administration took over in January. (August 5)

Minister of Agriculture resigns, accused of corruption

The fourth minister to leave since Rousseff took office is Agriculture's Wagner Rossi, who resigned after accusations of suspected payoffs, lobbyists manipulating public biddings, and outside influence on appointments. (August 18)

ECONOMY

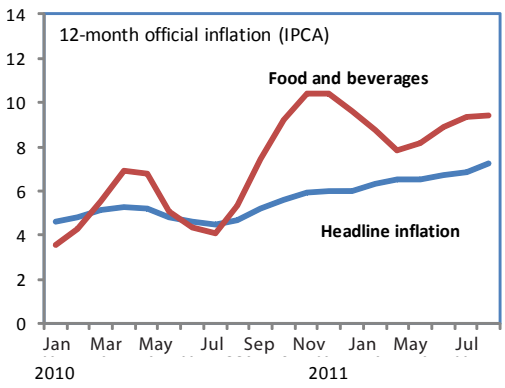
Inflation surge threatens government target

After just a two-month break, in August inflation again soared, pushed by renewed surges in food prices. According to the Institute of Geography and Statistics (IBGE), official inflation rose 0.37% in August, bringing the rate for the last 12 months to 7.23% — the highest year-on-year since June 2005. The government inflation target for 2011 is 6.5%. (September 7)

The economy cools, but not comsumption

Growth of the Brazilian economy slowed in the second quarter as industry was affected by the stronger real and higher interest rates. However, consumption — a major government worry because of its effects on inflation — has increased, driven by the surge in jobs and profits that bolstered the service sector. According to IBGE, GDP grew 0.8% in the second quarter compared with 1.2% in the first. Industry grew only 0.2% compared to the first quarter; it was held back by soaring imports and a lack of competitiveness due to exchange rate appreciation. (September 3)

Food and beverage prices are pushing up inflation.



Source: IBGE.

INFRASTRUCTURE

High-speed rail project gets riskier for the government



After contractors boycotted the high-speed rail auction, to attract bidders the government decided to take on more of the risks of high-speed operations. If the project generates losses, the government will bear them. Some critics point out that the risks are enormous; high-speed rail will take a huge share of the Ministry of Tranport budget, money that could be better spent on improving rail cargo operations. (August 3)

FOREIGN POLICY

Brazil to reduce Haiti peacekeeping mission

In 2012 the army will withdraw up to 250 (11.45%) of the 2,185 Brazilians currently serving in the UN Peacekeeping mission in Haiti, General Luiz Eduardo Ramos Pereira, head of the military mission, has announced. A study in July recommended that the UN reduce the mission by 18% (from 8,700 to 7,100 troops); the Security Council will decide in October whether to approve the general withdrawal. (September 6)

ECONOMIC POLICY

New industrial policy announced



Photo: Wilson Dias/Agencia Brasil

President Rousseff gives a press conference on the Greater Brazil Plan.

The government has announced the Greater Brazil Plan to encourage industry. The package reduces the taxes manufacturers of textiles, footwear, furniture, and software collect on their payroll and creates a tax credit to encourage export of manufactured products. The new policy offers relief for industries with high labor costs, especially those suffering from appreciation of the real against the dollar and from competition with goods imported from China. The total value of tax benefits for 2011 and 2012 is estimated at US$16 billion. (August 2) (For economist opinions of the plan, see p. 12)



Photo: Elza Fiuza/Agencia Brasil

Finance Minister Mantega explains why the primary budget surplus will increase . . .

Primary surplus to rise

Finance Minister Guido Mantega said the primary surplus (budget balance less interest payments) will rise this year by US$6 billion, from US$51 billion to US$57 billion. The intent is to increase resources to maintain investments and social programs and stimulate economic growth and job creation against the risk of low to no growth in the U.S. and Europe, major markets for Brazil. Controlling public spending, Mantega added, will help the central bank to cut interest rates over the medium term. (August 29)



Photo: Wilson Dias/Agencia Brasil

. . . and Central Bank Governor Tombini explains a softer stance on inflation.

Unexpected cut in the benchmark interest rate

Surprising the government as well as the financial markets, the central bank has dropped the benchmark interest rate from 12.5% to 12% a year. Since the international crisis, especially with indications of a slowdown in domestic activity, the bank has been under pressure to cut rates. "The balance of risks for inflation has become more favorable," Central Bank Governor Tombini explained, adding that the "revision to the scenario for fiscal policy" should improve the outlook for inflation. (September 1)

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

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

ONLINE DATABASES

- FGVData – Follow the movement of prices covering all segments of the market throughout your supply chain.
- FGV Confidence – Have access to key sector indicators of economic activity in Brazil through monthly Surveys of Consumer and Industry.
- Inflation Monitor – Anticipate short-term inflation changes.

CONSULTING SERVICES

- Research and Management of Reference Prices – Learn the average market price of a product and better assess your costs.
- Custom Price Indices – Have specific price indices for your business, calculated in accordance with your cost structure.
- Macroeconomic Forecasts and Analysis – Understand Brazil's macroeconomic outlook and assess the effects on your company.
- Sector Analysis and Projections – Obtain detailed studies and future scenarios for the main sectors of the economy.
- Costs and Parametric Formulas – Find the most appropriate price index to adjust your contracts.
- Domestic inflation – Follow the evolution of domestic costs of your company and compare with market costs.
- Retail Metrics – Learn how your customers react to price changes by studies of the demand for your products.

For more information about our services please visit our site (www.fgv.br / IBRE) or contact by phone (55-21) 3799-6799

FGV
IBRE

Time for Brazil to get creative

The creative economy, a term popularized by John Howkins as the title of a best seller a decade ago, is concerned with making ideas and information marketable in a variety of ways. It incorporates, though it is not limited to, traditional cultural activities, which are more concerned with values other than monetary. The creative economy in effect turns ideas into income.

Today around the world the creative economy is overtaking the old industrial economy, just as the industrial economy overtook the agricultural economy long before. But this transformation will move a lot faster. In a double issue more than 10 years ago, Business Week said that "the advanced economies have gotten so efficient at producing food and physical goods that most of the workforce has been freed up to provide services or to produce abstract goods: data, software, news, entertainment, advertising, and the like." But understanding of how the creative economy operates has been slow to reach Brazil.

For instance, elsewhere in the world — especially to the north of us in the U.S. and Canada — because banks have recognized the possibility of gargantuan returns from idea-based companies like Facebook or Apple or Disney, companies founded on creativity have easy access to capital. But banks in Brazil, and even venture capitalists, seem to have no idea how to value an idea-based company. As a result, such companies are starved for money, the financial sector is missing out on a huge opportunity because it's still stuck in the past, and Brazil has found yet another way to lose competitive ground globally. BNDES seems to be starting to catch on, but the private sector is far behind the curve and falling farther back daily.

The expanding global market for creative goods and services is less vulnerable to crises than the industrial economy. The creative economy is also socially inclusive and a strong job generator. Even though Brazil rode out the recent global crisis well and unemployment is the least of our problems today, hiding behind those facts and doing nothing is a very short-term option.

We don't even train workers for the old industrial economy, much less for the new creative economy that's taking over the rest of the world.

Brazil needs policies that educate our people for the future. Yet we don't even train workers for the old industrial economy, much less for the new creative economy that's taking over the rest of the world. And Brazil's other industrial policies are still ... industrial.

Policymakers have no idea how the creative economy works and what it needs, and it shows. Here, as in so many other economic areas, they tend to be too specific and the result is to choke off innovation, as the Greater Brazil Plan painfully demonstrates: As Salomão Quadros says, "Measures related to innovation must be long-term," but the new plan is targeted to resolve specific problems in the short term. He also points out that the Greater Brazil Plan has nothing to say about the service sector, where many of the most productive creative companies operate.

And so we ask: How much longer will it be before we learn the creative economy lessons so many other countries learned long ago? And how much will it cost us in the meantime?

Brazil's foreign policy: Moving backwards?

After a promising start, with more concern for human rights violations and rapprochement with the United States, President Rousseff seems to have fallen back on Lula's ideology-oriented foreign policy of nonintervention in other countries' affairs and opposing the United States. Rousseff has little flair for or interest in international affairs, and Lula's unmitigated political craving often gives him an informal diplomatic role. Result: more continuity than significant shifts in foreign policy.

João Augusto de Castro Neves, Washington D.C.

Amid domestic political turmoil and growing economic uncertainties, foreign policy represented a much safer haven for Dilma Rousseff during her first eight months in office. Changes concerning human rights violations, a positive gesture toward the United States, and keeping Iranian president Mahmoud Ahmadinejad at arm's length were interpreted as positive diplomatic shifts. The general perception both in and outside Brazil was that pragmatism had replaced ideology as the benchmark of Brazilian foreign policy.

A complex world picture

Several recent episodes, however, paint a more complex picture and suggest that, despite some rhetorical inflection, there are significant continuities between the Lula and Rousseff foreign policies. Consider Brazil's posture on two Middle Eastern hotspots, Libya and Syria. As a nonpermanent member of the United Nations Security Council (UNSC), Brazil has shown reluctance to endorse resolutions drafted by Western powers. On the airstrike resolution supporting military action against Gaddafi, Brazil abstained. On the draft resolution condemning violence in Syria, Brazil sought an alternative course, trying to bridge the divide between the Western powers and Russia and China, traditional allies of the Syrian regime.

What Brazil's UNSC role tells us is that the emerging powers coalitions remain a top priority in Brazil's global diplomatic strategy. By abstaining on the Libyan resolution, Brazil joined fellow BRICS in the Council (except South Africa, which voted for the resolution). On Syria, Brazil is working with India and South Africa, which are not only fellow



Photos: Antonio Cruz/Agencia Brasil

Former President Lula's preeminence (left) still looms large over Rousseff's foreign policy.

BRICS but also part of the India-Brazil-South Africa initiative (IBSA). Less ideology and more pragmatism thus do not necessarily translate into a more cozy relationship with the West or with U.S foreign policy goals.

Even if the ideology driving Brazil's foreign policy has dissipated, some deep-rooted difficulties constrain further changes. President Obama's trip to Brazil earlier this year, though generally positive, fell short of Brazil's expectations for a revamped strategic relationship. Receptive gestures aside, it seems that the relative U.S. disregard of Brazil's new global status works against any significant change in the relationship. In fact, the recent past suggests that for Brazil the shortest path to the center of the U.S. strategic field of vision has been through friction and controversy, as with Brazil's posture on the Iranian nuclear program and on regional issues, such as the Honduras political crisis and American military presence in Colombia.

Relations with the neighbors

Brazil's regional policy has shown signs of inertia since the Rousseff administration began. Upbeat official rhetoric toward the region is still habitual, as is working with the bundle of relatively ineffective and redundant regional institutions. But a positive force may emerge from a traditionally "distant" neighbor: Colombia, which under President Santos has shown new interest in Mercosur. This

What Brazil's Security Council role tells us is that the emerging powers coalitions remain a top priority in Brazil's global diplomatic strategy.

Any conscious attempt at brusque alterations in foreign policy could expose Rousseff to unnecessary dispute with her still very powerful predecessor.

is good news for Brazil.

It is also noteworthy that the recent lowering of the profile of President Chávez — a perennial inconvenience for Colombian foreign and defense policies — has cleared the landscape of unnecessary controversy. However, the ailing Venezuelan leader will face a crucial battle for political survival next year. His quest for resurrection will most certainly reverberate negatively throughout the region.

Trade is also a regional issue. With no permanent solution in sight for Brazil's disputes with Argentina, Mercosur will remain as a free trade area incomplete and as a customs union imperfect. As a result, its lack of credibility will most likely retard not only further expansion of the bloc but also trade negotiations with other regions, such as the European Union. Moreover, for a country that claims that its regional leadership role is benevolent, the fact that Brazil has for years sustained trade surpluses with every South American nation except Bolivia may be seen by neighboring leaders as a sign of political insensitivity, if not thoughtless hypocrisy.

Not too late

Of course President Rousseff still has time to pursue an innovative foreign policy agenda — fortunately, because confidence-building and trade negotiations take time. And new political and economic challenges that stem from China's rise as a global power and its role as Brazil's main economic partner may bring about structural changes for Brazilian diplomacy, demanding fresh approaches and more strategic planning.

Nevertheless, Lula's shadow still looms large over the Rousseff administration and its international agenda. Rousseff seems to have little flair for diplomacy or interest in international affairs; Lula's activity as an informal diplomatic envoy certainly suggests more continuity than significant shifts in Brazil's foreign policy. His influence in the recent appointment of former foreign minister Celso Amorim to the Ministry of Defense was one example of this. In fact, any conscious attempt at brusque alterations could expose Rousseff to unnecessary dispute with her still very powerful predecessor. No doubt this helps explain why business as usual has seemed the most prudent and reasonable plan for Rousseff's own political survival.



Parks: the city will have 100 parks by the end of 2012

Theatro Municipal: after the restoration, even more beautiful and modern.

Theatres: Showing more than 200 plays

São Paulo Subway: US$ 1,2 billion invested through 2012

Soccer Museum: in two and a half years, more than 1 million visitors

Guarapiranga Reservoir

Mário de Andrade Library: fully renovated

Bicycle lane: 45 km linking four city parks

WHAT TO EXPECT FROM A CITY THAT HAS EVERYTHING? EVERYTHING.

São Paulo reinvents itself every day. New people, different cultures, an increasing number of places to visit. A city that tells its story on the streets, in the buildings and in the parks, such as the recently-renewed Guarapiranga lake. Visiting São Paulo allows you to immerse yourself in the stories of its restaurants, museums, such as Brazil's unique Soccer museum, and its theaters, such as the Theatro Municipal, which is now even more modern and exciting. São Paulo welcomes all those who are willing to dive into this sea of attractions that suit all tastes and budgets. São Paulo is culture, entertainment, art and creativity. **São Paulo. A creative city.**

Photo credits: Caio Silveira, Dede Fredrizzi, Jefferson Pancieri, Sylvia Masini, Caio Pimenta, Fábio Góis, Alex André Diniz, Nage Gonzaga, Fernando Conti (Secom), Paulo Dias (Seme), Luiz Guadagnoli (Secom) e Ronaldo Franco. Subway: publicity photo.

COME TO SÃO PAULO.
CITYOFSAOPAULO.COM
CONSULT YOUR TRAVEL AGENT.

São Paulo tourism
www.spturis.com

CITY HALL SÃO PAULO

Brazil's new industrial policy frustrates expectations

Claudio Accioli and Solange Monteiro, Rio de Janeiro

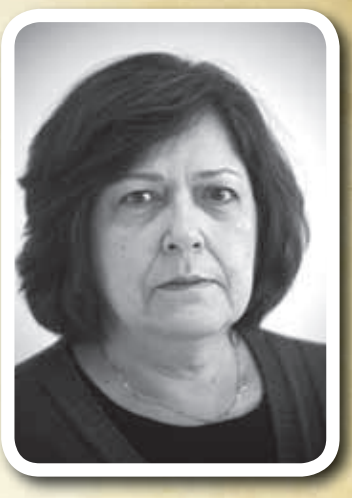
Disappointment and skepticism mark most of the analysis of the new industrial policy by economists of the Brazilian Institute of Economics, Getulio Vargas Foundation (IBRE-FGV). The Greater Brazil Plan announced on August 2 they believe to be insufficient to recover competitiveness and targeted mostly to providing relief to vulnerable sectors affected by exchange rate appreciation. "Protecting the industrial sector generates only inefficiency, not growth," says economist Silvia Matos, coordinator of the IBRE Outlook.

There was consensus on aspects of the new policy. Reduction of payroll taxes for the clothing, shoes, furniture, and information technology sectors is "great news," Matos said. "For the first time, the government seems to accept the idea that industrial competitiveness can be increased by reducing labor costs.... If the policy is not ideal, it is still a step in the right direction."

More negatively, the analysts found reprehensible the 25% preference for domestic goods and services in government procurement. Matos said it "makes no sense that the government pays more for a good only because it is national .... The measure is an incentive to inefficiency, just when Brazil is racing against time, given global uncertainty."

Here is how IBRE economists analyzed the main aspects of The Greater Brazil Plan:

"Trade protection is not a solution."



Lia Valls Pereira

With regard to foreign trade, the policy is fluid, with little substance. For example, initially the government announced it would pay back exporters 4% of the total of their exports, and then said no more than 3%, depending on sector and import content. In Brazil, apparently, you announce things before you have settled everything [which means] you give lobbyists opportunity to seek more gains.

One of the sensitive issues for business is taxes on exports. The export sector argues that Brazil needs a single value-added tax. But that requires a difficult reform lacking political support, and the government tries other ways to reduce export costs. This is certainly not the solution.

The most important financing measure is the export-financing fund for micro and small businesses. Supporting this segment is always good because it creates jobs, but this measure does not solve the problem of the trade balance, because most exports originate with large companies. Also, small businesses have difficulty remaining in foreign trade, so export financing is not enough. There is a need for other policies to help small businesses become exporters.

It is important to improve defenses against unfair trade, but they cannot be used to check imports. Some sectors of the economy need imports to modernize. Another risky point is the debate to increase to 100 the products with a maximum import tariff of 35%; though temporary this could easily become permanent. Trade protection is also connected to exchange rate appreciation, but it will not solve the appreciation conundrum. We need to reduce such costs as transportation and port operation costs.



Salomão Quadros

"Paying more for domestic products will create inefficiency and raise government procurement costs."

Measures related to innovation must be long-term; those defending industry and the domestic market are targeted to resolve specific problems in the short term. This is the case with payroll tax relief, which should not be restricted to certain sectors. The service sector, for example, which has great potential to create jobs, was not contemplated. The tax relief was designed to mitigate job losses in specific sectors because of foreign competition and the appreciated exchange rate; it is not a long-term policy to stimulate employment. In the long term, gradual reduction of payroll tax rates would encourage formalization of employment and thus increase tax revenue for health and welfare programs.

As for government procurement, paying up to 25% more for domestic products will bring about inefficiency and increase the costs to government.



"Informal employment should fall."

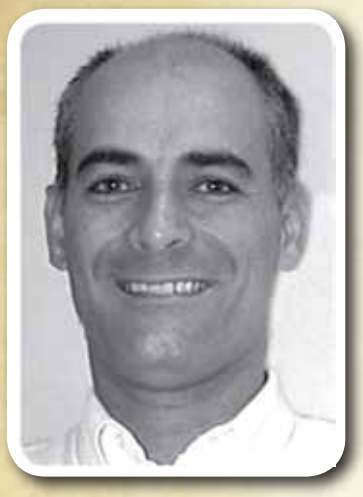


Rodrigo Leandro de Moura

Payroll tax relief, which was limited to a few sectors, will have only a marginal effect on job generation, but it may be the first step to extend payroll tax relief to other segments of the economy. Although it created a tax on revenues of some companies, the net effect should be positive for them. The first offshoot of this measure is a likely decline in informal employment, which is not all that high in industry in general but is very significant in the sectors covered. It will stimulate formalization of employment in these sectors but probably will not be noticeable in the aggregate.

The question is to what extent companies will turn the incentive into profit or will invest in increased production, thus creating new jobs. I do not think there is a significant effect on wages, not only because they are already high but also because there is high turnover in these sectors, and the recent slowdown of the labor market tends to reduce worker bargaining power.

As for government procurement, governments do this sort of thing to promote domestic industry and encourage innovation in the production process. The positive side of this policy is that it can stimulate research and development in leading sectors and generate positive externalities for society as a whole, expanding the possibilities for general economic growth. But the federal government paying up to 25% more for domestic products will produce inefficiency and lower productivity. To avoid this, it is fundamental to put limits on the benefit, so a company does not enjoy a privileged position indefinitely. The measures adopted will have little effect on the labor market in the short term, and unemployment can be expected to hold at about 6% till year-end.



Pedro Cavalcanti

"The diagnosis is wrong."

Even with a diagnosis that Brazilian manufacturing is experiencing a crisis caused by predatory competition of foreign products, especially Chinese, and the "currency war," the new industrial policy will not solve the problem. Probably it will adversely affect productivity and unjustifiably benefit certain interest groups and sectors rather than the population as a whole.

The data available do not reveal a widespread crisis. There are serious problems in some sectors hit by international competition, but others, like the automotive industry, are growing at healthy rates. A second mistake is to consider the appreciated exchange rate to be the root of the problem. Even if it were, more important distortions have been ignored, such as Brazil's costly and bureaucratic tax structure and excessively high tax burden. Moreover, to a large extent the appreciation is caused by foreign capital pouring in, attracted by high interest rates, which were aimed at curbing the inflation caused, among other factors, by excessive government spending and credit expansion.

Here, too, we are not confronting the problem. Treasury transfers to the National Bank for Economic and Social Development (BNDES) remain high and there is no long-term program to relieve fiscal difficulties. But there are positive measures, such as reducing the period of return of the social contribution taxes (PIS–PASEP) on purchases of capital goods, the industrial products tax (IPI) exemption on capital goods, and a significant increase in resources for innovation and payroll tax relief — although here expectations have been frustrated because it covers only four sectors. The few strengths, however, are not the core of the new industrial policy.



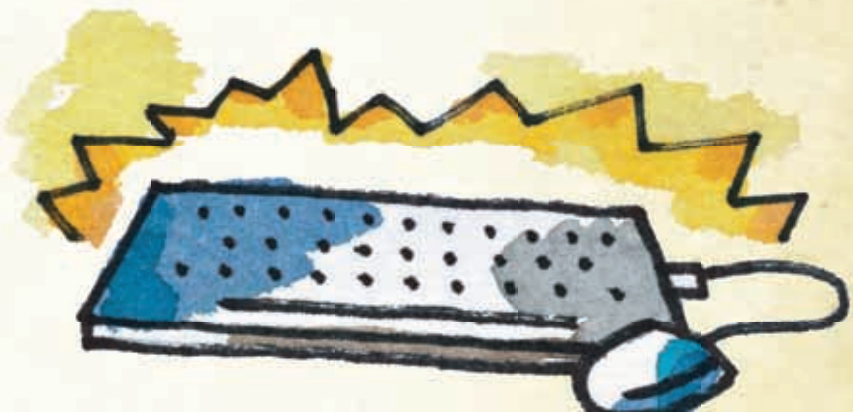
"Any industrial policy that does not address performance becomes income distribution policy."



Fernando de Holanda Barbosa Filho

Past industrial policies have not been positive. They transferred income to sectors that lobbied best. For example, the National Informatics Policy of 1984 has not generated a competitive industry — IT companies exposed to competition did not survive. Our history condemns us.

Any industrial policy that does not address performance, as the Asians did, becomes income distribution policy. In some sectors contemplated in the new industrial policy, exchange rate appreciation in recent years did badly damage competitiveness. There are some good measures, such as payroll tax relief. In cases like clothing, for example, there is a high degree of informality, individual entrepreneurs, and heavy competition from Chinese products. This can really help, although the effect is not neutral: except for Social Security, there will just be a transfer of tax revenue from one sector to another. A policy that deals with the economy's competitiveness as a whole would be better. Addressing only problems in some sectors has not worked in the past, especially when relief is not tied to performance.





Mauricio Canêdo

"Companies innovate because they are pressured by competition."

Brazil's new industrial policy has very little to do long term with what is usually defined as industrial policy because many of the measures have expiration dates. The new policy seems to be more about alleviating structural problems (exchange rate issues, competition from China, the Brazil cost, etc.). Instead of innovation, as the government had earlier suggested, the emphasis is on protecting the domestic market. BNDES programs have been strengthened and the Financier of Studies and Projects (FINEP) budget increased by R$2 billion. Payroll tax relief for some industries goes in the right direction; I hope it leads to broader reduction of the tax burden on wages. Most of the measures to encourage investment and innovation represent a continuation or extension of what has already been done.

The big challenge is to build an environment encouraging companies to innovate. We are not doing this. The preference for domestic goods in government procurement goes back to early 2010; the main motivation was supposed to be to use the purchasing power of government to encourage innovation. But companies innovate because they are pressured by competition.

"It looks like a Christmas tree."



Armando Castelar

The most interesting measure of the new industrial policy is the payroll tax relief. Although it is protective, in the medium term it can have a major effect in Brazil by reducing informal employment. The idea of starting in some sectors makes sense both because we need to better understand the effects and because Brazil is experiencing a situation of almost full employment.

What is missing is coordination: it is difficult to understand how the initiatives relate to each other, and what the goals are. That makes it difficult to assess whether these measures are appropriate and whether together they will produce the expected result. The policy looks like a Christmas tree. In addition to evaluating each measure individually, we should analyze them together, and that is not possible. The intent may have been to show that the government is not insensitive to the difficulties industry is going through, but I am not sure there is sufficient magnitude to meet the challenge created by exchange rate appreciation.

HIGHLIGHTS OF THE GREATER BRAZIL PLAN

Defense of Domestic Industry and Market

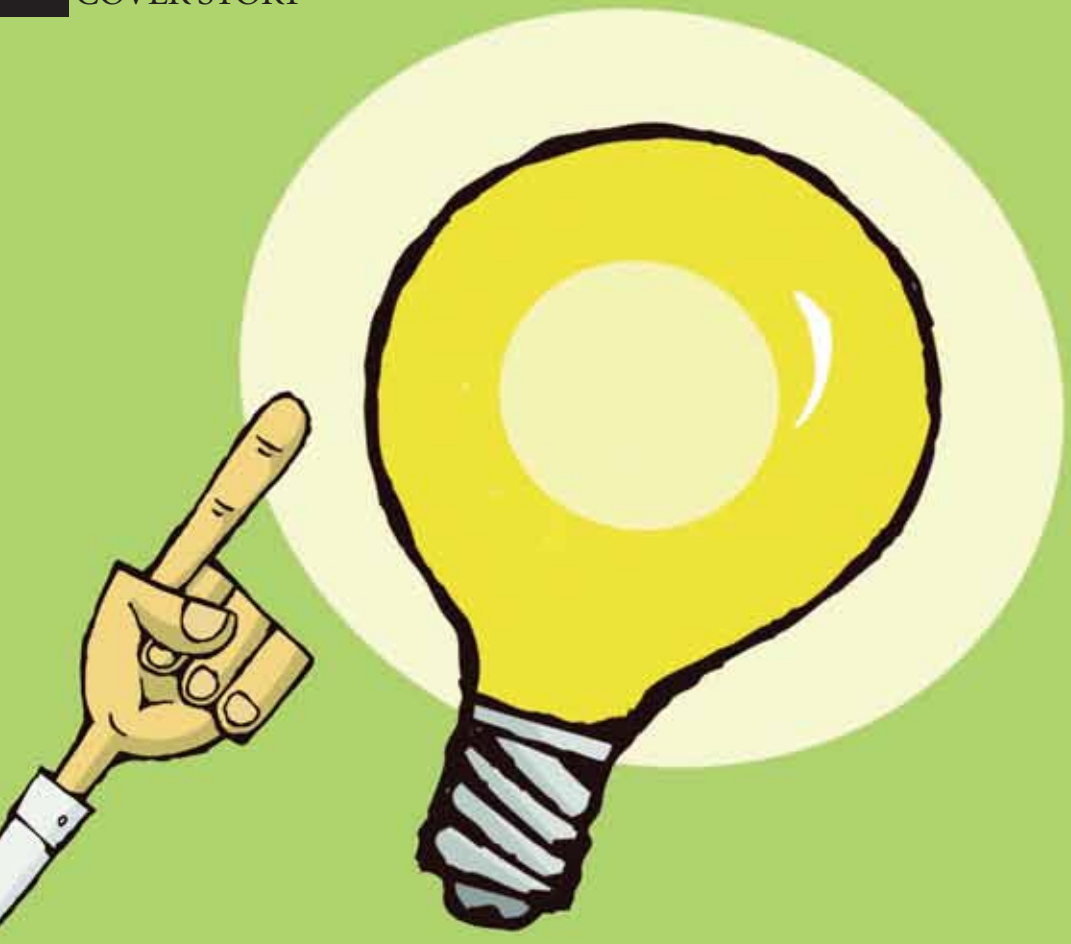
- Reduces to zero the social security tax of 20% on payroll in the clothing, shoes, furniture, and information technology sectors.
- Institutes a preference allowing the government to pay a 25 percent premium over the lowest price for Brazilian-origin products and services that meet certain employment, income generation, and technological innovation standards.
- Creates a new regime for the automotive sector with tax incentives for investment, more value added, employment, and innovation.

Incentives for Investment and Innovation

- Extends for 12 months the IPI reduction on capital goods, building materials, trucks, and light commercial vehicles.
- Reduces the deadline for returning social tax credits on capital goods.
- Extends the Investment Support Program of BNDES to December 2012 with a budget of $75 billion.
- Expands BNDES working capital loans for small and medium-sized businesses from R$3.4 to R$10.4 billion.
- Increases by R$2 billion Finep's 2011 innovation portfolio.

Foreign Trade

- Institutes the Reintegra program to reimburse exporters of manufactured goods of 3% of exported value of taxes indirectly levied on the export production chain, such as the local service tax (ISS), the financial transactions tax (IOF), and the royalty tax (CIDE).
- Reduces delays in trade defense (antidumping, safeguards, and countervailing measures) from 15 to 10 months (investigation) and from 240 to 120 days (application of provisional right).
- Creates an Export Financing Fund for companies with revenues of up to R$60 million.



Can Brazil become a creative economy?

Other countries have recognized that today economic success depends on ideas, not crops or machinery; Brazil has some catching up to do.

Claudio Accioli, Kalinka Iaquinto, Solange Monteiro and Thais Thimoteo, Rio de Janeiro

Quick: What do the cities of Sheffield in England, Brisbane in Australia, and Buenos Aires in Argentina have in common? Confronted with stagnation or crisis, all have committed to a new economic approach: The Creative Economy. Devastated by unemployment as the coal and steel industry declined, Sheffield has become a center for digital media. Brisbane's business strategy is now centered on marketing cultural goods and services and on education that encourages talent and creativity. Buenos Aires has been promoting talent development in the audiovisual field.



Throughout the world, says economist and researcher Lidia Goldenstein at Alberto Luiz Coimbra Institute for Graduate Studies and Research in Engineering (COPPE-RJ), there has emerged a consensus on the importance of economic sectors that intensively use new technologies and new ideas — creativity. "These sectors are now regarded as generators of competitiveness, innovation, and value," she says. Beyond traditional cultural and mass media activities, such as movies and publishing, the new approach is stimulating business models based not only on generating intellectual property but also on adding innovative features to traditional products, such as distinctive design that adds value.

"The creative economy ... has an important role in contemporary lifestyles," says Edna dos Santos Duisenberg, a Brazilian who since 2004 has led the Creative Economy and Industries Program of the United Nations Conference on Trade and Development (UNCTAD). UNCTAD says the expanding global market for creative goods and services is less vulnerable to crises. In 2008, for example, when international trade fell by 12%, transactions in creative economic goods, which amounted to US$592 billion, averaged 14% growth between 2000 and 2008. The creative economy is also socially inclusive and a strong job generator. Duisenberg notes, for instance, that "Today, we are evaluating how to rethink many sectors in Portugal, Greece, and Spain, which were hit hard by rising unemployment and the decline in the construction sector and tourism."

Brazil is lagging behind this movement, which goes far beyond Europe, Duesenberg says: "China, for example, has made a huge effort to move from 'made in China' to 'created in China'. Today the country exports US$84 billion in creative economy goods. Brazil is not even close to that." She notes that although the creative economy has been discussed in Brazil since 2004, it was not until February 2011 that the government created an agency and appointed as Secretary of the Creative Economy Claudia Leitão, who had been professor of public policy and society at the State University of Ceará.

WHERE TO START

To become a creative economy Brazil needs data to support international comparisons, formal public policies, and an understanding of an appropriate direction. There is already some dynamism. According to UNCTAD in 2008 Brazil exported US$6.3 billion in creative services and US$1.22 billion in creative goods — far behind the

"Throughout the world there has emerged a consensus on the importance of economic sectors that intensively use new technologies and new ideas — creativity."

LIDIA GOLDENSTEIN

10 leading developing countries, led by China, India, and Turkey — and imported US$4.6 billion in such services and US$1.7 billion in goods. In 2010, PriceWaterhouseCooper reports, Brazil was among countries with the highest growth in media and entertainment: 15.3% over 2009, for a total of US$33.1 billion. Cable television, internet access, and television advertising all had over 20% revenue growth. A joint report from the World Intellectual Property Organization (WIPO) and the European Institute of Business Administration (INSEAD) ranked Brazil 12th among 125 countries in dynamic artistic and cultural productions, and in 2008 the Federation of Industries of the State of Rio de Janeiro (Firjan) found that "jobs involved in the creative economy

The creative economy according to UNCTAD





- Boosts tax revenues, job creation, and exports, promoting social inclusion, cultural diversity, and human development.
- Promotes economic, social, and cultural rights and involves technology, intellectual property, and tourism.
- Is characterized by cross-cutting activities that connect macro and micro levels to the total economy.
- Demands innovation, interdisciplinary public policies, and interministerial actions.
- Has a solid core of creative industries.

in Brazil represent 21% of total formal employment, and in Rio de Janeiro that reaches 23%," says Cristiano Prado, Firjan's manager of new business.

Recently, the Brazilian Service of Support to Micro and Small Enterprises, Rio de Janeiro City Hall, and the Municipal Institute of Urbanism Pereira Passos (IPP) commissioned a study of "Fashion Territories" from the Center of Technology and Society (CTS) of the Getulio Vargas Foundation (FGV) Law School, which surveyed brand and apparel industry representatives. "Business turnover is R$891 million a year, and the sector employs more than 34,000 people, formally and informally," says Pedro Augusto Francisco, a project coordinator. IPP president Ricardo Henriques explains that "With this information, it is much easier to define incentives and policies to encourage [such] businesses."

For instance, it is not by chance that Argentinean director Juan Jose Campanella won an Oscar for "The Secret in Your Eyes," says Fernando Arias: "It all comes from an effort that begins in incentives to the local market, encouraging national projects as well

Brazilian Drums Challenge game is a mix of memory and music game. It is exported to more than 60 countries.

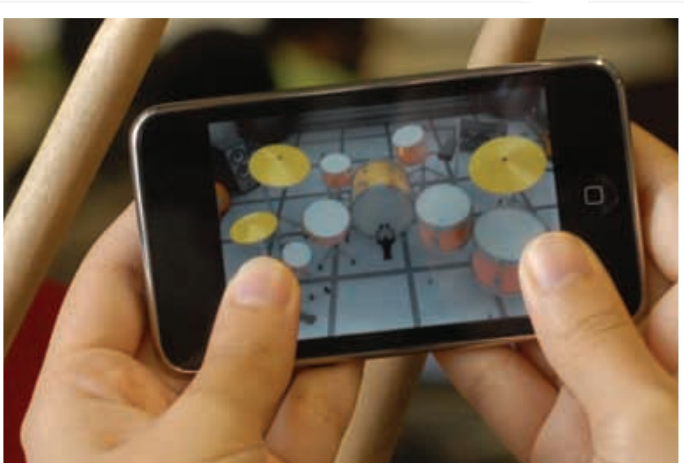




Photo: Chico Porto





"China, for example, has made a huge effort to move from 'made in China' to 'created in China'. Today the country already exports US$84 billion in creative economy goods. Brazil is not even close to that."

EDNA DOS SANTOS DUISENBERG

as co-production strategies." Arias is coordinator of the Creative Industry Observatory in Buenos Aires, which collects information about what is happening in the city and in the country. In 2004, because American productions had been dominating the local box office, Argentina passed a law setting minimum quotas of Argentine films for theaters to show. Arias says his group and others are lobbying the legislature to provide incentives to promote an audiovisual hub for companies to set up in Palermo.

Goldenstein of COPPE-RJ points out that in Canada today, animated films generate more than 200,000 jobs and export revenue of US$5 billion, but in Brazil "this activity, as well as the related production of games, still is not seen as an industry more important than the auto industry for job creation and generating positive externalities to other sectors of the economy."

Arthur Protasio, CTS researcher and coordinator of game studies, agrees. He notes that in Brazil game development is yet a "fragmented" market and that edicts to promote the market mistakenly use film as the main reference. They require that 60% of the funding be dedicated to the script, which means "the programming, often the main part of any software development, ends up receiving fewer resources." He laments that internationally, Brazil has no identity in this market, and there is a risk that what is created here "will not have the same quality or investment as big players in this sector."

ART AND CAPITALISM

Another challenge for creative endeavors is professional market-oriented management, which is not clear how to associate art and business. Some cultural sectors, Goldenstein says, "are afraid that the creative economy will be taken over by a corporate bias. … They do not realize the importance of creating a channel capable of promoting skilled workers and attracting sophisticated consumers. At the other end, there are people in the creative economy who think it is just about crafts and similar activities. They overvalue the social and playful."

David Parrish, an English consultant who wrote *T-Shirts and Suits: A Guide*

The Jazz & Blues Festival of Guaramiranga, Ceará state, has taken advantage of government incentives and its program now takes one month and involves the local community.







Photo: Chico Gadelha

to the Business of Creativity, recognizes that "confusion over the exact meaning of the 'creative economy' is the main obstacle to such activity being treated as an autonomous business. We need to discuss two issues separately: the value of creativity in terms of business and the value of artistic and cultural creativity to society." Firjan's Prado adds that "The dialogue between creators and business is still not significant. To the extent that artists begin to be recognized as professionals, the industry can identify them as key figures in the transformation of its products to gain market share."

QUANTIFYING INTANGIBLES

Reconciling business and artistry is important to another issue: the difficulty of getting credit in a financial system used to traditional collateral. Goldenstein points out that "When it comes to tangible assets — nails, bricks, machines — there is not much to explain. But it is much more difficult to value intangible assets, which the current financial system does not yet recognize." Brazil's National Bank for Economic and Social Development (BNDES), she says, would never have financed Apple when it started.

Even successful creative companies in Brazil struggle to get financing. Coopnatural in northeast Paraiba state produces clothing made from naturally colored cotton and in 2010 earned about R$2 million in 2010. The work of the parent Northeast Cooperative was possible thanks to a genetic improvement

"Jobs involved in the creative economy in Brazil represent 21% of total formal employment, and in Rio de Janeiro they reach 23%."

CRISTIANO PRADO

in cotton supported by the Brazilian Agricultural Research Corporation—but "Banks do not finance any business connected to organic products because they believe that an agricultural product that does not use pesticides presents higher risk," says Maysa Gadelha, president of Coopnatural and the Natural Fashion brand.

Venture capitalists, who should be used to dealing with higher risk, still have yet to move fully into the creative economy. Sidney Chameh, president of the Association of Private Equity and Venture Capital, explains, "Companies cannot focus just on the creative question: you need management, market focus, know what you want to sell. The investor has to see clearly the direction of business if he is to add value, improve governance, and leave with his profit. If there isn't a clear opportunity for profit, the investor will not enter."

The lack of credit triggers a vicious circle. "Sometimes it feels like building a sand castle," says Raquel Gadelha, a producer and one of the organizers of the Jazz & Blues Festival of Guaramiranga, Ceará state. The Federal Law on Cultural Incentives (Rouanet law), and sometimes state laws encourage such festivals, Gadelha says, "But every year is like starting from scratch with sponsors and partners. We need to create mechanisms so that some cultural projects have medium-term funding."

Luciane Gorgulho, head of the BNDES Department of Cultural Economics, thinks that incentives to the cultural sector, such as the Rouanet and Incentive Audiovisual laws gave new impetus to cultural activities but affected the existing financial structure. "In the 1970s, there



Coopnatural in northeast Paraiba state produces clothing made from naturally colored cotton.





Above photo: W. Jan
Below photo: César de Cesário



was a history of performance that allowed a theatrical or movie producer to get a bank loan, profit, and pay off the debt. The incentive laws have changed this situation. Somehow, the production of the show or movie has become an end, which obscures a more comprehensive production chain," she says. For this reason, or perhaps because banks do not fully comprehend the cultural segment, viable companies lost access to bank lines of credit. "By providing lines of credit, BNDES intends to help the industry reorganize itself financially, so that the incentive laws become increasingly focused on segments that have not and will not have their own economic dynamics," Gorgulho says.

Among successful cultural actions, Gorgulho highlights the financing of a Brazilian-Canadian animated co-production through lines of credit and grant resources provided by the Audiovisual Law. In July 2011, the BNDES audiovisual portfolio covered 25 projects with R$103 million in loans; the total value mobilized by these projects was R$237million.

PLAYING CATCH-UP

"We have an excellent decade ahead, and we must seize it from the start," says Paula Acioli, academic coordinator of the FGV fashion industry business management course. "We have a dynamic economy, with prospects of getting better; natural beauty; and a young population compared to many countries; Europeans, for instance,

"We have the opportunity to develop a different relationship from the old traditional industry, one that promotes diversity and regional identities, one that is solid and sustainable."

CLAUDIA LEITÃO



are aging. It brings a freshness," she explains. UNCTAD's Duisenberg points out the advantage of the growing Brazilian middle class: "The consumption pattern has changed in favor of creative industry. Young people begin to consume earlier, and with the general increase in life expectancy retirees need more cultural products and services, and entertainment."

Creative Economy Secretary Leitão has a busy agenda. She says the secretariat has goals for promotion, training, infrastructure, and regulation that involve interdisciplinary policies. Are the goals too ambitious? The secretary says no: "We have the opportunity to develop a different relationship from the old traditional industry, one that promotes diversity and regional identities, one that is solid and sustainable."

Brazilian animation production "Peixonauta" (below) has had success abroad, particularly in U.S. Discovery Kids and Al Jazeera Kids channels.





INSURANCE: A GROWING BUSINESS



INSURANCE BUSINESS ACTIVITY, THERMOMETER OF THE ECONOMY, IS CLOSELY RELATED TO THE GOOD PERFORMANCE OF PRODUCTIVE SECTORS

Over the past ten years, about 20 million Brazilians left the poverty line and became part of the middle class. This transformation has had a significant expansion since 2003, and currently 55% of the population became part of this segment, approximately 105 million people.

With more access to resources and consumer goods, increasingly more people wish to protect their wealth or ensure the life standards of their loved ones. With the new global economy landscape, more companies are seeking guarantees for new projects. As a result, insurance activity has begun to follow the growth of the country.

THE GENERAL INSURANCE INDUSTRY AND FENSEG

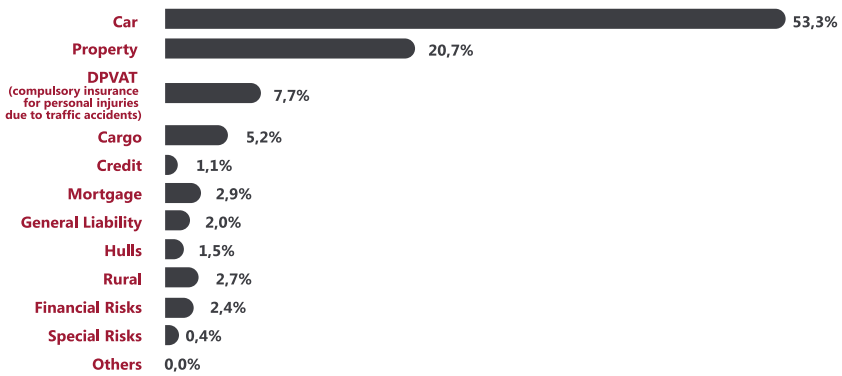
The segment most directly related to heritage preservation is General Insurance, which stands for a series of activities called non-life, excluding health: automobiles, property, DPVAT (compulsory insurance for personal injuries due to traffic accidents), mortgage, cargo, financial risk, credit, liability, hull, rural and special risks, among others. Companies operating in this market are represented in the National Federation of General Insurance (FenSeg).

In 2010, the general insurance industry earned R$ 37.7 billion in premiums, up 14.5% from 2009. The main type of insurance is still car insurance, which grossed R$ 20.1 billion, 15.3% over the previous year, and which represents 53.3% of total premiums.

There was also a significant growth of property insurance, premiums for which reached R$ 7.8 billion, an increase of 20.1% over 2009. In that segment, the extended warranty insurance performed remarkably: it grew by 90.0% in 2010, with premiums reaching R$ 2.1 billion against R$ 1.3 billion in the previous year.

The branches with the highest growth in 2010 were: mortgage (21.9%), that has shown annual growth always above 20% in recent years, property insurance (20.1%) and general liability (18.5%).

Brazil's insurance premiums by segment (%) – non-life, excluding health



In 2010, the main themes that FenSeg worked at were: car insurance, and its Best Practices Guide, implementation of operations on the open reinsurance environment; mortgage insurance; rural insurance; and update of the insurance rules for cargo and general liability.

OPPORTUNITIES

The projected growth of the insurance industry reflects optimism about the intensification of investments related to the 2014 World Cup and the 2016 Olympics.

But the insurance industry does not rely only on the main infrastructure works to support its growth. Other sectors highlighted today are:

- Development of microinsurance
- Rural insurance, through the regulation of the Catastrophe Fund
- General liability insurance

Caution: Pitfalls ahead for the Brazilian economy



Foto Biorn Maybury-Lewis

Riordan Roett

The Sarita and Don Johnson Professor of Political Science and Director of the Western Hemisphere Program, Paul H. Nitze School of Advanced International Studies, Johns Hopkins University

Anne R. Grant, Washington, DC

Riordan Roett is a political scientist specializing in Latin America and former national president of the Latin American Studies Association. Fluent in Portuguese and Spanish, he is a recognized specialist on Brazilian, Mercosur, and Mexican issues. In 2001 the president of Brazil named Dr. Roett to the Order of Rio Branco. His most recent book is *The New Brazil* (Brookings Institution: 2010). In this interview Dr. Roett deals briskly with the differences between the Lula and Roussef administrations, concerns about Brazilian de-industrialization, Brazil's relationships with India, China's relations with other developing regions, the Belo Monte project, and the interplay of politics and economics in Brazil. He points out, for instance, that no matter what the administration decides, "there are so many veto players in Congress" that making either political or economic changes is very difficult.

***The Brazilian Economy* — Earlier this year you wrote that "good luck is as important as good policies." What trends do you see as being lucky for Rousseff? What about unlucky?**

Riordan Roett — The situation is very different from what it was under Lula. During the global crisis Lula's stimulus to the economy was appropriate, but then it was continued and used for pre-election spending. Dilma now has to deal with the fiscal consequences. Currency appreciation is severe, and there's a lot of action from the carry trade — speculators borrowing elsewhere at lower rates so they can make a quick buck from higher rates in Brazil. Right now, Dilma is looking unlucky.

In what ways do you think Rousseff is creating a presidency that is different from Lula's?

Dilma is not powerful in her own party, the PT [Workers Party]; Lula is the PT. That makes a big difference. She has to learn how to manage Congress, too, which is hungry for jobs. Meanwhile, she is taking a stronger stand in favor of human rights and against corruption.

Fernando Henrique Cardoso recently said that "the old protectionist mindset is not easy to change." He also said that "the average Brazilian still believes that without state involvement, the economy can't move ahead." What do you think of these points?

Keep in mind that there's considerable animosity between Cardoso's PSDB [the Brazilian Social Democratic Party] and the PT, so what Cardoso says has to be taken with a grain of salt. Nevertheless, the PT approach is certainly more interventionist than is Cardoso's party. It seems to be following the China's model, with a larger state role in the economy.

There is regular concern in Brazil about de-industrialization. Yet India, whose economic progress is in some ways challenging China's and is ahead of Brazil's, seems to be surging because, as an Indian economist puts it, its manufactures are "brain-intensive, not labor-intensive." Do you agree?

Brazil definitely has to learn how to add value to its exports. Certainly, it has been slower to promote increases in important skill sets than India. This may have something to do with the differences in colonial history between India and Brazil — differences in British vs. Portuguese domination. Whatever the reason, Brazil's educational system has major deficiencies. The quality of public education is particularly troublesome. It needs attention desperately.

Brazil's educational system has major deficiencies. The quality of public education is particularly troublesome. It needs attention desperately.

Brazil seems to be stuck with coalition governments. Is that a recipe for political instability?

Commentators and politicians have been talking for decades about what can be done to organize politics differently in Brazil. What model might work best? Should it follow a more German model, for instance?

The big barrier preventing any change is that there are so many veto players in Congress. How likely is it that many of them would sacrifice their own and their party's interests for the good of the whole? I expect there will continue to be coalition governments for the foreseeable future.

Why do you think that, in spite of its own and the G-20 proclamations about a larger voice for emerging economies, Brazil voted for a European to run the IMF rather than the Mexican candidate?

The relationship between Brazil and France has been very close. Take, for instance, the matter of jet fighters. And Sarkozy has made several visits to Brazil.

But, unquestionably, the rivalry of Brazil and Mexico for dominance in the hemisphere was a factor. The rivalry is usually friendly, but it's still a rivalry — to the point that Brazil emphasizes that

it's in the southern hemisphere, putting Mexico firmly in the northern. Mexico hasn't been particularly supportive of Brazil getting a seat on the U.N. Security Council, either.

How do you think the recent U.S. Congress vote doing away with ethanol subsidies will affect Brazil?

It probably won't have much effect right away, especially with the projections of a poor sugar harvest, but it could have a major effect over the medium term. For one thing, Brazil's sugar-based ethanol is of a much better quality than that of the U.S., which is made from corn.

The Lula administration in general had street smarts. The Rousseff administration seems reluctant to get down and dirty. But Brazil is not run by technicians and the politics have to be dealt with.

With regard to the Bolsa Familia program, one theory is that it was successful because it bypassed states and is managed by municipalities, so it also bypasses corruption, which everybody recognizes to be a major political problem. Do you see any hope that Brazil can clean up corruption?

Corruption is endemic not only in Brazil but throughout the developing world. However, it seems that Bolsa Familia is indeed relatively corruption-free, and it does seem to be beginning to change federal-municipal relations. The program is relatively cheap, too.

Brazil has a lot of political and financial capital invested in the Belo Monte hydroelectric project. It's been compared to the Three Gorges dam in China — but Three Gorges right now is having some major problems. Do you think that will have repercussions for Belo Monte?

The situation of Belo Monte is quite different from Three Gorges, but it has raised major concerns, mainly related to the environment and to indigenous rights. Brazil does not have a good track record for protecting either. The situation is complicated by the fact that the industrial south of Brazil really needs dependable sources of power, and Brazil's economy has a continuing need for growth. Finding the right balance will not be easy.

The complex relationships of South American countries with China are regularly rehashed. But what about India? In the next few decades both our democracies will benefit from having a much younger population than China, among other things. How do you think this will play out?

Brazil and India have good relations, as is true to a considerable extent of all the BRICS. But the relationship is not as complex as the relationship with

China. It's true that the complementarities between Brazil and India may be stronger, and there are not as many tensions as in Brazil's relationships with China. But right now there are also not as many opportunities for a more productive relationship.

Speaking of China, is there anything we can learn — a question you raised in the book you co-edited about China and the Western Hemisphere — from China's relationships with other developing regions like Southeast Asia and Africa?

In a sense the answer is both yes and no. For instance, Brazil is aware of the asymmetries in China's relationships with African countries. China has found willing partners in African countries, many of which are still run by dictators, but Brazil would certainly not, for instance, sit still and allow tens of thousands of Chinese to "invade" as subcontractors and workers on Chinese investment projects.

Brazil also recognizes the hugely complicated situation China confronts in the South China Sea and the competing claims to various areas, and happily does not have to deal with anything like that. Yet other countries in that area, Vietnam for instance, have trade dependencies with China that they do not want to jeopardize. In effect, they are dependent but suspicious. In a sense, Brazil may be learning what to avoid as well as what might be useful.

There's a lot of concern about the Brazilian economy overheating. What's your take?

There's no question it's overheating. Dilma is clearly worried. But 80% of the budget is earmarked, and it all has to go through Congress, so there's not much room for her to maneuver.

I'm also not sure what weapons Finance Minister Mantega has left to protect the Brazilian economy. It's nice to be popular with investors up to a point, but the new 6% tax has had absolutely no effect on the carry trade. And the administration promised fiscal cuts, but as yet there's no sign of them. The next few months and years are going to be very complicated from the point of view of the economy.

It's a different time and a different crew. The old central bank crew seemed more politically savvy. The Lula administration in general had street smarts. The Rousseff administration seems reluctant to get down and dirty. But Brazil is not run by technicians and the politics have to be dealt with.

Financial innovations not bad, just misused



Antônio Delfim Netto

Former Minister of Finance, Planning, and Agriculture

Claudio Accioli, São Paulo

There was a time in Brazil when the finance minister was almost as important as the president, given the autonomy he was granted. Known for his irony, acid humor, and quotable phrases, Antônio Delfim Netto was Minister of Finance between 1967 and 1974, and architect of the "economic miracle" when Brazil grew at rates above 10% a year. He returned as Minister of Agriculture (1979) and shortly thereafter became Minister of Planning. It was he who in 1985 negotiated debt relief with foreign creditors and the International Monetary Fund (IMF). He has also been ambassador to France and was for five consecutive terms federal deputy from São Paulo. Delfim, now 83, here draws a comprehensive picture of the world economy.

***The Brazilian Economy* — How do you see the changes taking place in the world economy?**

Delfim Netto — First, anyone who is not confused is misinformed. We all have a hard time understanding how it was possible to end up in the present situation. Surely, what will come out is a different world, but humankind will continue to seek a social organization that ensures three conditions: productive efficiency; increasing independence and autonomy; and relative equality. The first two goals evolved over time in an almost biological process, but governments have tried to add equality, especially since the Industrial Revolution, by adopting social policies. But it is a highly competitive process, a race that to be fair must allow everyone the same departure point. It is a civilizing process, justice within capitalism.

Today, many complain that the current crisis is a consequence of the welfare state. Nonsense. It is the result of incompetent governments and short-sighted and dysfunctional financial systems, which instead of serving the real sector serve themselves. Financial derivatives can help make the economic system function better

but they can also become weapons of mass destruction, because central banks — and governments — failed to understand them. The current crisis would not have occurred if the Federal Reserve (Fed), the Bank of England, and the European Central Bank knew what they were doing. Letting Lehman Brothers break the way it did showed how myopic they were. Financial innovations are not bad; these were misused. This is changing.

In what way?

The financial sector took over not only the real sector but also political institutions. The Dodd-Frank Act is proof that the financial system has great influence in the U.S. Congress. In a document of 2,200 pages, 140 created new institutions. This is a repetition of the 1929 crisis ... the financial system, once unfettered, always produces the same effects. I often joke that bankers always go back to the scene of the crime. The financial and banking system needed to be saved, but was it necessary to also save the shareholders and managers of the financial system? ... Assisted by his academic advisers, President Obama has protected Wall Street and forgotten Main Street. Shareholders have lost little, financial institution managers came out very rich — and 25 million Americans are unemployed. Honest workers paid the price of the dishonest financial system. These things have to change.

The two main institutions that maintain the capitalist system, the market and the ballot box, will balance it out: when the market produces major distortions, the ballot corrects it; when the ballot produces major distortions, the market penalizes it. This dialectic will continue. The result will be a market economy, one I would call capitalist, that will probably be better than we have today. It is a civilizing process for which no better alternative has appeared. Slowly we are moving toward institutions more concerned with cooperation, altruism, and concern for the environment. At the same time, there are more restrictions on growth because the earth cannot hold 10 billion people with per capita income of US$20,000.

In Europe, some national central banks bailed out local financial institutions. However, since the European Central Bank automatically assumes these risks, the whole system is threatened. What does this say for the euro?

The euro was a political decision to establish peace on a continent with a 1,000-year tradition of war. Its civilizing value is extraordinary. Why is Europe in the current predicament? Because the European Economic Community was engaged in self-deception when it said no member could have a fiscal deficit of more than 3% of GDP or a national debt

This crisis is a repetition of 1929, which clearly shows that the financial system, once unfettered, always produces the same effects.

greater than 60% of GDP. The markets and financial institutions, with government complicity, were mistaken. When the rating agencies gave Greek bonds a AA rating, or when the Greek government confounded financial data with accounting tricks, there was no criticism.

Europe is not an optimum currency area, because member country fiscal policies are contradictory. Is the euro worth saving? I believe it will take a while, but there will be an institutional improvement and the [crisis] bill will be paid. Again, the market and the ballot: Over the next 12 or 14 months there will be elections in 24 countries.

No use now to tell the Greeks they spent too much; it is impossible to go back. The only way to produce a surplus is to grow out of it, even if growth is low. These issues are not solved by producing depressions or recessions in indebted countries but by finding mechanisms to ensure at least minimum growth. And there must be debt restructuring. It will take time because you need to strengthen banks' capital so they can absorb the new losses.

Do the serious U.S. fiscal problems pose a threat to its creditors or are U.S. Treasury bonds still the best protection for investors?

The United States has both of the necessary and sufficient conditions for economic growth: innovation and credit. It will grow back faster and more adjusted to the new world.

This shows how rating agencies are not worth anything: When Standard & Poor's reduced the U.S. rating from AAA to AA-plus, there was a race for Treasury bonds. Every week the U.S. places US$250 billion to US$300 billion in bonds with 30-day to 30-year terms. They will continue to be placed, at low interest rates. Rating agencies, not the United States, have lost credibility.

And why is the American economy not working? Families are consuming less because they are using their resources to pay debts and they are not sure whether they will have jobs. Corporations with US$2 trillion in cash do not invest because they have no expectation of demand. Banks, which have US$1.5 trillion in excess reserves, do not lend because they have doubts about the other banks. An economy lives on expectations. When no one has confidence, everyone is drowning in liquidity.

If Obama wins in 2012, he might possibly win majorities in the House and Senate and could implement his program, right or wrong. If a Republican is elected, it could be a great tragedy because they are locked in a retrograde ideological process. Obama did everything by the book: increased liquidity, gave money to states for public works, etc. He has

created all the conditions for the economy to work but failed to co-opt the private sector, to whom he dispensed very harsh treatment at the beginning of his administration. And society has rejected him. But the United States has both the necessary and sufficient conditions for economic growth: innovation and credit. It will grow back faster and more adjusted to the new world.

You mentioned elections as a remedy for economic distortions. But the latest revolution in the world economy was caused by a country with little sympathy for elections and until recently for capitalism. How would you decipher the enigma of China?

There's no enigma. China is actually a projection of the United States, the result of a strategic U.S. political act. When Mao Tse-Tung and Stalin quarreled and China moved away from Russia, the U.S. seized the moment to give China a big chance: "open special economic areas that I bring my capital and open my market for you." To get an idea of the symbiosis, currently 35% to 40% of Chinese exports come from U.S. companies based in China. Why has the U.S. Congress never declared that China is not a market economy? Because it would be forced to raise the tariffs on goods from China as high as the general appreciation of the yuan.

China needs to profoundly change the axis of production from the export to the domestic market. It is an extremely difficult transition.

China did a wonderful job, but now it is starting to show signs of the 30-year sin: it is abundantly evident that China needs to profoundly change the axis of production from the export to the domestic market. It is an extremely difficult transition. China's 12th Five Year Plan is hugely optimistic, based on very unlikely assumptions, such as a large increase in total factor productivity. We live in a time when the productivity of capital and demographic trends are down.

What is Brazil's weight in the BRICS group?

The comparison [with the other BRICS] has helped us demonstrate the dramatic improvement in the Brazilian situation. Of course there are sins, but it is also clear that the government is making efforts to address Brazil's fundamental problems, for example, carrying out a long-term fiscal balance program and tackling public sector pensions and control of personnel expenses. There is a perception that you need to make room for increasing domestic savings. Critics say this is just posturing to force the Central Bank to lower interest rates. This year the government will spend R$190 billion on interest on public debt. Who with common sense can imagine that Brazil needs a real interest rate of 8% a year? My hope is that the new fiscal policy allows the central bank to reduce

the real interest rate to about 2.5% to 3% over the next four years. Many people will have to earn an honest living.

Our reliance on exports of commodities has been much criticized. But when world economic growth falls, demand for agricultural commodities tends to be less affected. Could they be a competitive advantage for Brazil?

There is no contradiction in taking advantage of the [commodities] boom. Remember that Brazil went broke twice, in 1998 and 2002; today, we have US$350 billion in international reserves. We took advantage of the expansion of the world. We have become a creditor country.

But we were better competitors then than we are today. We have the highest gross tax burden among countries with our level of income and the highest interest rate and the most appreciated exchange rate in the world. When someone calls for general equilibrium models, that is completely crazy, because the general equilibrium theory has nothing to do with the world.

Emerging countries have managed to combine high rates of economic growth with stability, but some, like Brazil, face rising inflation. How do you promote growth with low inflation?

It takes a credible, feasible long-term fiscal policy and higher public saving. For Brazil to grow 4.5% to 5% a year, the domestic savings rate should be about 22% of GDP. We need to convince Brazilians that there is a tradeoff: more income distribution today means less growth for our children. As for inflation, it is a global problem and Brazil depends on imports, so there is no reason to think that Brazil could meet its target. There are also other factors. In the service sector, for example, there is a mismatch between demand and supply structures. This cannot be corrected by the interest rate but only with a policy of educating labor.

We need to convince Brazilians that … income distribution today means less growth for our children.

How would you assess Workers Party (PT) government, especially Rousseff's first few months?

The election of Lula consolidated democracy in Brazil. In the first election when I said I would vote for him, my people were very annoyed. This test was necessary. Lula proved to be a great president. So did Cardoso. Even Collor made an important contribution to opening the economy. What matters is that Brazil has been improving all this time. Lula addressed an important aspect of the Constitution of 1988: increased opportunities for the people, which are linked to the equal starting point I mentioned. He did a very good job, took advantage of what the world offered. I see President Rousseff as a technocrat who reads the same books that we read, studies reports, and is not fooled by bells and whistles. She represents very important continuity.

"Transforming public security in the Americas"

Eva Silkwood Baker, Institute for National Strategic Studies

How can nations better secure the safety and wellbeing of their citizens against the depravities of organized criminal networks, within a democratic framework and the rule of law that preserves and protects basic human rights? A consortium of six U.S. and Canadian universities grappled with this question in May at the 14th Annual Western Hemisphere Security Colloquium in Washington, DC (see p. 41 for sponsors).

Colloquium organizers were seeking ideas on how to create positive momentum in combating organized criminal networks that pose grave and multidimensional threats to social development and regional stability. Numerous polls within Latin America and the Caribbean have identified citizen safety as the number one public concern. People surveyed also want to be involved in improving security in their own cities, and they are asking their governments to enact more social-based responses that provide greater opportunities for economic advancement.

As one speaker noted, "The state is no longer the center of the [national] political universe — the city is becoming more and more important." Therefore, governments need to adopt measures that empower individual citizens and communities to de-legitimize and defeat criminal groups. Sessions of the colloquium explored the details of successful initiatives, such as Rio de Janeiro's civil-military collaboration to regain control of the favelas (slums), and joint activities by agencies on both sides of the borders the U.S. shares with Canada and Mexico. (Brazil and Colombia recently announced a similar collaboration around Brazil's northwestern border to combat trafficking by Mexican drug cartels in drugs, people, and weapons.)

One speaker adapted the old adage

"all politics is local" to "all insecurity, all crime is local." Attention to the community and the individual affected by crime is often lost in the macro-level planning of national governments. No criminal or criminal organization simply springs to life as national or international; it starts locally. Within the current frameworks to combat crime, often "the notion of community gets lost, citizens become statistics, and communities become operational zones." Government policymakers should be asking how societal actors can work together to enhance public security and what governments and citizens can do together. The fact that national-level security assistance programs trickle down slowly is another reason why societies must adopt local-level measures. Several speakers observed that not only do citizens want to be more involved in providing for their own security, it is essential that they do so if the solutions are to be sustainable.

Major shift in Brazil

In Brazil, there has been a major shift in public policy for dealing with organized crime in Rio de Janeiro. According to Thomaz Costa of the National Defense University College of International Security Affairs, the goal is not to end organized crime by itself but to turn Rio into a safe city so the country can generate tourism, economic development, and growth as it hosts the 2014 World Cup and 2016 Olympics.

Until the late 1960s organized crime in Rio was stable. It was mainly limited to illegal lotteries and contraband markets because of the country's high taxes on luxury goods. But with the arrival of organizations trafficking in drugs (mainly cocaine) in the 1980s, crime in the city shot up. Recently the Brazilian government has begun to use specialized joint police and military forces to root out the drug trafficking gangs occupying Rio's favelas. Pacification Police Units are helping the state government regain territorial control of areas once lost to lawlessness through a combination of law enforcement strategies and social components that are delivering a variety of government services to these historically marginalized communities. By reestablishing the state presence in these areas, giving social and economic development a central role, and rebuilding trust in police forces by prioritizing community relations, citizen security in Rio's favelas is steadily increasing.

The colloquium discussed other case studies of national and international cooperation in the hemisphere, and speakers encouraged policymakers, many of whom were present, to pursue additional regional cooperation and capacity-building measures. These examples and shared experiences can be used to meet the challenges of public security and offer additional tools beyond traditional north-south security assistance programs, which are facing a resource-constrained environment in the U.S. and other nations throughout the Americas.

However, Rebecca Bill Chavez, associate professor at the U.S. Naval Academy, warned that it is important to pay adequate attention to the issue of human rights as countries like Brazil and Mexico combat organized crime in heavily populated urban areas. She stressed that if government authorities do not integrate public security and human rights into a single coherent agenda, the legitimacy of the democratic system will be at risk. Not only is the moral high ground lost if human rights are violated, security forces cannot earn the community's trust and support. In practical terms, when human rights violations erode ties between citizens and security forces, security forces forfeit access to valuable intelligence. The community policing model provides deep lessons about fortifying the relationship between law enforcement officials and the community — daily interaction between police officers and citizens is crucial. This model becomes impossible, however, where police corruption is rampant.

COLLOQUIUM SPONSORS

Center for Latin American Studies (CLAI), The George Washington University
Strategic Studies Institute, U.S. Army War College
Institute for National Strategic Studies, National Defense University
Applied Research Center, Florida International University
Mario Einaudi Center for International Studies, Cornell University
Centre for International and Defense Policy, Queen's University



Photo: CLAI.

The U.S. Under Secretary for Democracy and Global Affairs Maria Otero delivers an address on the United States' commitment to citizens' security.



Photo: CLAI.

CLAI Director Dr. James Ferrer welcomes participants and guests at the opening section of the colloquium.