THE BRAZILIAN ECONOMY

FGV
Economy, politics and policy issues • DECEMBER 2010 • vol. 2 • nº 12
Publication of Getulio Vargas Foundation



DOMESTIC MARKET

Set to soar

The emergence of a new middle class makes the Brazilian domestic market one of the most attractive in the world. Building up that group, however, will require the new government to focus on industry and investment.

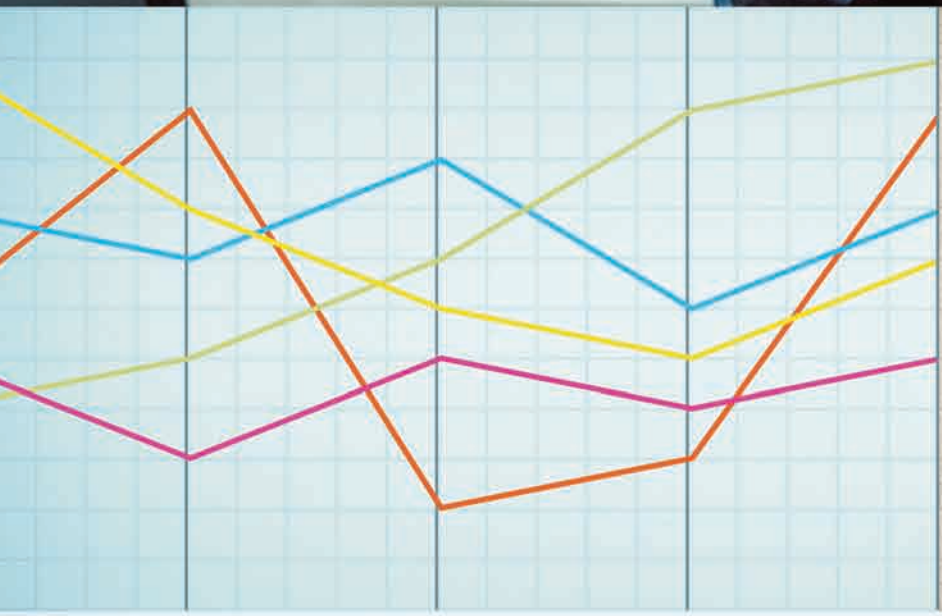
IBRE OUTLOOK

Risks and uncertainties of economic policy

Politics New government: Mixed signs

Interview Alicia Bárcena, Executive secretary of the Economic Commission for Latin America and the Caribbean





PRICE INDEXES AND ECONOMIC INDICATORS ACCORDING TO THE PROFILE OF EACH COMPANY MEANS THAT YOU HAVE 100% CHANCES TO IMPROVE YOUR COMPANY'S PERFORMANCE

For the production of price indices and economic indicators, the Brazilian Institute of Economics (IBRE) has a unique structure of research in Brazil in size and quality: eight offices located in major capitals of the country, researching prices for all units of the Federation, both retail and wholesale. IBRE collects monthly prices of around 200,000 products and services with the help of 15,000 companies and informants. Apart from general indices, IBRE develops indicators specifically directed to a sector, activity or company.

Explore the world of IBRE indicators in our site:
General Price Index, Sector Price Indices, Household Qualitative Research, Consumer Confidence Surveys, Industry Surveys, and Database.

FGV
IBRE

www.fgv.br/dgd Phone (55–21) 3788–6799

THE BRAZILIAN ECONOMY







FROM THE EDITORS

5 New Year's promises and risks

As this issue makes clear, Brazil and its economy are well positioned for the future, and so are its people. But there are clouds on the horizon that will bear watching. Previous administrations have constructed a solid path to future economic success for Brazil. The new administration must now decide how to follow that path and avoid such tempting side roads as populism.

POLITICS

6 New government: Mixed signs

Dilma Rousseff's early appointments suggest that her administration will indeed continue the policies of the Lula administration. But despite her vow of fiscal austerity, some have doubts about the autonomy of the Central Bank and the government's fiscal expansionism. Problems with either could entrench inflationary expectations and make it much more difficult to curb rising inflation. Concerns about the Central Bank have been exacerbated by reports that the previous Governor, Henrique Meirelles, chose to leave because he had conditioned his stay on keeping Bank operations autonomous. Our analyst sees the potential for conflict between those in the new government who lean toward the national development view, which implies more government intervention in the economy, and those who hold to what has become a more traditional approach, one that has served Brazil well through several administrations.

IBRE OUTLOOK

8 Brazil and the new government: Risks and uncertainties of economic policy

At a roundtable, "Brazil and the New Government," last November economists from the Brazilian Institute of Economics (IBRE) were markedly more optimistic about what lies ahead for Brazil than those representing private companies. The former tend to be more convinced that the new government is not likely to cause any major disruptions in current economic policy, although they do recognize that there are risks related to how consistent fiscal and monetary policies to control inflation will be, and that the Central Bank will continue to have the autonomy to raise the benchmark interest rate, if necessary. The latter believe it will take more than tightening fiscal policy to bring inflation down, and the Central Bank is not concerned enough about interest rates. They tend to be of the opinion that a rise in interest rates will be critical to manage the expectations of economic agents and avoid losing control of inflation. Liliana Lavoratti details the arguments made at the roundtable

INTERVIEW

12 The domestic market: Engine of the economy?

"Brazil has succeeded in showing that as the poor's income increases the engine of the economy could be the domestic market," Alicia Bárcena, executive secretary of the Economic Commission for Latin America and the Caribbean (ECLAC), tells Solange Monteiro in an exclusive interview. She also explains how the region as a whole is prospering because its member countries have adopted authentically prudential economic policies, discusses how important a coherent industrial policy is, and analyzes what China means to the region. She also expresses concern that over- and undervaluation of currencies worldwide is producing a global imbalance, and says that countries in the region must seek an appropriate mix of industrial, monetary, and fiscal policies that will encourage both domestic and external demand.

COVER STORY

18 The domestic market: Set to spend more

A new middle class has emerged thanks to government countercyclical policies adopted at the peak of the global financial crisis in late 2008; its continued consumption has helped the country maintain a pace of recovery that has turned Brazil into a global star. Particularly encouraging is that 70% of the new consumption is based on an increase in formal jobs rather than contributions from government programs. The signs of middle class activity in the market are everywhere: more of the middle class now have debit and credit cards; shopping malls are springing up even in rural areas. Solange Monteiro explains what the government must do now to further build up that group, which already represents 46% of purchasing power in Brazil.

GETULIO VARGAS
FOUNDATION

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 e 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

APPLIED ECONOMIC RESEARCH

Center for Economic Growth: Regis Bonelli, Samuel de Abreu Pessoa, Fernando de Holanda Barbosa Filho

Center of Economy and Oil: Azevedo Adriana Hernandez Perez, Mauricio Pinheiro Canêdo

Center for International Economics: Lia Valls Pereira

Center of Agricultural Economics: Mauro Rezende Lopes, Ignez Guatimosim Vidigal Lopes, Daniela de Paula Rocha

CONSULTING AND STATISTICS PRODUCTION

Superintendent of Prices: Vagner Laerte Ardeo (Superintendent) and Salomão Lipcovitch Quadros da Silva (Deputy Superintendent)

Superintendent of Economic Cycles: Vagner Laerte Ardeo (Superintendent) and Aloisio Campelo Júnior (Deputy Superintendent)

Superintendent of Institutional Clients: Rodrigo Moura (Superintendent) and Rebecca Wellington dos Santos Barros (Deputy Superintendent)

Superintendent of Operations: Rodrigo Moura (Superintendent) and Marcelo Guimarães Conte (Deputy Superintendent)

Superintendent of Economic Studies: Marcio Lago Couto

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/

The BRAZILIAN ECONOMY

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.

Chief Editor
Vagner Laerte Ardeo

Managing Editor
Claudio Roberto Gomes Conceição

Editors
Anne Grant
Pinheiro Ronci
Bertholdo de Castro
Liliana Lavoratti

Art Editors
Ana Elisa Galvão
Sonia Goulart

Administrative Secretary
Rosamaria Lima da Silva

Contributors to this issue
Solange Monteiro
Liliana Lavoratti

New Year's promises and risks

As this issue makes clear, Brazil and its economy are well positioned for the future, and so are its people. Between 2003 and 2009, 29 million Brazilians achieved middle class status. That is surely something to rejoice in — except that in terms of equality of income it simply means that we will soon be about where we were in 1960! And we are still among the 10 most unequal countries in the world.

The situation has changed a lot, of course, in the 50 years since 1960. Even as the Brazilian population has been growing, a series of stable governments with a commitment to macroeconomic prudence have made it possible for half the population to regularly earn between US$660 and US$2,855. As our cover story makes clear, there is more available for them to buy, of better quality, and stable jobs mean that lenders are more willing to extend credit so that the new middle class can buy more durable items — all of which are pushing the economy ahead. The main engine of income growth has been formal jobs, which account for 70% in the growth of average income, far more than the 20% from welfare benefits, and 10% from Family and other grants. The market is betting that the new government will pay attention to the demands of those in the emerging middle class, who will be deeply committed to consolidating their gains.

But there are clouds on the horizon that will bear watching. In the near future, the new administration will have to address up-front the deterioration of public accounts, which were barely disguised this year by accounting gimmicks, and worrisome signs of resurging inflation. Risks to the economy's outlook should not be ignored. In particular, the public account surplus target for 2011 is threatened by mounting pressure to increase public expenditure.

In the long term, there is the more fundamental question about the sustainability of current economic policy, which is based on increased taxes to pay for immensely popular social programs to reduce poverty. This has resulted in very low domestic savings and investment rates, and consequently mediocre economic growth of 4.5%, lowest among the BRICs. Another aspect of the current policy, seldom pointed out, is that transferring income to the poor without improving their education and productivity will eventually burden public finances permanently because they will not be able to generate wealth and tax revenues, which will constrain Brazil potential growth.

Previous administrations have constructed a solid path to future economic success for Brazil. The new administration must now decide how to follow that path and avoid such tempting side roads as populism.

The key to sustainable long term growth is productivity and innovation. In mid-November a report from the Ministry of Development, Industry and Foreign Trade expressed concerns that the country may be experiencing "deindustrialization," which means that although industrial output may not be falling, there may be a loss of dynamism in generating income and employment. Reviving the dynamism is one challenge for the incoming government. To do that, it must look at all aspects of industrial policy, and everything that affects it, meaning monetary and fiscal policy as well.

Another challenge has to do with education, which has been crucial to creating a new consumer class. It's estimated that each year of additional schooling represents on average a 15% increase in earnings. Although average schooling has increased by almost 3 years, that took an inordinate amount of time. Brazil still has a considerable deficit in education. Just to reach the eight years of elementary education required by the Constitution will take at least five more years. This has to be a priority if we are to maintain our competitive edge.

Previous administrations have constructed a solid path to future economic success for Brazil. The new administration must now decide how to follow that path and avoid such tempting side roads as populism.

New government: Mixed signs



Photo: BACEN.

Alexandre Tombini, Central Bank governor



Photo: Vitor Soares (Radiobras).

Antonio Palocci, Chief of Staff

On the face of it, it seems likely that Dilma Rousseff will continue the policies of the Lula administration. As expected, she has appointed Antonio Palocci as her Chief of Staff. His experience as political negotiator and Finance Minister will certainly contribute to government moderation. His Finance Ministry tenure (2003–2006) was marked by a fiscal austerity that invited international investors to have confidence in the Lula administration. Rousseff has also reappointed the current Finance Minister, Guido Mantega, and appointed the chief banking oversight officer, Alexandre Tombini, to be Central Bank governor.

However, despite President-elect Rousseff's vow of fiscal austerity and central bank autonomy, some have doubts about the new government commitment to these goals. Problems with either could make it much more difficult to curb rising inflation. These concerns have been heightened by reports that the Governor, Henrique Meirelles, chose to leave because he had conditioned his stay on keeping Central Bank autonomy — even though his successor, Tombini, is respected by the market and has reaffirmed the commitment to inflation targeting established 11 years ago.

Concerns about the new government's fiscal stance seem to arise from the perception that the new government leans toward the

> To what extent the more orthodox policies represented by Palocci and Tombini may prevail over the national developmentalists represented by Mantega and Coutinho is far from clear.

national development view represented by Finance Minister Mantega and Luciano Coutinho, president of the National Bank for Economic and Social Development (BNDES), which gained acceptance in the final years of Lula's administration. According to this view, economic development depends fundamentally on industrial policy, so government intervention — and expansion of the government role in the economy — is warranted. To carry forward an ambitious development policy it would be necessary to spur public spending on personnel, income transfers, and investments.

To what extent the more orthodox policies represented by Palocci and Tombini might prevail over the national developmentalists is far from clear. National developmentalists are seen as less inclined to raise interest rates to curb inflation because they see high rates as an obstacle to implementing industrial policy and reducing the fiscal deficit. Finance Minister Mantega has already announced that he may create a new inflation target that excludes food and fuel price variations to make it possible to reduce interest rates faster. Tinkering with the inflation target could backfire by undermining government credibility.

When the Monetary Policy Committee meets in January, it may have to raise interest rates to a point not necessarily to the liking of the Finance Minister and the President.

Given the limited room for fiscal adjustment in 2011, raising interest rates will be critical to curb inflation. Some market economists argue that the Central Bank may already be laggard in raising interest rates. The moment of truth has yet to come. When the Monetary Policy Committee meets in January, it may have to raise interest rates to a point not necessarily to the liking of the Finance Minister and the President.



Photo: BNDES.

Luciano Coutinho, President of BNDES



Photo: Ministry of Finance.

Guido Mantega, Finance Minister

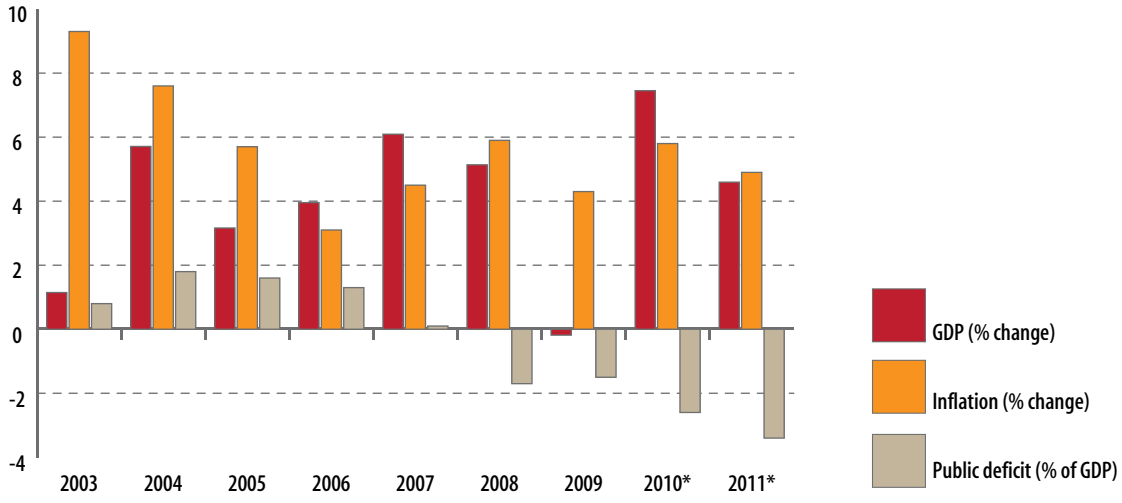
Brazil and the new government: Risks and uncertainties of economic policy

Liliana Lavoratti, Rio de Janeiro

As with the arrival of each New Year, a change in government is marked not only by the passage of time but also by expectations stimulated by the current circumstances. Despite the apparent continuity in economic policy and practice that the continuation of the Workers Party in the presidency might suggest, the changes should go beyond the mere gender difference of the departing President Lula and Dilma Rousseff as the imminent head of the country.

At a roundtable, "Brazil and the New Government," in November there was a marked difference of views between economists from the Brazilian Institute of Economics (IBRE) and those from the market. The former are moderately optimistic about the possibility that the new government will cause no major disruptions in current economic policy, although there are risks related to how consistent fiscal and monetary policies to control inflation will be. Market economists are more pessimistic; they do not believe that inflation can be tamped down simply by tightening fiscal policy. The Central Bank, they believe, is not concerned enough about interest rates.

The IBRE outlook is moderately optimistic but underscores risks of a larger public deficit.



*Projections

IBRE optimism

According to the scenario its representatives presented at the roundtable,[1] IBRE is projecting that in 2011 growth in gross domestic product (GDP) will fall from 7.5% in 2010 to 4.6%; inflation (measured by the Consumer Price Index Expanded) will fall from 5.8% to 4.9 %; and the external current account deficit will rise from 2.6% of GDP this year to 3.4%. IBRE expects that the Central Bank will hold its nominal benchmark rate at 10.75%, and the average nominal exchange rate will move from R$1.8 per US dollar to R$1.7.

This outlook — more optimistic than market projections — is based on two fundamental assumptions, explains Silvia Matos, one of its authors: "The new government will be able to tighten public expenditures, and the Central Bank will continue to have the autonomy to raise the benchmark interest rate, if necessary."

Other assumptions of the IBRE outlook are a minimum wage of R$550 (US$324) and a primary surplus (nominal deficit excluding interest payments) target of 3.3% of GDP — above the current goal of 3.1%. "If the government does everything right, including keeping fiscal policy tight, the Central Bank benchmark rate may stay at the current level and inflation will slowly decline — although it would meet the inflation target only in 2012," says IBRE's Samuel Pessoa. But if a tighter fiscal policy does not force inflation to yield, interest rates would have to rise. This is where the assumption of Central Bank autonomy has an effect: The Central Bank would have to raise its benchmark rate even though respected Central Bank governor Henrique Meirelles has departed.

The IBRE outlook is based on the information that was available in mid-November, including the market's evaluation of potential GDP. While most analysts believe the global crisis undermined potential GDP, the IBRE economists believe the negative impact was limited to the reduction in investment. Although the IBRE outlook on growth in output is in the same range as that of market analysts (between 4.3% and 4.4%), the IBRE estimate is slightly higher

IBRE is projecting that in 2011 growth in GDP will fall from 7.5% in 2010 to 4.6%, and inflation will fall from 5.8% to 4.9%.

IBRE predicts that there will be no new cycle of rising commodity prices because China's economy is slowing down. "Smaller Chinese demand for agricultural products will push down their prices, benefiting the domestic market. If not, the conditions for inflation in Brazil will be more adverse," says Matos.

Risks

The IBRE outlook does not ignore potential risks. The first is reduction of the primary surplus. "When there is a primary surplus — when tax revenues exceed expenses — the government affects aggregate demand because it takes more income from society than it returns in the form of spending. This is important to the extent to which actions of the public sector operate to increase or reduce inflation," says Pessoa.

This aspect of government policy becomes more relevant now that there are worrisome signs of resurging inflation. Public accounting gimmicks used by the government — such as giving revenues from its sale of future oil to the state-owned oil company (Petrobras) — do not

Fulfilling the new government's promise to achieve a primary surplus of 3.3% of GDP will require an impressive fiscal adjustment of 1.3% of GDP.

help to reduce the demand of households and firms and therefore do not suppress price rises.

The IBRE outlook assumes that the Rousseff government will fulfill its promise to hold the primary surplus to 3.3% of GDP without resorting to accounting gimmicks; 3.3% is well above the 2% seen in 2010. Although there is no reason to doubt the promise of the President-Elect, the fact is that fulfilling the promise will require an impressive fiscal adjustment of 1.3% of GDP.

The target could be particularly difficult to achieve if fiscal risks increase public expenditure by R$54 billion, reducing the primary surplus by 1.4% of GDP. Among the threats are the increase of 56% in judiciary workers' salaries; compensation to states for their losses because of VAT tax exemptions to exporters (the Kandir law); the increase in the minimum wage to R$570 with consequent impact on pensions; and salary adjustments for the military, firefighters, police officers, and Supreme Court justices.

A lower primary surplus means higher inflation, especially if interest rates are not raised. Matos comments that "Realization of these risks has a direct effect on the need to raise the Central Bank benchmark rate to at least 12.75%," adding, "We believe that the decisions of the Central Bank continue to be guided by technical criteria, and therefore the monetary authority will maintain its credibility and help curb market expectations, as has happened so far." Questioning Central Bank credibility would surely put price stability at risk.

Although the IBRE outlook assumes that inflation expectations will not transcend the inflation target, market analysts believe that this assumption is no longer valid given the recent surge in what the market expects for inflation in 2011, which according to a Central Bank survey is 5.2%. Pessoa, however, thinks that "The appointment of the new economic team and commitment to a high fiscal surplus without accounting gimmicks may help to anchor expectations close to the inflation target."

However, the use of accounting gimmicks in 2010 after statements from members of the economic team that the primary surplus target would be achieved poked holes in the current administration's fiscal policy. Pessoa says, "Rebuilding credibility will be very difficult. In retrospect, it would have been better if the government in the middle of 2010 had

Fiscal risks could increase public expenditure by R$54 billion, reducing the primary surplus by 1.4% of GDP.

recognized the impossibility of achieving that year's fiscal target, explained the reasons, and laid the groundwork for a more ambitious target in 2011."

Considering that the Workers Party surprised Brazilians in the past by continuing the macroeconomic policies of the Fernando Henrique Cardoso government — primary surplus, floating exchange rate, and inflation targets — it is prudent to wait for the next meeting of the Monetary Policy Committee (Copom) January 18–19 to see how the Rousseff economic team will face the inflationary threat. "The ideal scenario is that tighter fiscal policy would be consolidated in the first year of government, when there is greater political support for tough measures," Matos said.

The baseline scenario is constrained by political factors. Pessoa remembers that a "social contract of Brazilian social democracy" has characterized economic policy for the past 16 years; taxes have increased on average 0.4 percentage point of GDP annually since 1999, the minimum wage has risen faster than inflation, and social programs have expanded. This has resulted in very low domestic savings and investment rates and in growth of 4.5%, which is mediocre for an economy like Brazil: "This raises the question of whether the social contract is durable going forward."

Market pessimism

Market analysts are more pessimistic about the new government policy mix of high interest rates and tightening public spending to curb prices. At the roundtable Alexandre Schwartsman, Santander Bank chief economist and former director of the Central Bank, expressed disbelief that inflation can stay below the target in 2011 with only a fiscal adjustment. He believes that the Central Bank is already lagging at raising interest rates.

Market analysts do not believe that inflation will stay below the target in 2011 with only a fiscal adjustment and thinks the Central Bank is already lagging at raising interest rates.

Another former director of the Central Bank, Itau Bank chief economist Ilan Goldfajn, also feels that tighter monetary policy is necessary to keep inflation around 5.5% next year. Affonso Celso Pastore, former Central Bank governor, agrees. He says a rise in interest rates will be critical to manage the expectations of economic agents and avoid losing control of inflation.

IBRE's Armando Castelar observes that addressing the overvalued exchange rate, something the next government can hardly escape, will mean more pressure on prices. As the *real* weakens against the dollar, import prices, and consequently domestic prices, will rise. At the same time, domestic prices will no longer benefit from the external environment because rich countries will gradually rise away from deflation .

[1] Silvia Matos, Samuel Pessoa, and Gabriel Leal de Barros, "IBRE Macroeconomic Outlook" (Brazilian Institute of Economics, Getulio Vargas Foundation, November 2010).

The domestic market: Engine of the economy?



Alicia Bárcena

Executive secretary of the Economic Commission for Latin America and the Caribbean (ECLAC)

Solange Monteiro, Rio de Janeiro

For the Mexican Alicia Bárcena, in 2010 Latin America is demonstrating that, in the last global financial crisis, it was part of the solution rather than the problem. "Our region has learned the lessons of the past," she says, with praise for Brazil. A biologist trained at the Universidad Autónoma de Mexico with a Master's in Public Administration from Harvard University, Bárcena highlights the fact that "Brazil has succeeded in showing that as the poor's income increases the engine of the economy could be the domestic market." Executive secretary of ECLAC since July 2008 and previously former chief of staff to Kofi Annan, former secretary general of the United Nations, Bárcena says that LAC governments now have the challenge of building a public policy that promotes regional productivity and social cohesion as well as increasing intraregional trade.

***The Brazilian Economy* — How does ECLAC evaluate the economic performance of Latin American and Caribbean countries in 2010?**

Alicia Bárcena — Our region has learned the lessons of the past: it has adopted authentically prudential macroeconomic policy: greatly reducing foreign debt, accumulating international reserves, and keeping inflation low. We estimate that our region will grow over 5% this year — we had originally estimated 4.2%, but the dynamism of our economies has proven to be greater. Brazil leads, with growth above 7%. Mexico, where GDP fell last year by 6.5%, this year is expected to register growth of 4.2%, partly because exports have grown. World trade has recovered, especially trade within the region, among the countries of Latin America and the Caribbean.

The forecast of slower growth in developed countries has made emerging market consumers more attractive to both exporters and foreign investors. How do you think

countries like Brazil can leverage this interest by ensuring sustainable growth?
We find ourselves in a world situation where appreciation of the currencies in emerging countries is growing, with the exception of China. This has caused a great imbalance at the global level. It is important that there be a rebalancing in which surplus countries enhance their domestic demand and deficit countries reduce domestic consumption. I think the countries in the region must seek an appropriate mix of industrial, monetary, and fiscal policies. I always highlight the example of Brazil because it was able to balance incentives to domestic and exporting markets. Brazil and seven other countries [Peru, Uruguay, Costa Rica, Paraguay, Venezuela, Panama, and Colombia] have improved income distribution, boosting domestic demand. Domestic demand is the engine that enables some countries to go further than others.

Have the region's countries achieved this policy mix?
In our view at ECLAC, Brazil leads in industrial policy. There are countries that have not emphasized it and now suffer the consequences. Brazil has adopted a clear, explicit industrial policy that is associated with promoting innovation and specific investments in science and technology. This is the key. Some countries are making the mistake of using the exchange rate as industrial policy. I think that's asking too much of exchange rate policy. Countries that have managed their industrial capabilities and were able to diversify their activities are those that are structurally better positioned to move forward.

Which countries are wrong in their approach to industrial policy?
Fundamentally, Mexico has not adopted an explicit industrial policy. It has been building up reserves, trying to prevent exchange rate appreciation. This policy has a limit; you cannot get the best results by simply accumulating reserves by buying dollars, because that also may affect domestic productivity. What is needed is to separate currency appreciation due to improved productivity, which may result in more competitive exports, from that due to attracting foreign capital inflows. The latter needs policy adjustments. Brazil took a quick and correct step by increasing the tax on short-term capital inflows from 2% to 6%. I think this is a move that could greatly help to send signals to the market on capital inflows.

The significant appreciation of the Brazilian currency against the dollar and the unraveling of international exchange rates have provoked intense debate. What is your opinion? Does this situation carry a risk that would justify greater intervention?

Our region has learned the lessons of the past. It has adopted authentically prudential macroeconomic policy: greatly reducing foreign debt, accumulating international reserves, and keeping inflation low.

First, I think it requires global coordination. The measures that Brazil is taking are appropriate, timely, and clear but should be complemented with international agreements. Minister Guido Mantega was the first to make this warning clear in international forums and called forcefully on China and other surplus countries like Germany to consider the need to allow their currencies to appreciate to achieve better global balance. Undoubtedly, the definitive solution is to avoid an exchange rate war. That is what happened in the 1930s, causing a trade war, which could greatly affect the policy of developing countries. What Brazil has done is correct: give a clear signal that capital cannot freely enter the country. But it is necessary to solve the issue at a global level.

Brazil has adopted an explicit and clear industrial policy that is associated with promoting innovation and specific investments in science and technology. This is the key.

All year China has been criticized for keeping its currency artificially undervalued to boost the competitiveness of its exports. At the same time China is a major buyer of our commodities and has been investing in Latin America. On balance, do you consider China to be good or bad for the region?

The United States had its time as a major engine of world growth, because it had huge demand for goods produced worldwide. What is important now is whether China will manage to sustainably replace U.S. demand. In Latin America, the role of China has different meanings: For South America it has been good news, because China is demanding more and more products, resulting in greater trade. For Central America and Mexico the situation is different. The impact of expansionary monetary policy on commodity prices (which are rising) is negative for Central American countries that are exporters of raw materials. Mexico is not benefiting from better oil prices because of problems in its oil sector and its terms of exchange, and its manufactured goods are facing increasing competition from China. What is necessary is a more balanced trade relationship than the current one in which China buys only raw materials and Latin America buys manufactures from China.

How about Chinese investments in the region?

In Latin America these investments are still low and concentrated in natural resources, targeted to areas where surveillance is less strict. Therefore, although China is an important partner, there is a need to define a regional plan to support a more strategic relationship between China and the region.

Do you think there is a risk in the increasing concentration of Latin American exports in commodities?

Foto: Crédito das fotos

A recent ECLAC report shows an increase in commodities exports from Latin America. This worries the region because it can generate Dutch disease — sustained appreciation of the exchange rate. It is also true that one could gain greater investment in more productive areas. However, our report, "Outlook for International Integration of Latin America," shows that it is possible to develop more productive sectors, because while it is true that commodity prices are rising and trade is increasing, it is also true that today our countries have clearer policies for investing profits from commodities in diversifying production and improving domestic productivity. Countries like Brazil with industrial policies may have a better future because they are taking advantage of this cresting wave of good commodities prices.

In a document released earlier in the year, ECLAC defends countercyclical government policies in times of crisis. Do you also suggest a limit to these policies?

Some areas require private investment and others require public investment. Government action is necessary to deal especially with income redistribution and greater regional convergence and social cohesion. Here the instruments are undoubtedly fiscal policy and income transfer programs. I want to highlight the extraordinary role of Brazil in implementing its income transfer program, the Family Grant. It is one of the few countries where we see a trend of reduced inequality, and that's good news. Brazil has succeeded in showing that the engine of the economy may be the domestic market as incomes of the poor increase and they demand more goods and services.

To solve the problems of Latin America, we should emphasize productivity, competitiveness, and innovation.

ECLAC is historically known for defending the policy of import substitution that influenced the economic policies of many countries in the 1950s. Today, is it possible to imagine a new version of that policy?

The import substitution policy occurred in a different historical context after World War II when there was a scarcity of inputs worldwide. At that time, Latin America adopted it out of trade reality, not for political reasons. Now things are different. What I think we should talk about now is how to strengthen intraregional trade. There have been times when intraregional trade has helped countries to be more resilient in the face of international crises. South-South trade has also increased significantly worldwide, and that could give more muscle to our economies. Today, South-South trade represents about 18% of world trade in goods and is growing at very high rates. Latin America has a chance to set up frameworks to facilitate this integration process. In no way should anyone be inclined toward protectionism. As I pointed out, an exchange rate war may encourage a trade war that is not constructive. Each country has defined its ability to open up as a function of its domestic market and its

productivity. To solve the problems of Latin America, we should emphasize productivity, competitiveness, and innovation.

Is the region moving toward trade integration?

I think so. Last year we saw a deepening of preferential and trade links between Central America, Colombia, Mexico, Peru, and Chile with the completion of commercial agreements between them, and a process has begun in the countries along the Pacific, which met in Peru seeking trade convergence. Also, Brazil and Mexico, the two major economies of the region, are talking about establishing a strategic association that would be of enormous benefit for the whole region, because this deal could give us a good opportunity to consolidate integration.

What about Mercosur?

The Mercosur meeting last August in San Juan city in Argentina shows that its member countries can move forward, as demonstrated especially by the agreement to eliminate double taxation, the agreement on infrastructure, and the theme of special funds to support small and medium enterprises. Mercosur has become more dynamic, and that's good news.

Some business people view this progress with caution due to problems such as trucks carrying Brazilian food being blocked at Argentina's border, which could be considered a nontrade restriction on Brazilian sales to a neighboring country.

In the last decade, governments in the region have carried out prudent macroeconomic policies yet have been progressive on social issues.

What I am seeing is better understanding between Argentina and Brazil. The Mercosur negotiations have taken a concrete step since the meeting in San Juan, particularly on the important issue of regional infrastructure. In 2009 there were negotiations between Mercosur and Chile that have liberalized trade in services, architecture, engineering, construction, and advertising, and addressed some important issues of infrastructure. In early 2010, 74% of the projects of the Initiative for the Integration of Regional Infrastructure in South America made concrete progress.

In your opinion, what kind of mark are the democratic governments of the last two decades leaving in the region?

In the last decade, some governments in the region have carried out prudent macroeconomic policies yet have been progressive on social issues. These were the countries that have advanced more: those with more equality, better income distribution, and better perspective in coordinating macroeconomic policies and development.

What everyone is looking for is development. President Lula said that economic development and social justice have become a priority, that democracy is installed in the continent, and that the engine of development can be the marginalized and excluded classes. But it certainly requires strong governments who must also work with the private sector to establish alliances and it also requires an attentive citizenship.



Conjuntura Econômica
Valuable information

For subscriptions call:
(55-21) 3799-6844 or
Fax: (55-21) 3799-6855

FGV
IBRE



DOMESTIC MARKET

Set to soar

The emergence of a new middle class makes the Brazilian domestic market one of the most attractive in the world. Building up that group, however, will require the new government to focus on industry and investment.

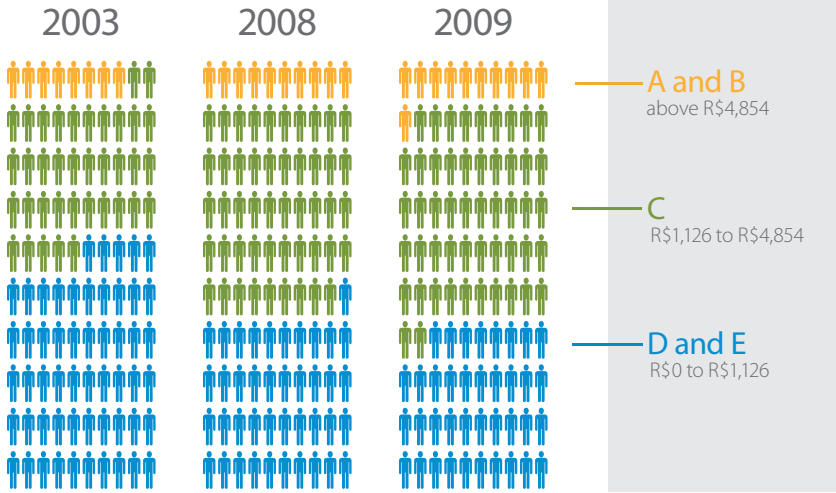
Solange Monteiro, Rio de Janeiro

Maria Lucia Moreira is a self-employed saleswoman who has left the Paraisópolis slum in São Paulo city for an apartment purchased with a federal government "My House, My Life" subsidy. "Here I have a legalized property, I have security and comfort for my children, and I can have my friends over," she says. Thanks to a US$765 income, Moreira has already bought a new stove and DVD and is anxiously awaiting installation of her fixed telephone line to ensure that her children can access the Internet on their computer. Her next goal is to buy a car. "It will speed up my life," she says, describing her busy schedule that includes a technical course on sales management, which

Photo: AF Rodrigues / Imagens do Povo

"We are still among the ten most unequal countries in the world, but the image of Brazil today is considerably better." Marcelo Neri

BRAZIL HAS BECOME LESS POOR.



Source: Center for Social Policies of the Getulio Vargas Foundation.

encouraged her to think about finishing high school and even considering college in the future. "I think until I'm 50 there is still time to improve professionally," she says.

This year Moreira is encountering consultants and corporate executives interested in surveying her tastes and preferences. Why? They want to learn how to sell to people like Moreira who have just moved into the emerging Brazilian middle class. "Until 2007, this population was considered a niche; today it is the true Brazilian market," says Renato Meirelles, managing partner of Data Popular consulting. The numbers confirm his opinion: at the end of 2009 the emerging middle class numbered 94 million, according to the study "The New Middle Class in Brazil" (Center for Social Policies of the Getulio Vargas Foundation). "From 2003 to 2009, 29 million people were added to the emerging middle class. Soon we will reach the lowest level of income inequality since 1960," says Marcelo Neri, coordinator of the study. The methodology used defines the portion of the population in this emerging middle class as those whose monthly income ranges from US$660 to US$2,855. "They already represent 50% of Brazilians," Neri says, "and in 2009 they had more than 46% of Brazil's purchasing power."

This emerging middle class emerged thanks to government countercyclical policies adopted at the peak of the global financial crisis in late 2008; its continued consumption has helped the country maintain a pace of recovery that has turned Brazil into a global star. "Brazil has succeeded in showing that the engine of the economy may be the domestic market as the poor increase their income and demand more goods and services," says Alicia Bárcena, executive secretary of the Economic Commission for Latin America and the Caribbean (ECLAC; see interview, page 12). According to Neri, the National Household Survey

(PNAD) recorded per capita income growth of 2%.

"Today, Brazilian society expresses a desire for a development pattern based on a social contract that is in turn based on better income distribution," says Samuel Pessoa, head of the Economic Growth Department of the Brazilian Institute of Economics. He reminds us that the income transfer model — most prominently the Family Grant program and an aggressive policy of raising the minimum wage — was possible thanks to continuous improvement in stable macroeconomic policies over the last 15 years, including the consolidation of fiscal responsibility and primary surpluses, inflation targeting, and a floating exchange rate. "However," he adds, "a model centered on income distribution and consumption implies slower economic growth and a fiscal cost, which increases the tax burden and slows reduction in interest rates. This stifles the productive sector and raises the question of whether the model is sustainable in the future."

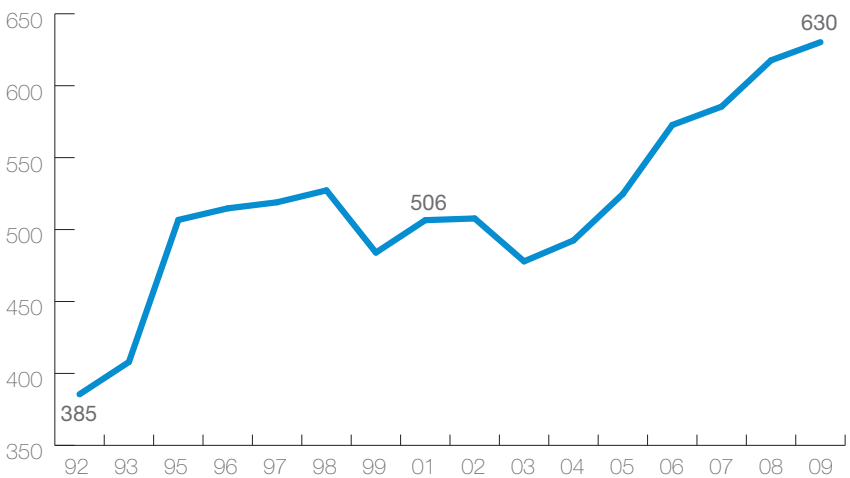


Photo: Tim Brakemeier/dpa/Corbis

A GREAT CONSUMER FAMILY

Voices in the market sound a note of optimism. "This is justified mainly by the growth of formal jobs, the main engine of income growth," says Neri. "Formal employment accounts for 70% of the income increase, compared with 20% from welfare benefits and 10% from the Family Grant and other benefits." Meirelles expects that those who have achieved some upward mobility in recent years will make every effort not to backtrack. "Moreover, there is the demographic factor: Today, the largest share of Brazil's population is concentrated in the productive age group, which means less in benefit payments and more opportunity for growth," he says.

THE GROWING INCOME OF THE POOR. (R$)



Source: Center for Social Policies of the Getulio Vargas Foundation

The increase in formal employment has been responsible for the proliferation of credit and debit cards. "This market has grown by 430% since 2000. There are now 628 million credit, debit, and store cards," says Milton Kruger, president of the Brazilian Association of Credit Cards. "And the emerging middle class participation jumped from 42% in 2003 to 53% in 2010 without any changes in the default rate."

Another factor is more access to credit. Supported by a high level of consumer confidence, credit terms with long maturities enable consumers to think about purchasing more durable goods, says Aloisio Campelo, coordinator of the IBRE confidence surveys: "Income ensures direct consumption of nondurable goods, but it is confidence in the future that leads consumers to borrow to purchase high-value durable goods."

The increase in credit, especially tied to retailers, and the overvalued exchange rate have benefited such sectors as information technology, where the price of components is dollarized and much is imported. "Today, the middle class is experiencing a period of euphoria and ties the purchase of a computer to incredible achievement related to professional improvement," says Adriana Flores, director of new products of Positivo. The company's computer sales rose from 22,000 in 2003 to a million in 2010, mostly to individual consumers.

Another novelty is the expansion of shopping malls in the countryside, tracking the growth in purchasing power of those living outside major cities. "We currently have 100 shopping mall projects under construction and will finish the year with 39 mall openings," says Nabil Sahyoun, president of the Brazilian Association of Shopping Mall Storeowners. The same optimism can be seen in the tourism sector. For the airline TAM, which this year opened ticket counters in Casas Bahia stores, class C accounted for 6% of passengers through October. "Our goal is to reach 17% over the next five years," a company spokesman says.

EDUCATION

In creating a new consumer class, the major breakthrough comes from education. According to Neri, increasing the number of years at school between 2003 and 2009 was responsible for 65% growth in average income per capita for the poorest 20% of the country. "The creation of programs like the Evaluation System of Basic Education in 1988 and the Index of Basic Education Development in 2007 was fundamental," he says. According to Meirelles, new members of class C believe that education is part of their path to social ascension. "Today, consumption by the class C population focuses on improving the quality of life," he says, citing as major consumer purchases electronics, educational services, and hygiene and beauty products, adding, "Each year of additional schooling represents on average a 15% increase in earnings."

> "Today, Brazilian society reflects a desire for a development pattern based on better income distribution."
> Samuel Pessoa

Nevertheless, considering Brazil's deficit in education progress is still slow. Analysis by the Institute of Applied Economic Research (IPEA) of PNAD 2009 data points out that it took 17 years to expand by 2.3 years the average number of school years. At that rate, it would still take five more years to reach the eight years of elementary education required by the Constitution.

"The issue of lack of qualified workers can already be seen in specific sectors, but it is possible that at some point the economy as a whole will experience a shortage of qualified people," says João Sabóia, director of the Institute of Economics, University of Rio de Janeiro. For Márcio Pochmann, IPEA president: "It's not a question of lack of resources. Today if we compare the education expenditure-to-GDP ratio, Brazil spends about 50% more than the United States on training programs. But the fact is that many actions of the ministries and the private sector are not complementary but competitive."



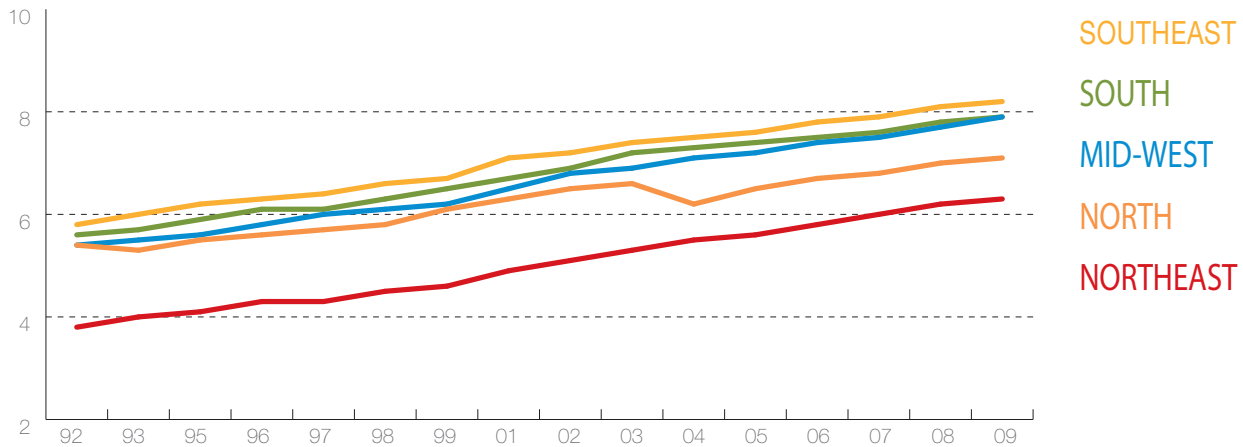
Photo: ABr

SALARIES

Even if Brazil can ensure a good education to open the doors to social mobility for most of the population, we will still not have eliminated all the negative factors. "The social contract we have today privileging income distribution implies

POPULATION'S NUMBER OF SCHOOL YEARS HAS GROWN SLOWLY..

(number of school years of population older than 15)



Source: National Household Survey (PNAD).

slower economic growth and less dynamic markets. Consequently the private sector pays little and does not generate prospects of advancement," Pessoa says.

Data from the General Register of Employed and Unemployed of the Ministry of Labor show that, although September 2009 to August 2010 saw the creation of 2.5 million formal jobs with salaries of up to twice the minimum wage, there was a loss of 284,600 higher-income jobs. "On the one hand, this reflects the value of the minimum wage in recent years," says Sabóia. "On the other it indicates that the bulk of the jobs created paid workers poorly. This is alarming." He suggested a risk of frustrating Brazilians who have just climbed to the base of Class C and invest in a college degree seeking a better quality of life.

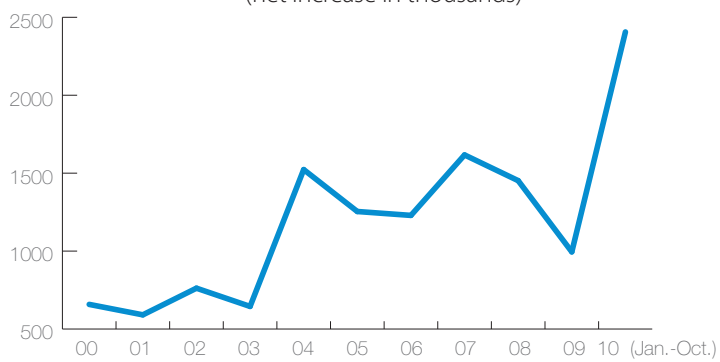
Waldir Quadros, professor of economics at the University of Campinas, argues that this problem is due to Brazil's lack of an industrial policy, which deters growth. "I believe the problem is not social spending but the lack of industrial progress that energizes the entire chain of suppliers and services," he says. "At the moment, this sector is constrained by high interest rates and the appreciation of the exchange rate." IPEA's Pochmann says that "One should not bemoan the fact that in recent years precarious informal jobs declined: for every ten jobs created, nine were in occupations that are protected by the labor laws. However, we must complete the cycle of industrialization, making it more technology-intensive and ensuring the

"The problem is not social spending but the lack of industrial progress that energizes the entire chain of suppliers and services."

Waldir Quadros

FORMAL EMPLOYMENT IS ON THE RISE.

(net increase in thousands)



Source: Caged.



Photo: AF Rodrigues / Imagens do Povo

"There is room to reduce poverty and strengthen the domestic market, provided there is improvement in public accounts and growth of 5% a year." João Sabóia

lower interest rates needed to make this possible," he says. "The focus on production and export of primary commodities like iron ore and soybeans does not create industrial jobs."

In mid-November a Ministry of Development, Industry and Foreign Trade report expressed concerns that the country was experiencing "deindustrialization," highlighting the role of the external trade balance. Deindustrialization, the report said, is characterized not by a fall in industrial output, which may even increase, but by a loss of dynamism in generating income and employment. "The electronics and pharmaceutical sectors cannot compete internationally, they end up importing raw materials, and so the best jobs we need are created outside the country," says Pochmann.

Data from the Brazilian Association of Electrical and Electronics Industry show a record sector trade deficit of US$20 billion in the first nine months of 2010 — 69% higher than in the same period in 2009. In the pharmaceutical sector, in the first six months of the year drug imports totaled US$3 billion. "There is no way to deny that this year cheaper imports of certain products were a great ally in keeping inflation under control, especially given pent-up demand for some durable goods," says Denise de Pasqual, a partner at Tendências Consultoria. "But it is clear that we need a correction, more focused on external competitiveness, since devaluing the exchange rate is one of the most inefficient measures there is."

The result of all these factors was a reduction in industrial confidence. IBRE surveys indicate that confidence in the manufacturing industry fell 18% from August 2009 to August 2010 in the consumer durable goods segment. "Our diagnosis is clear: We have been saying for years that we need to reduce interest rates to prevent exchange rate appreciation and discourage foreign investors from pouring dollars so eagerly into the economy," says Eduardo Eugênio Gouvea Vieira, president of the Federation of Industries of Rio de Janeiro. He thinks "It is necessary to reduce interest rates, cut payroll taxes, and ensure adequate infrastructure for production."

EXTERNAL DEFICITS

With growing external deficits, Brazil needs to attract more foreign direct investment. (US$ billion)

	2008	2009	2010*	2011*
Trade balance	25	25	16	(-)8
Exports	198	153	200	225
Imports	173	128	185	233
External current account (- deficit)	(-) 28	(-) 24	(-) 49	(-) 80
Foreign direct investment	45	26	27	29
Average exchange rate (R$ per US$)	1.8	2.0	1.8	1.8

* Estimates.

Source: IBRE/FGV.

THE NEW GOVERNMENT'S POLICIES

Even before President-Elect Roussef announced her economic team, the market showed reservations about the possibility of a consistent reduction in the Central Bank benchmark interest rate in 2011. IBRE projects that in 2011 the benchmark rate will remain at the 10.75% it reached in late 2010. This is understandable because until now, high interest (though trending downward) has been the main policy for curbing inflation threats — the first victims of which would be the emerging middle class. In their first declarations, the future president's new team showed some sensitivity to this important issue, signaling concern about reducing the public deficit and an intention to accelerate the reduction in interest rates.

The market is betting that the Rouseff government will pay attention to the demands of the emerging middle class. Sabóia thinks, "There is room to reduce poverty and strengthen the domestic market," provided there is an improvement in public accounts and no slowing in the pace of growth, which, he says, must be at least 5% a year. Pessoa notes that the country needs to attract foreign savings to complement domestic saving and finance investment: "If we want this, we must persevere in building the institutional framework, guaranteeing contracts, improving the regulatory agencies, and recovering the primary surplus." For Neri, Brazil has the potential to react strongly and positively to the new government changes in policy. The general outlook, then, seems to be hopeful despite the challenges.



CONJUNTURA ECONÔMICA

Subscriptions
conjunturaeconomica@fgv.br
Call (55-21) 3799-6844