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CONSTRUCTION TAKES A GREAT LEAP FORWARD



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There seems to have been some sleight of hand operating in the recent megacapitalization of Petrobras. The scheme is so complicated that almost no Brazilians can actually understand how R$25 million materialized in the Treasury's vaults at the end of the web of share transfers, barrels of oil, and cash spun by the Treasury, BNDES, and Petrobras. (page 4)

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Cover Story

Construction takes a great leap forward

In a sea change from the first few years of this century, and despite the global financial crisis, the prospects are good for all segments of the construction sector, Liliana Lavoratti reports. Investment is growing steadily, domestic sales are up thanks not only to the World Cup and the Olympics but also because of growing demand for housing as more people enter the middle class, and financing also has become more available for low-cost housing. (page 8)

Construction from North to South

Thais Thimoteo describes what state and local governments are doing to promote construction and curb the housing shortfall in Brazil, where programs like Minha Casa, Minha Vida (My House, My Life) have created a new market. Not only are they building housing units themselves and offering incentives to private companies to do so, but educational institutions and unions are partnering to train skilled construction professionals. (page 15)

Roundtable

The exchange rate dominates the economic debate

Klaus Kleber reports on the recent conference on "The role of industry in Brazil's growth," where presenters, including the Minister of Finance, expressed concern about the overvalued exchange rate, but where there was also considerable confidence about the strength of Brazilian industry. Even though services now represent a larger share of GDP, that was seen as a normal development as Brazilian incomes rise and offer more scope for purchasing services. (page 18)

Good news for the poor

Marcelo Cortes Neri analyzes the results of the latest National Household Survey and, concentrating on the income figures, finds that social welfare in areas like poverty reduction has been forging ahead faster than per capita income. He deduces that improvements in living conditions are likely to continue, raising living standards for more and more Brazilians. (page 24)

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After a bumpy ride through 2004, the construction sector is reaping the fruits of the expansion of housing credit, government programs to encourage affordable housing, the Growth Acceleration Program (PAC), enhanced regulatory framework, and a booming economy. The sector is currently one of the engines of industry growth, and is contributing to the expansion of jobs. This year construction is projected to be almost double (13%) the expected growth in gross domestic product (7%) compared with 2009. Despite the braking effects of the global crisis, the sector, which represents about 5% of GDP, has resumed the growth trend of 2008. For a sixth year annual growth in construction jobs should reach double digits. The strength of the construction industry is also reflected in the volume of investments directed to the sector, which has surged since 2005. In 2008, investments reached R$258.6 billion, 43% of the total invested in Brazil, according to the Getulio Vargas Foundation (FGV). This issue takes a panoramic X-ray of the sector and also shows the challenges that lie ahead if the industry is to maintain high growth rates.

A hot topic in business and economic circles, as well as among politicians, is the exchange rate and the effects it has on national development, as demonstrated by the audience for the roundtable, "The role of industry in Brazil's growth," sponsored by the Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation (FGV) and the Federation of Industries of São Paulo (FIESP). Among those attending was the Finance Minister, Guido Mantega. Although the participation of industry in the formation of GDP is losing ground, it is not correct to say that Brazil has been undergoing a deindustrialization process, the minister said, and referred to the August issue of The Brazilian Economy that addressed the issue at length. Luiz Guilherme Schymura, director of the IBRE, had similar opinions: the decline of the share of industry in gross domestic product (GDP) from 36% in 1985 (measured at current prices) to 17% in 2008 should not be cause for surprise, since it follows international trends. As incomes rise in a country, they raise demand for services and consequently the share of industry in GDP decreases. Brazil is no exception. In recent years, however, Schymura said, the "China effect" has become worrisome. Chinese manufacturing is competing more intensely with Brazilian manufacturing, especially in the other countries in South America, Brazil's main export market. Cheaper Chinese products are competing within Brazil with products manufactured domestically. Highlights of the roundtable can be seen in the article beginning on page 18.

Juggling with the public accounts



In the past, many governments tried to create money from nothing. In modern societies, there are more sophisticated ways of doing this than the old expedients, such as reducing the amount of precious metals in the coins minted. But inflation offers a classic example of what happens when governments try to be too clever; the maneuvers turn against them in the end. When governments use their power to create money so that they can increase spending beyond what is feasible, they generate inflation.

Many analysts see that stubborn human inclination recurring in the Treasury's financing of the BNDES (National Bank for Economic and Social Development), which has already exceeded more than US$100 billion. Some contend that this financing mechanism was a resurrection of the movement account, which was extinguished in the late 1980s; that account which gave the government commercial bank, Banco do Brasil, unlimited access to funding from the Central Bank.

We do not believe this is the case. In fact, the great virtue of Treasury funding of the BNDES is that it is very transparent. By making it clear how the BNDES is financed, the government drew the attention of the public, who have responded with questions and criticism. This reaction in turn has encouraged the government to place healthy limits on this financing mechanism.

A quite different case is the complex megacapitalization operation of the state oil company, Petrobras. Indeed, the scheme is so complicated that except for a few experts, almost no one can actually understand how R$25 million materialized in the Treasury's vaults at the end of the web of share transfers, barrels of oil, and cash spun by the Treasury, BNDES, and Petrobras. This opacity is evidence of excessive craftiness.

The Treasury purchased R$50 billion of shares from Petrobras, increasing the government participation in company ownership. To pay for the shares, the Treasury issued bonds in that amount and transferred them to Petrobras, for which the company issued shares to hand over to the government. The government then sold Petrobras the rights to barrels of oil worth R$50 billion to be extracted in the future from the deep sea oil fields and was paid back with the bonds it had itself issued. The government has thus bought shares of Petrobras with barrels of oil that it expects to turn up in the future.

This is where it gets complicated. The BNDES also participated in the capitalization of Petrobras, buying R$25 billion in shares — using money loaned by the Treasury. Petrobras used the money to buy more rights to future barrels oil from the government, paying the Treasury in cash. Petrobras thus acquired five million barrels worth R$75 billion by issuing shares to the Treasury and BNDES, and the government ended up with R$25 million.

But there is one crucial detail that has been overlooked: When the government chipped in its R$50

billion, Petrobras should have reciprocated with only 3.3 million of barrels, not the 5 million worth R$75 billion. Moreover, BNDES paid in cash rather than in barrels of oil for its shares of Petrobras. There was no reason for Petrobras to buy the additional third in barrels.

So Petrobras used the R$25 billion in capital it acquired by selling shares to the BNDES, funded by the Treasury, to purchase from the government 1.7 million barrels in oil futures. In fact, the government financed the BNDES acquisition of Petrobras shares. This allowed Petrobras to acquire government property, which effectively can only be sold, and which will generate cash for the government at an uncertain and relatively distant future. Thus a loan turns into government revenue.

The government argues that the operation was not very different from the privatization of state-owned companies by previous governments, when promises of future cash flows from the companies' operations were exchanged for money now; these arrangements were often financed by the BNDES. The comparison does not hold water. In the government of Fernando Henrique Cardoso, during which keeping Brazil solvent was the imperative, it made sense to anticipate future cash flows. Regardless of the opinion one might hold about privatization by the Cardoso government, at that time there was neither excess demand nor pressure on prices. The solvency of the public sector was the main concern. Interest rates were high to curb capital flight, and not to cool the economy.

Today, there is considerable reason to be concerned about overheating of domestic demand, and putting more money in the economy does not seem sensible.

The recent megacapitalization of the state oil company, Petrobras, is so complicated that almost no one can actually understand how R$25 million materialized in the Treasury's vaults at the end of the web of share transfers, barrels of oil, and cash.

The reason for juggling the public accounting, apparently, was to meet the government primary surplus target of 3.3% of GDP. Whether the juggling will be convincing to investors and experts in public accounts is another matter.

Election countdown

The October 31st run-off is giving new life to the candidacy for president of José Serra (PSDB, Brazilian Social Democratic Party). Dilma Rousseff (PT, Workers' Party) continues to have the upper hand, but her advantage is shrinking. "The presidential campaign has finally begun. No more the apathy of the first round. Now it is a fight between two honest proposals for the future of Brazil," wrote historian Marco Villa in *O Globo* newspaper. Datafolha shows Serra only 8 points behind Rousseff. With a margin of error of 2 percent , the possibility of Serra winning has improved significantly, especially as his camp has been revitalized by winning outright in the first round the governorships of important states (Beto Richa in Paraná, Geraldo Alckmin in São Paulo, Antônio Anastasia and Aécio Neves in Minas).

Rousseff's advantages in the first round — President Lula's support, a strong economy, more TV time, and more financial resources — led many analysts to believe she would have an easy victory, as it is clear from rereading the newspapers for the last week before the first election round. Her advantages are much less marked in the run-off.

The first TV debate between the two contenders showed a marked change in their strategies. Serra is now more confident, is more vigorously defending the PSDB legacy (the Real Plan and structural reforms), and is more directly comparing himself with Rousseff. Also, after its governorship wins the PSDB is rallying round; its members are participating with more time and dedication in the Serra campaign. Rousseff instead chose the attack course in the first debate, adopting a more aggressive tone. As both camps exchange accusations, the campaign's temperature has risen considerably.

Marina Silva (PV, Green Party) was a key factor in bringing about the run-off. While there is much speculation about who she will endorse in the second round, that is not very important because PV voters, who are more educated and have higher incomes,

Photo: Fabio Rodrigues-Pozzebom/ABr



Serra's (second from the right) campaign has been revitalized by PSDB's victories in important state governorship contests.

Photo: Marcello Casal Jr/ABr



President Lula's support to Rousseff (PT) and the strong economy will be less important in the run-off.

are more likely to choose a candidate on the merits. The latest Datafolha poll shows that 51% of Marina's votes would go to Serra and 22% to Rousseff; 18% are undecided and 9% would vote blank or null.

In Congress, the PT coalition guaranteed a majority large enough to be able to approve constitutional amendments (3/5 majority). Nevertheless, if Serra were to win, forces are likely to realign and give Serra some room to maneuver in the legislature.

In any case, it is unlikely that macro policy will be changed. There is a considerable political consensus for promoting economic stability and keeping inflation low. However, the candidates have quite different views about development policy: Rousseff emphasizes industrial policy and a large role for the government in the economy; Serra favors structural reforms and a large role for the private sector.

The candidates have quite different views about development policy: Rousseff emphasizes industrial policy and a large role for the government in the economy; Serra favors structural reforms and and a large role for the private sector.

CONSTRUCTION TAKES A GREAT LEAP FORWARD

Liliana Lavoratti, Rio de Janeiro

After a series of ups and downs through 2004, the construction industry is reaping the fruits of the expansion of housing credit, government programs to encourage affordable housing, the Growth Acceleration Program (PAC), more supportive regulation, and the boom in the economy. It has become a primary engine of industry growth and job expansion.

Construction in 2010 is projected to be almost double (13.3%) the expected growth in gross domestic product (7.2%) compared with 2009, according to LCA Consultores. After braking for the global crisis, construction, which represents about 5% of Brazil's GDP, is again picking up the trend of 2008. Despite the pullback in 2009, this means that for the last six years annual growth in construction jobs has averaged double digits.

"The prospects are good for all segments of the construction sector.... In December total construction jobs will be 16.6% higher than in December 2009, and higher than expected for the



economy overall (6.9%)," predicts Fabio Romão, an LCA Consultores' economist. The percentages also reflect job growth in industries that supply construction, such as paint, ceramics, and cement.

Investment boom

Investment in construction has grown solidly since 2005, reaching R$259 billion in 2008, 43% of the total invested in the country that year, according to the Getulio Vargas Foundation (FGV). Although the global crisis then reduced investment, Paulo Safady Simão, president of the Brazilian Chamber of the Construction Industry (CBIC), predicts that investment in construction, like jobs, will return to the previous pace, adding that "These numbers represent outstanding performance, and bigger investments are expected in the next few years. The Growth Acceleration Program (PAC) the development of the deep sea oil field, the 2014 World Cup, the 2016 Olympics will all boost the sector."

The Survey of Construction of the National Confederation of Industry (CNI) indicates that construction companies will purchase more inputs and raw materials over the next six months. Preserving the reduction in the industrial products tax (IPI), which was adopted in 2009 and is scheduled to end late this year, would help sustain this expansion, says Danilo Garcia, a CNI analyst.

In the 12 months ended in August 2010, domestic sales of basic and finished products rose 17%, reports the Brazilian Association of Manufacturers of Construction Materials (Abramat). As for cement, "We are moving completely in the opposite direction to the rest of the world," says José Otavio Carvalho, vice president of the National Syndicate of the Cement Industry (SNIC). This year, cement sales will grow about 14%, as they did in 2008 and 2009.

Government programs are seen as essential to this performance because they create incentives to meet the demand of lower-income Brazilians for housing (see state

GDP and Capital Formation (% change)

	GDP	Gross Fixed Capital Formation		
		Total	Construction	Machinery and Other
1996	2.2	1.5	3.2	0.2
1997	3.4	8.7	8.5	8.9
1998	0.0	-0.3	1.1	-1.8
1999	0.3	-8.2	-2.9	-13.9
2000	4.3	5.0	2.0	8.5
2001	1.3	0.4	-2.1	2.9
2002	2.7	-5.2	-2.2	-7.9
2003	1.1	-4.6	-3.3	-5.8
2004	5.7	9.1	6.6	11.1
2005	3.2	3.6	1.8	5.1
2006	4.0	9.8	4.7	13.5
2007	6.1	13.9	4.9	19.9
2008	5.1	13.4	8.2	16.5
2009	-0.2	-9.9	-6.3	-12.1
2010	7.2	21.0	13.3	26.4

Sources: Institute of Geography and Statistics, and LCA Consultores' projections.

and municipality initiatives, page 15). Before the federal initiatives, there was no private sector supply of housing for classes C and D due to low profitability, bad debts, and lack of bank financing. "Low-interest financing for low-income people and tax incentives for the sector have made it feasible to supply low-cost homes," Garcia comments. He points out that this process is also producing upward social mobility, which implies higher family consumption.

Financing sources

In 2004, 321,149 houses were financed, 53,787 of them from savings and the rest by the Guarantee Fund for Workers (FGTS). In 2009, 897,000 houses were financed, 302,680 of them from savings accounts — a fivefold increase — and the rest by FGTS and the federal program Minha Casa, Minha Vida (My House, My Life).

In 2004, house financing totaled R$7 billion, R$4 billion of it by the FGTS and the rest by the Brazilian Savings and Loan Institutions (SBPE). Just five years later, it had reached a staggering R$49 billion. "The market leap occurred in a short period and was not only quantitative but also qualitative. In 2004, financing was scarce and limited to the middle class. Even the FGTS funds were limited to families with incomes of up to five times the minimum wage (US$450). The My House, My Life program finances homes for families with incomes up to three times the minimum wage who had previous been practically excluded from the housing market," explains Ana Maria Castelo, project coordinator for the construction sector in the Brazilian Institute of Economics (IBRE) FGV.

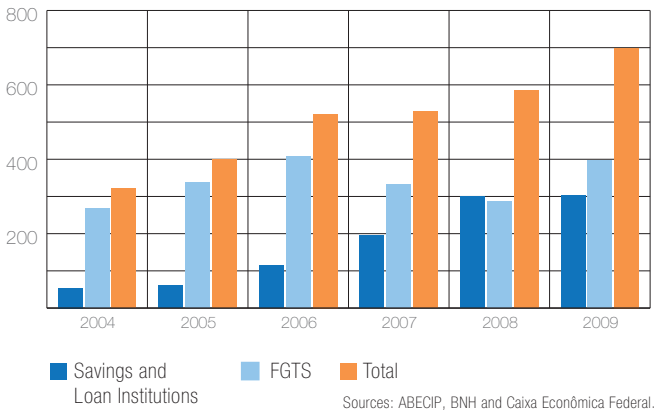
Sector overhaul

Until 2004, construction had struggled because of the scarcity of financing resources, public and private, for investments and housing loans. Changes to the real estate market law then have brought more security to

In 2009, 897,000 houses were financed by savings accounts, the FGTS and the federal program Minha Casa, Minha Vida (My House, My Life).

NUMBER OF HOUSES FINANCED

(thousand units)



Sources: ABECIP, BNH and Caixa Econômica Federal.



investors and expanded resources for housing. "The decision to use the construction sector as a development tool was essential. Besides contributing approximately 40% to fixed investments in Brazil, the sector is critical to ensure sustainable growth and help to resolve bottlenecks in national infrastructure — social, urban, logistics, energy," Simão says.

In addition to the new law that allows mortgages and liens as collateral, the Central Bank's decision to require banks to direct more resources from savings to housing financing was fundamental, Castelo adds: "No changes in the regulatory framework would make families seek financing. Economic stability, greater security, and above all income growth have increased both supply and demand."

Eduardo Zaidan, director of economics for the Construction Industry Union of the State of São Paulo (Sinduscon-SP), believes that the real estate market has grown since 2006 largely because financing has expanded. "In 2002 and 2003 the housing finance system did not fund more than 1,000 buildings a year," he says.

As the credit market has developed, financing terms have become more favorable: loan maturity has increased from 12 to 30 years and for financing from savings and loan institutions annual interest rates have fallen from about 12% a year above the Central Bank benchmark rate to about 8% to 9%. The cost is even lower for My House, My Life borrowers. This has encouraged a group of large construction companies to go public since 2005, which has increased the inflow of resources. "Banks are more confident because they realize the advantage of having captive customers for 20 to 30 years. With lower interest rates, customers felt safer in seeking credit," Castelo explains.

However, the construction sector became so overheated that in the first half of 2008 costs soared and there were fears of shortages of material and skilled labor. Then, with the international crisis, credit disappeared and construction was paralyzed. But not for long: the government moved swiftly to offer working capital for business and in early 2009 launched Minha Casa, Minha Vida.

Labor

In 2009, the Annual Social Information Report (RAIS) of the Institute of Geography and Statistics (IBGE) reports that the number of formal workers (with signed contracts) increased by 6.9% for all

Photo: Flavio Demarchi/Getty Images



Employment

	Total		Construction		Industry		Commerce		Services		Agriculture	
	(Thousands)	(% change)	(Thousands)	(% change)	(Thousands)	(% change)	(Thousands)	(% change)	(Thousands)	(% change)	(Thousands)	(% change)
2000	20,437		1,086		5,236		4,240		8,809		1,065	
2001	20,862	2.1	1,111	2.3	5,310	1.4	4,470	5.4	8,898	1.0	1,074	0.8
2002	21,953	5.2	1,096	-1.4	5,593	5.3	4,817	7.8	9,320	4.8	1,127	5.0
2003	22,596	2.9	1,040	-5.1	5,748	2.8	5,106	6.0	9,502	1.9	1,200	6.4
2004	24,270	7.4	1,109	6.7	6,340	10.3	5,569	9.1	9,954	4.8	1,297	8.1
2005	25,655	5.7	1,235	11.3	6,566	3.6	5,984	7.5	10,567	6.2	1,303	0.4
2006	27,133	5.8	1,380	11.7	7,055	7.4	6,303	5.3	11,048	4.6	1,347	3.4
2007	29,033	7.0	1,603	16.1	7,561	7.2	6,810	8.1	11,685	5.8	1,374	1.9
2008	30,871	6.3	1,897	18.4	7,811	3.3	7,287	7.0	12,466	6.7	1,410	2.6
2009	32,150	4.1	2,112	11.4	7,872	0.8	7,650	5.0	13,097	5.1	1,419	0.6
2010*	34,361	6.9	2,459	16.4	8,423	7.0	8,104	5.9	13,934	6.4	1,442	1.6

Sources: RAIS, and LCA Consultores' projections.

sectors but by 11.4% in construction. Employment in construction grew 14% on average for 2005–2009. For 2010 LCA Consultores predict a 16.4% increase in construction jobs, compared to 6.9% for all sectors. In 2010, it is expected that of 2.2 million new formal jobs created, 300,000 will be in construction.

The Monthly Employment Survey (PME) of the Brazilian Institute of Geography and Statistics (IBGE) shows that workers' incomes have been rising above inflation: income growth in July, compared to a year earlier, was 5.1% for all categories but 14.2% for construction.

The government thinks raising the minimum wage has been important in expanding employment in Brazil. Carlos Lupi, Minister of Labor and Employment, explains: "With the increase of the minimum wage by 64% in real terms in the Lula administration, the purchasing power of the people, and thus their consumption, has increased, creating a strong domestic market."

In 2009, the number of formal workers increased by 6.9% for all sectors but by 11.4% in construction.



All these factors together generate demand for labor and construction materials. "Today one of the major issues in the sector," Castelo says, "is the training and qualification of manpower. This has led construction companies to partner with SESI (Industry Social Service) and SENAI (National Service of Industrial Education)."

The National Index of Construction Costs-Market (INCC-M) increased by 6.2% from January to August this year compared with 9.1% in the same period of 2008.

Inflation

In 2008, the construction industry was moving full speed ahead, prices for wages and materials accelerated, and there were shortages of inputs. The world economy was booming and high oil prices pushed up industrial costs. Then in 2009 the scenario changed, and prices fell because of recession and tax relief from countercyclical government policies.

Since January prices have begun to show a small increase, but not nearly as substantial as in 2008. The National Index of Construction Cost-Market (INCC-M) saw materials, equipment, services, and labor increase by 6.2% from January to August this year compared with 9.1% in the same period of 2008. Wages have risen by 8%. "The high wages in 2008 reflected the overheated labor market," says Castelo. Romão projects that the INCC index will rise by 7.4% in 2010 compared to 3.3% in 2009, materials and services will be 6% more expensive, and labor 9% costlier.

Future

One concern for construction companies today, says Castelo, is productivity, which requires investments in technology so companies can produce more at lower cost. Other issues she raises are the sustainability of the recent expansion in house financing and the need to improve workforce skills.

REAL ESTATE INDEX

With economic stability and declining interest rates, investing in real estate becomes an attractive alternative for investors, especially pension funds. However, structural changes require indicators for tracking changes in the value of real estate. "In the current context it is highly desirable to have an index for commercial real estate," says Paulo Picchetti, coordinator of the Weekly Consumer Price Index of the Brazilian Institute of Economics of Getulio Vargas Foundation (IBRE-FGV).

The market wants information on what is happening with prices of commercial properties in different regions and types of enterprises. This year, therefore, the IBRE-FGV is launching the Brazilian Real Estate Value Index, which is designed to measure the profitability of commercial properties. "Encouraging investors to be more active in the housing market requires data that show with certainty price variations in major markets," he says.

Picchetti explains that a real estate value index will show clearly whether recent price increases should be characterized as a bubble. "Everyone has a strong feeling that prices have risen sharply but lacks comprehensive figures for a more consistent analysis. Historical series will give a picture of how property prices have evolved over the business cycle and whether properties are overpriced."

The sector is worried, too, about the exhaustion of resources earmarked for house financing, such as the FGTS and the 65% of savings deposits that banks are required to direct to financing houses. Castelo points out that the pace of contracting for new buildings is already outpacing savings deposit growth.

In these circumstances, there has been debate about creating new funding for housing loans by directing pension funds, which are now concentrated in commercial real estate, to invest in housing. The expectation is that the Ministry of Finance and the Central Bank will soon introduce measures to stimulate funding for housing.

Although a 1977 law introduced the Certificate of Real Estate Receivables (CRI), high interest rates pushed the instrument into the background. Since 2008, there have been some initiatives to securitize housing loans and offer an income tax exemption for individuals who invest in mortgage securities.

Resolution of these obstacles will promote sustainable growth in construction, especially a new leap in housing credit. With only current sources of funding it will be impossible in the next few years to double the volume of credit, as has happened since 2007. Castelo says, "At best, there would be some stability. Moving beyond the level already achieved would require the entry of new investors."



BETTING ON THE GAMES

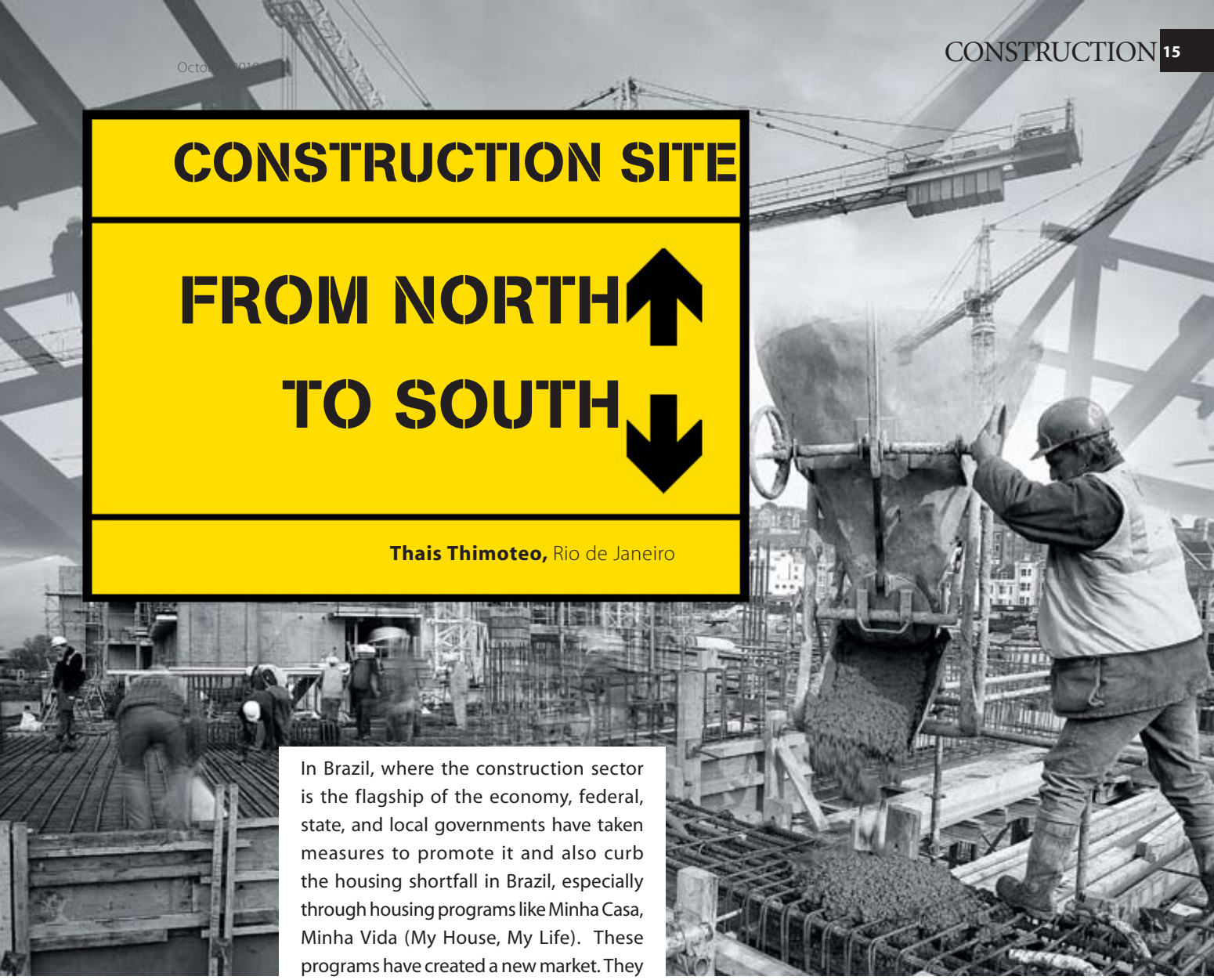
The fact of Brazil will soon host two major international events — the World Cup (2014) and the Olympics (2016) — has generated positive expectations for construction. This is the sector that could benefit most from such mega-events, says Carlos Lupi, Minister of Labor and Employment.

Heavy investment in infrastructure, such as expansion and improvement of airports and construction and renovation of stadiums, is a priority for the public sector. "The financing of these works affects not only the entire construction sector, but also the mining, chemical, plastic, and glass industries," says José Silvestre Prado de Oliveira, coordinator of union relations at the Department of Statistics and Socioeconomic Studies (Dieese). João Alberto Viol, president of the Association of Architecture and Engineering (Sinaenco), points out that the country will have to correct deficiencies in urban environments, especially Rio de Janeiro city.

Based on planned investments of R$29 billion (US$17 billion), the Ministry of Sports projects that 120,833 direct and indirect new jobs will be added each year until 2016 and 130,970 more jobs a year between 2017 and 2027. "The construction of stadiums and the Olympic Village is an exceptional new development that helps heat up the sector," Viol says. It is estimated that construction alone accounts for about 60% of investments in stadiums.

Viol believes that up to the 2014 World Cup construction of stadiums will require R$3.6 billion (R$1.2 billion a year). He expects that "Spending will spike between the second half of 2011 and 2012. Construction to improve urban transportation will move later but should also peak in 2012."

Photo: AFP/Getty Images



Thais Thimoteo, Rio de Janeiro

In Brazil, where the construction sector is the flagship of the economy, federal, state, and local governments have taken measures to promote it and also curb the housing shortfall in Brazil, especially through housing programs like Minha Casa, Minha Vida (My House, My Life). These programs have created a new market. They are mostly geared to low-income Brazilians and also foster local economies.

Pará state — Consider Credicasa, the initiative of the Housing Company of the State of Pará (COHAB) that is a program of direct income transfer for civil servants and for families at risk living in poverty. Credicasa aims to reduce the housing shortage and increase the share in Brazil's GDP of civil construction in the Northern Region.

"In addition to addressing the problem of the housing shortage, the program helps to heat up purchases of building materials," says Vando Vidal, Secretary of Finance for Pará state. The beneficiaries use the checks received from the government of Pará to purchase construction materials. The merchants can then use this "credit" to pay off certain Pará taxes and purchase materials from suppliers.

Mato Grosso — Further south, Nova Mutum, about 250 km from Cuiabá, stands out among cities in the interior of Mato Grosso state that are promoting industry and construction. The municipality reports average growth in its GDP of 24% and in population of 22%; this has attracted to the area such large corporations as Perdigão (food processing); the multinational corporation ADM (grain, biofuels, and chemicals); and Bunge (the largest agribusiness exporter in Brazil).

With the industrialization, demand for both housing and labor has grown. In response, state and federal housing programs — Tô Feliz (I'm Happy) and Minha Casa, Minha Vida — are building about 1,300 low-income housing units, and educational institutions and unions are partnering to train skilled professionals.

Despite this progress, Nova Mutum's infrastructure is far behind most other regions. For instance, the sewage system relies on cesspools. However, the municipal administration intends to implement sanitation service throughout the area by 2012. "We are adopting public policies that value the lives and personal and professional development of citizens," says mayor Lírio Lautenschlager.

São Paulo state — In the region where the housing shortage is greatest — the Southeast represents 36.9% of Brazil's shortfall, according to the National Housing Department of the Ministry of Cities (2008) — the Secretary of Housing of the State of São Paulo last year signed a partnership and cooperation agreement with Caixa Econômica Federal, the federal savings and loan institution. The intent is to construct 12,000 affordable housing units through Minha Casa, Minha Vida. The first 1,900 homes have already been contracted for and construction of 192 units has started in the Mogi Guaçu municipality. "The Growth Acceleration Program (PAC) and the National Fund for Social Housing (FNHIS) promise to generate more than R$1 billion (US$600 million) in investments in 21 building sites across the state, which will benefit nearly 36,000 families," says Lair Krähenbühl, State Secretary of Housing and President of the Urban Housing Development Company (CDHU) of São Paulo.

THE EXPANSION OF RESIDENTIAL CONSTRUCTION HAS EXPOSED ANOTHER PROBLEM: LACK OF EFFICIENT SANITATION.

Paraíba state — In the Northeast construction has also registered solid growth. "We have experienced a construction boom not only near the coast but even in interior cities, such as Campina Grande, Patos, Sousa, and Cajazeiras." says Francisco de Assis Gadelha, president of the Federation of Industries of the State of Paraíba (FIEPB). In João Pessoa city, according to FIEPB, the stock of housing, which currently amounts to R$1.1 billion, has doubled from 2,500 to 5,000 units. In Campina Grande, the second largest city in Paraíba state, 80 buildings are already under construction, which will provide about 2,000 residential units.

For families with incomes up to three times the minimum wage (R$1,530, US$900), the government of Paraiba has a housing subsidy program in which the construction company gets a rebate corresponding to the VAT tax on materials purchased; this will cost about R$100 million (US$60 million). In addition, the housing program (Pró-Moradia) has partnered with the federal government to build more than 6,300 units in 111 cities. Minha Casa, Minha Vida is also contributing to projects of the government of Paraiba. "All this has encouraged entrepreneurs to invest heavily in this market niche that has wide long-term prospects, given the housing shortage," Gadelha said.

Rio Grande do Sul state — Erechim, the second most populous area in northern Rio Grande do Sul with about 100,000 residents, stands out in the state for its recent housing investments. According to Joselito Onhate, director of the city's Department of Housing, it has accomplished this by reducing bureaucracy, speeding up projects, and subsidizing materials and staff. He explains that "From January 2009 to August 2010 more than 1,500 housing units were built. During this period, funding from Minha Casa, Minha Vida alone reached R$98 million (US$58 million)." The county currently has 12 projects in which it is partnering with state and federal governments and private enterprises.

As in Nova Mutum, sanitation is also a problem for Erechim. To address it the county will promote competitive public bidding for the concession of public services of water supply and sanitation in all urban areas and townships.



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The exchange rate dominates the economic debate

Klaus Kleber, São Paulo

The economic debate in Brazil today is primarily about the exchange rate and its impact on national development, as was demonstrated in September at the seminar on "The role of industry in Brazil's growth" sponsored by the Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation (FGV) at the Federation of Industries of São Paulo (FIESP).

Luiz Guilherme Schymura de Oliveira, IBRE director, emphasized the importance of the debate, given factors that have affected Brazilian industry. In his view, the declining share of industry in gross domestic product (GDP), from 36% in 1985, measured at current prices, to 17% in 2008, should not be cause for surprise, since it follows an international trend. As a country's income increases, demand for services rises, so the share of industry in GDP decreases. Brazil is no exception.

In recent years, however, the "China effect" has become worrisome, Schymura said. Chinese manufacturing is competing more intensely with Brazilian manufacturing, especially in South America, Brazil's main export market. Within Brazil cheaper Chinese products are also competing with products made domestically. However, there is no evidence of deindustrialization. Employment in Brazilian industry grew from 13% of total employment in 1992 to 14% in 2008, according to the National Household Survey (PNAD). In the same period, the share of manufacturing in total gross fixed capital formation (GFCF) increased from 14% to 18%.

Price

Highlighting the importance of the seminar's subject, Benjamin Steinbruch, acting president of FIESP, said that Brazil is paying the price for its success. In recent years, the country managed to add 50 million consumers to its domestic market, 30 million people having risen into the middle class and 20 million having been assisted by government social programs. This was done by controlling inflation, an organized production system, and a sound financial system. The services and agribusiness sectors are also doing well. But there is a lack of synchronization between growth in Brazil and in other countries whose economies still have not overcome the effects of the global credit crisis and still have much of their industrial capability idle. There is thus a serious imbalance between supply and demand in international markets.

"China and Brazil are now major targets of the world," said Steinbruch. In his view, because of the peculiarities of its economy China is able to protect itself. That makes Brazil the biggest target for countries trying by every means to increase their exports. "Besides the low price of imported goods," he said, "nine Brazilian states are subsidizing imports by deferring the VAT. Normally, imported goods would pay 12% VAT but they end up paying 3%."

The fall in industry's share in GDP is occurring prematurely because of the overvalued exchange rate, Steinbruch observed. He also cited the "Brazil cost" as another major problem. He explained that to build a steel plant in Brazil with annual capacity of five million metric tons requires an investment of US$5 billion. In China it is possible to build the same plant for US$3 billion. In addition, a steel plant of this size would take five years to build in Brazil and only three years in China.

Steinbruch called the adjustment of salaries of 10% or more obtained by some categories of workers a "time bomb." Besides increasing the cost of domestic production, increases of about 4.5% above inflation that have been granted to some categories where there is a shortage of trained and skilled workers affect consumption and increase imports.

Exchange rate disorder

Finance Minister Guido Mantega, citing the August cover story of *The Brazilian Economy*, agreed that there is no deindustrialization in Brazil but also was very concerned about the evolution of the exchange rate. He said the capitalization of Petrobras attracted estimated foreign capital of more than US$15 billion, but the government has the means to prevent currency appreciation. Mantega mentioned its successive purchases of dollars to support the exchange rate against the U.S. currency that had increased foreign reserves to over US$275 billion by October 1.

The minister assured participants that government has a battery of measures available to avoid further appreciation of the real. Besides action by the Central Bank, the government may apply to Brazil's Sovereign Fund or use fiscal instruments, as it did in early October, when it increased from 2% to 4% the tax on financial operations related to fixed-income securities and investment funds.

Mantega said he plans to take the exchange rate issue to the G20 for discussion. In his view, there is an ongoing "currency war" prompted by China, which remains adamant in its decision not to let the yuan appreciate. Thus, each country seeks to devalue its own currency, as did Japan and other Asian countries; the United States let the dollar slide down. The managing director of the International Monetary Fund, Dominique Strauss-Kahn, said he would not rule out the possibility of a global currency war, but he believes that is unlikely.

Minister Mantega promised a realignment of the VAT rate but did not specify how it would be done, since decisions on the tax must be

There is an ongoing "currency war" prompted by China, which remains adamant in its decision not to let the yuan appreciate.

Guido Mantega, Minister of Finance

approved unanimously by the Council on Tax Policy (Confaz), which is composed of the 27 state Secretaries of the Treasury. Naturally, states that consider themselves worse off will claim compensation from federal authorities even though federal finances are precarious and the government has used fiscal gimmicks to keep the public sector primary surplus at 3.3% of GDP this year.

Primary products

Businesspeople participating in the meeting emphasized the increasing share of primary products in Brazilian exports at the expense of industrial products. For exporters of primary products, rising commodity prices offset the exchange rate appreciation, which does not happen for the industries that have been forced to give ground in foreign markets. According to data presented by Roberto Giannetti da Fonseca, director of the FIESP Department of International Relations, the share of manufactured goods in Brazilian exports fell from 61% in 1994 to 44% in 2008. Exports of commodities rose from 20% of total exports in 2004 to 41% in 2009.

As incomes increase, demand for services rises, so the share of industry in GDP decreases. Brazil is no exception.

Luiz Guilherme Schymura

Giannetti admitted that good prices have strengthened commodity exports, which would tend anyway to have greater participation. However, it seems unacceptable that industrial products have been losing competitiveness against other countries not only because of the "Brazil cost" but also because of the decision to maintain an exchange rate policy contrary to that of other countries. Between 2004 and the first half of 2010, the Brazilian real appreciated by 41%, the most in the world (the Colombian peso was in second place, having appreciated by 33.6%). In the same period, among other emerging countries Turkey devalued its currency by 7.6% and Mexico by 16.3%.

Industry also suffers the effects of increasing imports of consumables. Among the reasons that Brazilian industry has lost competitiveness Giannetti cited not only the overvalued exchange rate but also tax rebates, failure to negotiate trade agreements, Chinese competition, and lack of adequate financing for exports.

On the importance of industrial policy and technological innovation, José Ricardo Roriz Coelho, director of the FIESP Department of Competitiveness and Technology, pointed out that it is difficult to find countries that have made productivity leaps without putting in place policies to foster productive development. He said that such policies "should be seen by society as part of a growth strategy that aims to expand opportunities for everyone, not just for the privileged sectors."

Brazil must therefore fund the instruments of the Innovation Law, increasing investments in research and development (R & D), which are very low in Brazil compared to GDP but may improve as a result of the Policy for Production Development (PDP). Coelho noted that the PDP does not include subsidies or tax breaks, or anything else that would violate

World Trade Organization (WTO) rules. What is provided is tax relief for investments in equipment and R&D.

Vulnerability

Lia Valls Pereira, chief economist at the IBRE Center for Foreign Trade, said that the fiscal crisis in the 1990s put an end to the policy adopted in 1970 that aimed to increase exports of manufactured goods through tax subsidies and credits. Due to commitments in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), predecessor of the WTO, the Brazilian government had financed export companies using public funds, the National Bank for Economic and Social development (BNDES), and drawback operations (tax exemptions for the import of raw materials and parts for products intended for export).

Since 1991 there has also been a major liberalization of imports. The average tariff on imports fell from 57.5% in 1987 to 30.5% in 1990 and 11.2% in 1994, though there has been some recent increase in the average, which rose to 13.6% in 2008. Most protected are industry, with an average tariff of 14.1%, and agriculture, with 10.2%. The maximum rate permitted by the WTO is 35%, applicable to automobiles, garments, and textiles, imports of which, despite the high tariff and other charges, have been increasing in recent years.

In recent decades, said Valls, Brazil has made little progress on its agenda for trade agreements. Mercosur has failed to realize the goal of becoming a common market, but Brazil has signed free trade agreements with all the other countries of South America, seeking closer political dialogue with its neighbors through the Union of South American Nations (UNASUR). As negotiations with the European Union (EU) are proving increasingly problematic, Brazil has failed to consolidate any agreements with developed countries.

At the same time, Chinese goods have been crowding out Brazilian exports because of the exchange rate and competition, especially from China, as a new study presented by Valls found. The study identifies products that both China and Brazil export to certain markets that accounted for 70% of total exports by Brazil in 2005 and 64% in 2008.

Brazilian exports fell 40% to the United States and 18% to the EU. This can be explained partly by the increase in the export value of Brazilian commodities. The decline is more pronounced in South America , to which Brazil exports virtually no basic commodities. In 2008, Brazilian export earnings losses reached 41% in Argentina, 52% in Uruguay, and 37% in Chile.

Opposite situations

For the economist Samuel Pessoa, head of the IBRE Center for Economic Growth, disparities in economic policies between Brazil and China may not be limited to interest rates and exchange rate policy. While the Brazilian real appreciates, the yuan remains undervalued against the main convertible currencies. “Actually,” he said, “we are the opposite of China. Our savings are low, consumption is increasing, and we have a lot of natural resources. In China, savings are 50% of

The adjustment of salaries of 10% or more obtained by some categories of workers is like a “time bomb.”

Benjamin Steinbruch

Brazilian exports have fallen 40% to the United States and 18% to the EU.

Lia Valls

GDP, investment is 40%, and 10% of savings are exported, which lowers domestic consumption. In addition, China is poor in natural resources."

Moreover, he noted, the Chinese social contract and the nature of its people produce an economy that stimulates the production of manufactures, since in general services are not tradable. The social contract in Brazil is quite different. As a percentage of GDP, income growth was channeled to social security spending (80%) and social programs (10%), including the Family Allowance Program, Bolsa Familia. In recent years, the Brazilian government has spent 13% of GDP on pensions in the public and private sectors and about 3.5% of GDP on real interest payments.

"Building up a great network of social welfare causes private consumption to be strongly procyclical," Pessoa said. "When the economy goes well, consumption and investment also grow. The low average level of savings means that we have to live with high current account deficits as investment rises."

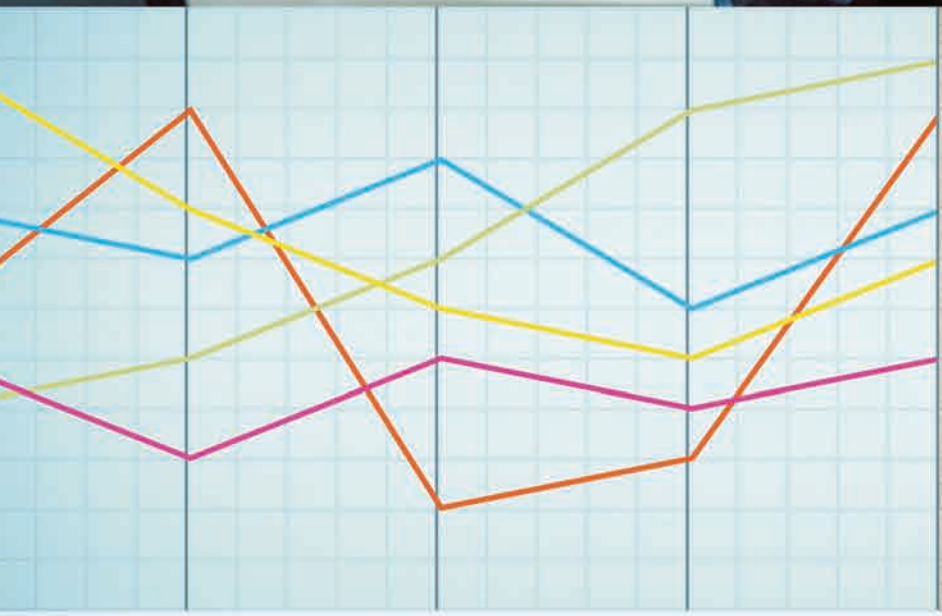
He commented that "the Keynesian mechanism has not worked in Brazil: the growth of autonomous spending leads to an elevation of output growth but does not increase savings. Consequently, foreign savings have to fill the gap." As an example he mentioned that from 2004 through the third quarter of 2008, investment rose from 14% to 19% of GDP but the savings rate was unchanged.

For the country to live with an external current account deficit and not be exposed to an external crisis, Pessoa believes, it should keep a sound fiscal position, adhere to its exchange rate policy, and avoid currency mismatches. He stressed that with regard to foreign direct investment and portfolio investment (investments in stocks and fixed-income securities) the country has to be a creditor in foreign currency and a debtor in domestic currency or equity. In his view, the public sector must also signal that it will not provide the private sector with a hedge against exchange rate variations, leaving it to private companies to hedge their own risks.

Disparities in economic policy between Brazil and China may not be limited to interest rates and exchange rate policy.

Samuel Pessoa, IBRE





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Good news for the poor



Marcelo Cortes Neri

Brazil reached a milestone in 1995 when the Institute of Geography and Statistics (IBGE) opened its data to the public, allowing anyone to look at Brazilians in their homes from a variety of perspectives. Today, at each release of the results of a new National Household Survey (PNAD), we can discuss our achievements and setbacks.

The PNAD is such a multifaceted database that it is very difficult to synthesize the results to draw simple conclusions about whether the lives of Brazilians life have improved or worsened. Our strategy is to approach a social welfare conclusion by looking at a single dimension, the information related to income. The assumption is that once the information is integrated, it will be easier to identify the relative magnitude of observed changes and perhaps suggest causes.

To provide a summary of well-being from all indicators by projecting a single number corresponding to the level of social welfare, we chose a simple solution to combine the effects of the mean and inequality in a single measure, a model proposed by Amartya Sen, who won the Nobel Prize in economics: social welfare is equal to average income per capita multiplied by the complement of the Gini (a measure of inequality). Inequality functions as a discount factor of well-being in relation to average income; when it is applied for 2009, average monthly per capita income of R$630 would be equivalent to R$287. By this measure, between 2003 and 2009, per capita income increased

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by 32%, but social welfare increased by 44%. This was reflected in the reduction of inequality in the period. Income inequality in Brazil has fallen since 2001. Between 2001 and 2009, per capita income in the richest tenth of the population rose by 1.5% annually, but the incomes of the poor grew at a remarkable rate of 6.8%.

GDP versus PNAD

There has been a marked difference between changes in income per capita as it relates to GDP and as it is measured by the PNAD. From 2003 through 2009 GDP per capita grew on average 2.9% a year, but the PNAD suggests per capita income grew annually by 4.7%. In 2009 per capita GDP fell by about 1.5%, but the PNAD found an increase of 2%. In China and India the opposite occurred: GDP grew more than income as measured by household surveys. On the scoreboard, welfare income inequality continued to grow in other BRICs although by less than previously.

How sustainable is the recent pattern of inclusive growth in Brazil? The PNAD shows that although income derived from pensions and social programs did grow, work income, which represents about 76% of average Brazilian income, increased more significantly, by 4.7% between 2003 and 2009. This suggests that improvements in living conditions are sustainable beyond government income transfers.

More generally, indicators of consumption (durable goods, housing, utilities, etc.) and productive income-generating assets (goods such as IT, education, and quality of employment) show that productive assets rose faster than consumption for 2003 through 2009. There was a 31.2% increase in productive assets and a 22.6% increase in consumption. Even during the global crisis productive assets rose 3.05% and consumption 2.49%. In the last six years Brazilians have been investing more in income-generating assets. Brazilians who invested in further schooling are now getting proportionately more formal jobs, and thus more income.

Looking into mobility between economic classes, about 29 million rose to the ranks of the middle class between 2003 and 2009.

As a consequence of sustained income growth, poverty continues its downward trend: the FGV estimates that, since 2003, 20 million people have risen out of poverty. Nevertheless, a significant number of Brazilians — 28.8 million — are still below the poverty line.

The 95 million Brazilians in the middle class now represent 50.5% of the population and alone could decide an election.

Economic classes
Total household income
(Brazilian reais)

Classes	Lower bound	Upper bound
E	-	705
D	705	1,126
C	1,126	4,854
B	4,854	6,329
A	6,329	

now 20 million (10.5% of the population).

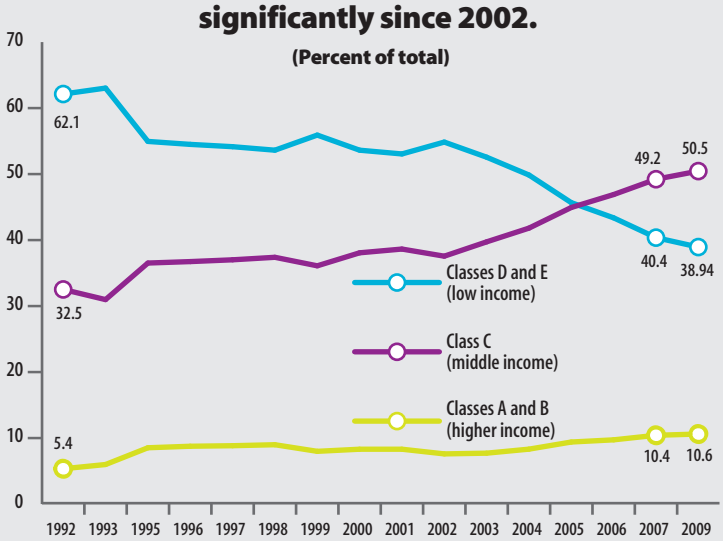
In sum, the middle and upper economic classes have increased by 35.7 million in the period since 2003; this means that these classes grew in the last seven years by the equivalent of more than half of the population of the United Kingdom.

These numbers have two implications, one political and one economic. If the

Changing classes

Looking into mobility between economic classes, about 29 million rose to the ranks of the middle class C (see table) between 2003 and 2009; the 95 million Brazilians now in this group represent more than half the population (about 50.5%). In the same period, the upper classes (A and B) grew most in relative terms (39.6%), representing 6.6 million additional members; the total in this group is

The new middle class has grown significantly since 2002.
(Percent of total)



Source: Center for Social Policies of FGV, and PNAD.

95 million Brazilians in the middle class represent 50.5% of the population, this means that the class not only represents the median voter who decides the second round of elections but also alone could decide an election. The new middle class is also the dominant class economically. Its members hold more than 46% of Brazilian purchasing power; the upper classes have 44% and the lower classes only 9.7%.

Rainbow

But how well have Brazilian pockets fared since the international crisis? This is the ultimate test of sustainability because the rest of the world is stagnant.

Family incomes from work in the six main metropolitan regions of Brazil were hit hard in January 2009, when for that month alone there was a 6.8% increase in poverty. However, since February 2009, growth in Brazil has recovered to its pre-crisis rate. Not only has Brazil emerged quickly from the crisis of 2009 but income growth exceeded that in previous prosperous years since 2003: Income is growing twice as fast and inequality is falling almost as much as in the period up to 2008.

The greatest moment for researchers is not when they confirm what we already knew but when they are surprised by something they did not know. At the end of the most recent PNAD, the IBGE data revealed not just the pot of gold at the end of the rainbow but the rainbow itself.

Since the end of recession, income has been growing twice as fast and inequality is falling almost as much as in the period up to 2008.



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