The BRAZILIAN ECONOMY

Economy, politics and policy issues • JULY 2009 • vol. 1 • nº 6
FGV Publication of Getulio Vargas Foundation

IBRE's Letter
Fair winds for the Brazilian economy may be back

Interview with the former secretary of the Federal Revenue Service, Everardo Maciel
Fiscal crisis possible in 2010

Yoshiaki Nakano
Recession and recovery: The worst of the crisis

Lia Valls Pereira
The displacement of Brazilian exports by Chinese

Brazil's economic and financial indicators

The BRAZILIAN ECONOMY

In this issue

IBRE's Letter

Fair winds for the Brazilian economy may be back
Though Brazil has resisted the global crisis well, it is paying a relatively high price in terms of economic growth in 2009. The 3.6% fall in quarterly seasonally adjusted GDP in the last quarter of 2008 and the 0.8% fall in the first quarter of 2009, compared with the immediately preceding quarters, undoubtedly indicates that reaching a positive result this year will be very difficult. Nonetheless, there are signs that the worst is over. In the second quarter, the consensus is that the economy began to grow again. However, what matters more than the 2009 outcome is to assess the vigor of the recovery already in process. The strength of the Brazilian economy recovery depends both on the recovery of foreign demand — which has an important impact on industry — and on continued resilience in domestic consumption.

Interview with Everardo Maciel
Everardo Maciel, the former secretary of the Federal Revenue Service, offers the opinion to reporter Klaus Kleber that the emergence of a fiscal crisis next year would not be a surprise. Although agreeing that some of the tax exemptions are justifiable, Maciel argues that the international crisis should not be an excuse for relaxation of fiscal responsibility standards.

Recession and recovery: The worst of the crisis
In Brazil, most recent indicators suggest that the economy is clearly recovering, but there is a need for caution in making projections. The worst consequence of the crisis was not the cyclical fall in GDP and higher unemployment, but the interruption of a process of rising potential growth of the Brazilian economy that has been on course for the past few years. The decline of potential GDP has major consequences for the recovery and resumption of growth, says Yoshiaki Nakano.

Displacement of Brazilian exports by Chinese
China will try to offset the loss of exports to the United States' and Europe's markets by selling more of its manufactured goods to developing countries, which have been less affected by the crisis. Brazil may lose market share to Chinese products, argues Lia Valls Pereira.

Brazil's economic and financial indicators

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 "Think Tank" of the Getulio Vargas Foundation. It is responsible for the calculation of the most used price indices and business and consumer surveys of the Brazilian economy.

Director: Luiz Guilherme Schymura de Oliveira
Deputy-Director: Vagner Laerte Ardeo
Management Information Division: Vasco Medina Coeli
Center for Agricultural Research: Ignez Vidigal Lopes
Center for Social Policy: Marcelo Neri
Administrative Management: Regina Celia Reis de Oliveira

Address
Rua Barão de Itambi, 60 – 5º andar
Botafogo – CEP 22231-000
Rio de Janeiro – RJ – Brazil
Tel.: (55-21) 3799-6840 – Fax: (55-21) 3799-6855
conjunturaredacao@fgv.br

THE GEORGE WASHINGTON UNIVERSITY
WASHINGTON DC

IBI – The Institute of Brazilian Issues
The Institute of Brazilian Issues was established in 1990 to promote stronger US – Brazil relations within the changing international order. IBI promotes a greater convergence of viewpoints and interests between the two nations. The Institute operates within the Center for Latin American Issues, an integral part of the School of Business.

Director: Dr. James Ferrer Jr.
Program administrators: Kevin Kellbach and Ray Marin

Address
Duquès Hall, Suite 450
2201 G Street, NW
Washington, DC 20052
Tel.: (202) 994-5205 Fax: (202) 994-5225
ibi@gwu.edu

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
Luiz Guilherme Schymura de Oliveira

Executive Editor
Claudio Roberto Gomes Conceição

Editors
Anne Grant
Pinheiro Ronci
Bertholdo de Castro

English-Portuguese Translator
Maria Angela Ferrari

Art Editors
Ana Elisa Galvão
Sonia Goulart

Administrative Secretary
Ana Elisa Galvão
Rosamaria Lima da Silva
Antônio Baptista do Nascimento Filho

Contributors to this issue
Klaus Kleber
Yoshiaki Nakano
Lia Valls Pereira
Aloisio Campelo
Salomão Quadros



Claudio Conceição

Executive Editor
claudioconceicao@fgv.br

The former secretary of the Federal Revenue Service, Everardo Maciel, says that the emergence of a fiscal crisis next year would not be a surprise. Although agreeing that some of the tax exemptions are justifiable, Maciel believes that the international crisis should not lead to the relaxation of fiscal responsibility standards. The Brazilian federal government has been neglecting personnel expense management, and that is the shortest way to a fiscal crisis. In an interview with *The Brazilian Economy* Maciel was skeptical about a tax collection recovery this year — last May the collection fell 6% in real terms, the worse result since 2003. This revenue drop is the seventh consecutive one, resulting in a loss on the order of R$ 11 billion (US$5.5 billion). For Maciel, "in crisis situations, revenue suffers not only from the slowdown of economic activity, but also from tax evasion." He explained that businesses put covering their payroll and paying suppliers first, at the expense of meeting tax obligations.

Another theme of this issue, based on the results of the FGV Business Cycle Dating Committee study, is the prospect of economic recovery for Brazil. According to Professor Yoshiaki Nakano, director of the FGV School of Economics in São Paulo, the contraction in credit and the loss of credibility caused by the financial crisis in the United States brought about a contraction in the Brazilian economy. Given the magnitude of the GDP fall, with full recovery nowhere in sight for the world as a whole, in Brazil the most recent indicators point to a clear economic recovery. The worst consequence of the crisis, however, was not the cyclical fall in GDP and higher unemployment, but the interruption of a process of rising potential growth of the Brazilian economy over the past few years. The decline in potential GDP has major consequences for the recovery and ensuring resumption of growth.

Fair winds for the Brazilian economy may be back

Brazil has resisted the global crisis well, but this year it is paying a relatively high price in terms of economic growth. According to most analysts, GDP slowed from a solid 5.1% expansion in 2008 (and 5.6% in 2007) to zero or even negative growth this year. The fall of seasonally adjusted GDP of 3.6% in the last quarter of 2008 and 0.8% in the first quarter of 2009, compared with the immediately preceding quarters, undoubtedly indicates that reaching a positive result this year will be very difficult.

Nonetheless, there are signs that the worst is over. In the second quarter, the consensus is that the economy began to grow again. A simple GDP projection for the second quarter of 2009, using the performance of manufacturing as a reference, points to growth of about 0.7%. True, if that forecast materializes, the economy would have to expand at an average rate of 2.7% in each of the last two quarters in 2009 to prevent the fall of yearly GDP. Obviously, that is not a likely scenario, which leads us to believe that GDP will fall in 2009.

However, what matters more than the 2009 outcome is the vigor of the recovery already on course. The global crisis has affected Brazil in very particular ways: its impacts were concentrated on the supply side on industry and on the demand side on exports and investment. The good news is that the service sector has performed surprisingly well, even exceeding expectations. Seasonally adjusted, the service sector did register a slight decline of 0.4% in the last quarter of 2008 but increased again by 0.8% in the first quarter of 2009. This performance contrasts with drops of 1% and 0.5% in the agricultural sector and 8.2% and 3.1% in industry, respectively, for the same periods. The strength of the Brazilian economic recovery will therefore depend both on the prospect of a recovery in foreign demand — which would have an important impact on industry — and on continued resilience in domestic consumption.

Signs of recovery — More specifically, there are signs that the drastic cycle of inventory adjustment triggered by the crisis, one of the major factors holding back industrial output during the turbulence, is coming to an end. This translates, for example, into reduction of the large gap between retail sales,

which continued to grow during most of the post-crisis period, and plunging industrial output. Indeed, inventory reduction in the two consecutive quarters ending in March totaled 6% — the highest since 1995.

But it will undoubtedly be in the labor market that the strength of the recovery will to a large extent be determined. Because the signs of vitality in the economy are currently coming from consumption and the service sector, it is fundamental to determine whether the good performance of employment and income will be sustained. There is some ambiguity in the labor market indicators that has led to very different readings by market analysts.

Despite the intensity of the crisis and its severe impact on industrial production and employment, both the wage bill and the employed population increased in the first five months of 2009 compared with the same period last year. The employed population has been growing, though more slowly than it did for the same months in 2008, from 1.9% in January to 0.2% in May. Unemployment — 8.8% in May — is 0.9% higher than in 2008, but month by month in 2009 it has been below the rates in 2002–2007.

A reliable source of information for understanding labor market trends is the General Registry of Employed and Unemployed Persons (CAGED) of the Ministry of Labor. It is from the interpretation of CAGED data, which only considers formal employment, that some of the most pessimistic analysts draw their conclusions. In fact, the net job creation in May celebrated by the government — 131,557 jobs — is lower than the figures registered in the month of May every year since 2002, the first year CAGED data became available.

The same data, however, can also be read more positively. The difference between the historical average of monthly net job creation figures from 2002 to 2008 and the same result in the first five months in 2009 has narrowed since January, with only a slight increase in April. Thus, the difference declined from 189,565 jobs in January (a loss of 101,748 jobs compared with the historical average of a gain of 87,817 jobs) to 46,787 jobs in May (a gain of 131,557 jobs, against a historical average of 178,344).

In the second quarter, the consensus is that the economy began to grow again.

Indeed, no one expected that the labor market would recover to full strength after a crisis as deep at the one that hit Brazil in the six months from October through March. The labor data also seem to suggest that the abrupt halt of industrial activity did not spread consistently throughout the other sectors of the economy. If this view is confirmed, Brazil might benefit from a lucky coincidence: the global credit crisis was relieved just in time to allow industry, once inventories were cut down, to resume production before the loss of jobs in the sector became widespread through slowed demand as a broader impact on the

economy. Thus, although the crisis has hit durable goods, which are more sensitive to credit, the possibility that the next sector to be weakened would be nondurable goods and services — closely linked to income — may not materialize. In this case, the classic circuit of deceleration being transmitted from one sector to the next may have been broken, making the recession particularly mild in Brazil — even though possible negative GDP in 2009 may give the opposite impression.

The strength of the Brazilian economic recovery will therefore depend on both the prospect of foreign demand recovery and on continued resilience of domestic consumption.

Policy merits — It would not be fair, if a deeper and more prolonged recession has indeed been averted, not to acknowledge the merits of the government's economic policy — from the very first steps, including effective and speedy management of liquidity by the Central Bank, which ranged from relaxing reserve requirements to inducing the absorption of banks and portfolios by better prepared financial institutions, through the many tax cuts by sector. Some of those measures have had particularly important positive consequences, as in the case of the automotive sector, which is registering record sales this year. This may have contributed to the recent moderate but consistent improvement in business and consumer confidence indicators.

If there are signs that the resilience of domestic consumption may be maintained, with the support of economic activity, in the months to come, the same cannot be said about resumption of foreign contributions to demand. During the first quarter of 2009 exports dropped 22.2% compared with the same period last year. Granted, imports also fell by 28.9%, which has secured the trade balance surplus and dissipated concerns about external accounts. Particularly worrying, however, is the fact that the direct and indirect effects of the fall in exports, according to a recent study by the National Bank for Economic and Social Development, represent approximately 50% of the reduction of industrial output from September to April.

Limited external demand — Looking ahead, the signs of a recovery of exports are not very encouraging. The indicator provided by the IBRE-FGV Industrial Survey on foreign demand for industrial products, which had been recovering rapidly, slowed its pace in June compared with May. This indicator has averaged 112 since 1993. At the peak of the crisis, it fell to 68, though it recovered to 96 in April. In May and June, however, it grew at a rate of only one point per month, ending at 98. It seems, therefore, that the slowdown in foreign trade may be a more lasting phenomenon. The American consumer confidence index, an important element in global foreign demand, has again declined after a period of recovery. Currently, it is 56.3, down from 62.6 in May. The average since 2005 has been 94.5, and there is still a long way to

go to return even to the 70 or so registered immediately before the crisis.

Regarding commodities, however, the better than expected performance of the Chinese economy has already had a positive effect on demand for Brazilian exports. From January to June, exports of basic products, compared with the same period last year, dropped only 7.4%, compared with a 22.2% reduction in total exports, and a contraction in manufactured goods by 30.6% and semimanufactured goods by 26.9%.This dimension of the crisis has changed the profile of Brazilian exports, which are now more geared toward basic products: the share of basic products jumped from 35.3% in 2008 to 42% in 2009. Manufactured products, on the other hand, fell from 48.5% to 43.3%.

One of the possible paths of recovery of manufactured goods exports could be the acceleration of Latin American economies specialized in commodities through the recovery of Chinese demand as what has already to some extent been felt in Brazil is disseminated among our neighbors. Latin American countries are among the largest importers of Brazilian industrialized products, and the impact of the global crisis on the continent's economies has had a direct negative effect on Brazilian exports. This is very clear in the case of Argentina, which — together with adopting protectionist measures — reduced imports of Brazilian products by 47% in the first half of the year. This brought about the Brazilian trade deficit of US$48 million with Brazil's most important trade partner in South America.

The Brazilian situation today is undoubtedly better than most projections at the beginning of the year, and much better than those published at the end of last year. Despite the drastic fall of industrial output in the first two quarters, the economy did not slow further because it was resisted by household and government consumption. In the second half of the year the effects of the Central Bank's policy rate cuts will be increasingly felt. The policy rate fell from 13.75% to 9.25% between December 2008 and June 2009. Additionally, significant increases in the minimum wage, federal civil servant salaries, and the number of beneficiaries of family grants will be equally felt. All signs thus point to a continuation of the gradual recovery of the economy in the second half of the year, possibly with positive repercussions for the labor market.

In the second half of the year the effects of the Central Bank's policy rate cuts and significant increases in the minimum wage, federal civil servant salaries, and the number of beneficiaries of family grants will be increasingly felt.

We foresee, however, that the performance of exports, industry, and investments (which will continue to be under pressure from inactive installed capacity) will continue to disappoint for some time. The recovery profile, impelled by commodities and the maintenance of domestic consumption, is compatible with a stronger real. As a consequence, the debate on the weight of primary products in our exports ("primarization" of the export base) is likely to be reopened.

Fiscal crisis possible in 2010



Everardo Maciel

Former secretary to the Federal Revenue Service; tax consultant

Klaus Kleber, São Paulo, Brazil

"The emergence of a fiscal crisis next year would not be a surprise," says Everardo Maciel, former secretary to the Federal Revenue Service, currently a tax consultant. Although agreeing that some of the tax exemptions are justifiable, Maciel argues that the international crisis should not lead to a relaxation of fiscal responsibility standards. The federal government, he says, has been neglecting personnel expense management and that is the shortest way to a fiscal crisis. Skeptical about a recovery of tax revenue in the second half of the year, Maciel affirms that revenue always falls faster than gross domestic product (GDP). And he adds: "In crisis situations, revenue suffers not only from the slowdown of economic activity, but also from tax evasion. The priority of businesses turns to covering their payroll and paying suppliers" at the expense of meeting their tax obligations.

The Brazilian Economy — As part of the government's anticyclic policy, tax exemptions have been granted for motor vehicles, home appliances, and building materials; more recently, exemptions have been extended for yet another quarter, starting July 1st, and they now cover capital goods as well. Furthermore, bread and flour have been exempted from social contributions. To what extent can this policy continue without compromising fiscal responsibility, which today represents one of the fundamental strength of the Brazilian economy?

Everardo Maciel — Some tax exemptions can be justified as tools to stimulate demand in a crisis situation. However, one should not forget that they have a negative effect on tax collections in a country that has not yet attained a sustainable fiscal balance. A loss of tax revenues compounded by increased current expenditure will, without any doubt, jeopardize realization of the primary surplus target, and consequently will result in a higher public debt-to-GDP ratio. In fact, according to the latest statistics published by the Central Bank, net debt of the public sector increased by 0.9% in May from the previous month and totaled R$1.2 trillion (US$600 billion) — 42.5% of GDP. This is the worst result in the historical series, pointing to a trend of deterioration. In

Photo: Valter Campanato/ABr

November 2008, the net public debt-to-GDP ratio was 37.7%.

Federal tax revenue fell 6% in real terms in May, compared with the same month in 2008 — the worst result since 2003. The real decline from April compared to May this year was no less than 14%. This was the seventh time in a row that federal tax revenue showed a decline. This is in part due to the economy's slowdown, compounded with a decrease in the rates of the tax on industrialized products (IPI) for certain sectors. It corresponds to a loss of about R$10.9 billion (US$5.5 billion) in federal revenues. In a recent address in Brazil, Danny Leipziger, an economist and chairman of the Commission for Growth and Development, an institution linked to the World Bank, stressed that it is necessary to recover to precrisis revenue levels to sustain Brazilian state investment in the areas of health, education and infrastructure. In your view, will it be possible to achieve this target with an economic recovery starting in the second half of the year?

I appreciate your quoting Danny Leipziger, someone I admire. I do not believe that one can be certain about the possibility of an economic recovery in the second half of the year. All the predictions on the current crisis have proven to be profoundly misleading. Nonetheless, if it happens, I think that revenues will not recover at the same pace as GDP growth.

When can one expect to see a recovery of federal revenues, considering that Brazilian society does not accept the idea of a heavier tax burden?

From the data at hand, it is clear that the fall in federal revenues has been larger than the fall in GDP. In crisis situations, revenue suffers not only from the slowdown of economic activity but also from tax evasion. The priority for businesses turns to covering their payroll and paying suppliers. Meeting tax obligations. particularly in Brazil, becomes secondary.

In crisis situations, revenue suffers not only from the slowdown of economic activity, but also from tax evasion.

With tax revenue falling, Planning Minister Paulo Bernardo announced, without offering details, that budget cuts are being considered. Because it is almost impossible to cut the civil servant payroll, there will be cuts in other expenditures associated with administration, but investment in the Program for Growth Acceleration will not be touched. Will this be feasible only if the government goes for more drastic measures, such as temporary suspension of the federal civil servant wage raise, as has been aired in the press?

Apparently, the idea of postponing the wage raise for federal civil servants has been abandoned. As there is practically nothing else to cut in terms of public investment, I fear that the victim will be the primary surplus. Fiscal responsibility seems more and more to be giving in to measures that are eminently political. Elections always threaten fiscal balance. In my opinion, the emergence of a fiscal crisis next year would not be a surprise.

According to the Central Bank, in the 12 months ending in May, the primary surplus was R$66.9 billion (US$33.5 billion), or 2.3% of GDP. For January-May, it totaled R$31.9 billion (2.7% of GDP), although it must be added that, for the first time ever, the government decided to exclude the government oil company (Petrobras) from the calculations.

In your view, could the primary surplus decline to 2% at the end of 2009? This would be well below the levels seen in the past few years, though still acceptable in a time of crisis.

Predictions are always risky in the present circumstances. Based on published data, the primary surplus in the 12 months ending in May is already below the published target of 2.5% of GDP. Two months ago, the target was 3.8% of GDP. The international crisis should not lead to the relaxation of fiscal responsibility standards, particularly when that is due to liberal increases in current expenditures. The federal government has been neglecting personnel expense management. That is the shortest way to a fiscal crisis.

The international crisis should not lead to the relaxation of fiscal responsibility standards, particularly when that is due to liberal increases in current expenditures.

However, this may have an upside. According to a recent study of the Brazilian Institute for Tax Planning, the tax burden in the first quarter of the year recorded 38.5% of GDP, 0.5% less than in 2008, although the level is still very high. This positive result reflects the tax exemptions. Is that a correct conclusion?

This calculation lacks technical significance, and some newspapers give too much importance to information of this nature. In order to know the tax burden as a proportion of GDP, we will have to wait until, after the end of the year, the Brazilian Institute of Geography and Statistics (IBGE) publishes data on GDP and total revenue at the three levels of government. Only then will we be able to determine the tax burden for the year. That would be a valid calculation.

This leads us to the draft tax reform currently being debated in Congress; the draft has been severely criticized and has not made any progress. It is unlikely it will be passed during Lula's term in office. What are its major flaws?

The "tax reform" project is an abundant collection of inconsistencies and errors. I will mention a few, in different areas. The first aspect that I would like to underline is the rigidity. The project seeks to introduce changes to the tax system through the constitutional channel; that will make the national tax system even more rigid. Absurdly, it goes so far as to incorporate tax rates into the constitutional text.

Another aspect deserving attention is the misuse of functions. The project gives the Finance Policy Council (Confaz), an administrative organ composed of representatives from the Finance Secretaries of the states, the power to lay down regulations for the sales tax for goods and services (ICMS) and to establish, in practice, the tax rates for goods and services. This is a clear-cut case of misuse of the legislative function.

Additionally, the draft tax reform includes an unusual merger of the Contribution for the Financing of Social Security (Cofins), the Social Integration Program (PIS), and education salaries. As a result, a unique "tax on costly operations with goods and services" would be created. Detailing of the actual structure of the tax, which is unlike anything in any other country, is left to future legislation. The issue remains thus open.

In my opinion, the draft tax reform also opens the way for greater tax evasion. It adopts

the principle of destination for the ICMS tax, though in a mitigated form, without taking into account the problems that may result, such as an increased propensity for tax evasion due to the considerable difference between in-state and inter-state tax rates.

The project has been severely criticized, particularly by the exporting states, which feel punished by the system suggested. In addition to the economic aspects — there is an interest in promoting exports — there are also political interests involved. What are your views?

The other absurdity is the creation of what I call the "ICMS exchange." The proposal currently being debated in Congress subjects the taxpayer to tax administration in all states, as the fiscal interest in interstate operations would be located outside the territory of the taxpayer. Actually, in its present form, the draft would result in significant tax losses for the net exporting states, which would, in principle, be offset by an indefinite fund, whose operation is described as the ICMS exchange.

You are among those who have argued that there would be no "fiscal war" involving the federal units if current legislation were effectively enforced. Why is that?

The 1975 Complementary Law no. 24 clearly prohibits the concession of any fiscal benefits without prior unanimous approval by the members of the Finance Policy Council (Confaz). What happens in practice, however? There is a kind of sloppiness on the part of the governments at disadvantage, supported by long-lasting indifference on the part of the Public Prosecutor's Office and of the Judiciary. Condemning the fiscal war is a major national hypocrisy.

How does the tax reform draft propose to eliminate the dispute between states on attracting businesses by granting a variety of incentives?

By trying to prohibit the tax war, the tax reform draft eternalizes illegalities practiced in the past. One might say that tax wars will be over because there is no gunpowder or interest left. Nothing is said about the Complementary Law, which should curb the practice.

A migration from investment funds to savings accounts is already taking place because of the better yields offered by savings accounts — 6% a year plus the referential rate (TR), in addition to tax exemptions and absence of administration fees. One of the alternatives discussed is reducing taxes on investment funds to avoid problems placing government bonds. It would be a patchwork solution, but the issue would remain unresolved. Is it not time to change the system of savings account yields by fixing them at one or two points below the Central Bank's policy rate, for instance, instead of taxing amounts above R$50,000 from 2010? Could the government also resort to tax exemptions for investment funds?

Without any doubt, a review of savings accounts yields is long overdue. They are completely out of line with the other modalities of fixed-rate investments. Indeed, the confiscation of savings accounts that stigmatized the Fernando Collor

The federal government has been neglecting personnel expense management. That is the shortest way to a fiscal crisis.

administration has blocked any attempt to introduce innovations — an argument widely exploited politically. I oppose any rate cuts for investment funds because this would discourage investment in the real sector of the economy, which would be more heavily taxed than the financial market.

What do you suggest to settle this messy issue, inherited from inflationary times, that would extend some degree of guarantee to the small saver?

I believe it would not be convenient, particularly in terms of investor confidence, to introduce changes to the rules governing current savings accounts, especially where taxation is concerned. An alternative could be to close existing accounts to new deposits and create a new guaranteed and tax-exempt savings account for small savers, with yields similar to those offered by financial markets.

Successive reductions in interest rates determined by the Central Bank's Monetary Policy Committee (Copom), culminating in a 9.25% yearly rate in June, have reduced government expenditures associated with service on public debt. Apart from its effects, such as stimulating the economy in general, and considering the declining trend of inflation, which this year should be in the neighborhood of 4%, would that not be another reason for the Copom to announce further cuts to the interest rate?

This is an issue that should be treated with extreme caution. Cuts in interest rates should always be conditioned on meeting inflation targets. There remain many doubts about the future of our economy. Often, the policies adopted by the Central Bank do not please everyone, but they have been characterized by prudence, a fact recognized internationally.

The inclusion of more activity sectors in SIMPLES (the Integrated System for Payment of Taxes and Contributions by Small and Micro-sized businesses), limited solely by turnover, would help promote entrepreneurship and curb the informal sector in the country. Why is this facility the privilege of only a few sectors?

In fact, only a few sectors are excluded from SIMPLES. Most of them are in the field of personal services, activities which are very similar to those of individuals. Those are reasonable restrictions, in my opinion.

Has the merging of the Federal Revenue Service with the Social Security Revenue Service been showing positive results from the point of view of oversight and control?

This merger was a wise decision from the point of view of fiscal administration. Positive results have already been seen . . . because the advances achieved by the Federal Revenue Secretariat have been passed on to the Social Security Revenue Service. Some problems remain, particularly in the area of service to taxpayers, but nothing that cannot be corrected over time.

A review of the system of savings accounts yields is long overdue. They are completely out of line with the other modalities of fixed-rate investments.

agência3



THE MOST TRUSTWORTHY SOURCE OF INFORMATION
ON THE BRAZILIAN ECONOMY
12 ISSUES FOR ONLY R$123 (US$62)

Subscriptions: Phone (55-21) 37993-6844, Fax (55-21) 3799-6855; e-mail conjunturaeconomica@fgv.br conjunturaeconomica@fgv.br

Subscribe to Conjuntura Econômica, published in Portuguese by the Brazilian Institute of Economics of Getulio Vargas Foundation, since 1947, and receive insightful economic, political and social analysis.

FGV
IBRE

CONJUNTURA
ECONÔMICA
FGV publication

Recession and recovery: The worst of the crisis

Yoshiaki Nakano*

That the credit crunch and loss of confidence triggered by the financial crisis in the United States have precipitated a recession in the Brazilian economy is officially confirmed by data published by FGV. Because GDP fell so steeply in the last quarter of 2008 and the first quarter of 2009, the economy's performance for the year has been compromised—growth will probably be negative by about 1%. Unlike the United States, Europe, and Japan, where recovery is not in sight, however, in Brazil the most recent indicators point to a clear economic recovery from the contraction on the supply side that started at the end of September 2008. The worst consequence of the crisis was not the cyclical fall in GDP and higher unemployment; it was the interruption of a process of rising growth of the Brazilian economy over the course of the past few years. The fall of potential GDP has major consequences for recovery and the eventual resumption of growth.

First, it is important to remember that it is too early to be optimistic about the recovery of economic activity. The recovery is so far more vigorous in sectors supported by the government's fiscal policy, particularly the automotive industry and some other durable consumer goods and construction segments. Thus, fiscal measures prevented the worst and are supporting the recovery. However, it was the contraction of domestic credit in the banking system, nervous about the global confidence crisis triggered by the bankruptcy of Lehman Brothers, that brought about the supply side contraction that started at the end of September 2008. Had the Central Bank reacted swiftly, with more daring interest rate cuts and an injection of liquidity into the system, the domestic crisis might have been milder. The consequences of the crisis on the demand side have recently been reflected in the drop in exports, particularly of manufactured goods.

Because of the elevated interest rates and the appreciation of the exchange rate, the most adequate response to the crisis would have been a more vigorous and faster Central Bank response — particularly because at that point inflationary pressure had disappeared completely and the appreciation of the exchange rate was creating an explosive increase in the current account deficit. That is why the excessive expansion of demand should have been controlled by fiscal policy, with cuts in public spending, not by a monetary policy of increased interest rates, which worsened the deficit in current transactions and the appreciation of the exchange rate.

Risk to the future — The government has resorted to fiscal policy to avoid the worst, and it is precisely this policy that is responsible for promoting the economic recovery. The most important aspect is that an abrupt contraction of credit has led to a substantial drop in investment, which will jeopardize growth of the Brazilian economy in the next few years. Clearly, the reduction of reserve requirements, the cuts in interest rates, and the measures introduced by the official banks are slowly bringing the credit situation back to normal. However, those measures have not been sufficient to trigger the resumption of investment, nor to accelerate recovery of the economy generally.

The worst consequence of the recession and the contraction of investment is that we put the future at risk. As a rule, recession tends to destroy productive capacity as

*Director of the FGV School of Economics, São Paulo

factories shut down and businesses go bankrupt. Potential Brazilian GDP, which had been rising over the last few years, was definitely making it possible for the Brazilian economy to grow at a rate of 5% a year without creating inflationary pressures or problems in the balance of payments. After the recession, potential GDP will decline for a few years, for a variety of reasons. The investment rate, which was recovering and had reached 18% of GDP, has been drastically reduced, and it will take several years to return to previous levels. In the meantime, we will not be able to expand our productive capacity, which means a GDP loss during this period.

In times of recession, businesses also suffer losses and accumulate debt, which compromises their investment potential. Businesses that shut down or go bankrupt also help to destroy potential GDP. This would be the most serious consequence of the effective reduction in Brazil's production capacity.

It is no longer possible to extrapolate potential GDP as projected before the crisis into the after-crisis period. In the best scenario, if we return to the pre-crisis situation by 2011, with 5% to 6% growth of the Brazilian economy, the trajectory of potential GDP shifts downward, resulting in losses that may easily reach 20% of GDP.

Consequences — The fall in potential GDP has other, perhaps more serious, consequences — fiscal consequences, for example. The structural deficit, calculated on the basis of potential GDP, should be zero when effective production equals potential production; it increases with the drop in potential GDP because tax revenues fall while costs remain fixed. This means that post-crisis the government will have to make an additional fiscal effort to restore the previous scenario, by either cutting spending or raising taxes — either of which would have perverse consequences for the economy. Furthermore, a recessive period increases both the deficit and public debt, which in turn demands that the government at some point make an additional fiscal effort.

Also, growth is a process that can positively affect what happens next and that generates a virtuous cycle. For instance, when in 2004 the economy started growing due to external stimulus (an increase in exports), investments increased, promoting growth that in turn generated positive feedback in terms of investment. Once this virtuous cycle is broken, it may become a vicious cycle, and restoring the previous situation would not be easy. Likewise, lower unemployment was affecting salaries positively, which expanded demand for consumer goods; the higher salaries in turn led businesses to introduce innovations to increase productivity to contain unit labor costs and sustain profit margins. This is yet another virtuous cycle. Increased unemployment also breaks this virtuous cycle that we have been building on for years.

The worst consequence of the crisis was the interruption of the process of rising potential growth of the Brazilian economy.

In conclusion, the recovery of the Brazilian economy is underway, but one must be cautious in making extrapolations. One must also bear in mind that higher unemployment has already affected increases in salaries, which are no longer real increases, and that in turn affects aggregate demand. The reduction of the industrial products tax (IPI) and record sales of automobiles and other durable goods in the first half of the year have an expectation component. When the IPI tax reduction is lifted, sales will fall more than proportionately. The increase in idle capacity may also have two adverse effects: on one side a fall in productivity and benefits, and on the other, postponement and reduction of investment.

The displacement of Brazilian exports by Chinese

Lia Valls Pereira

China will try to offset the loss of exports to US and European markets by increasing sales of manufactured products to developing countries. All income projections suggest that those countries are less affected by the crisis than economies in the North. Thus, we should expect an increase in Chinese competition that could crowd out exports from other countries. Brazil fears the loss of markets to the Chinese, particularly in South America, the main destination of Brazilian manufactured goods.

The Brazilian Institute of Economics (IBRE) carries out periodic calculations of the loss of Brazilian exports to Chinese competition. The results of the comparison between 1991–2001 and 2002–2004 were published in the July 2006 issue of *Conjuntura Econômica*. Later the same exercise was carried out for 2003–2004 and 2006–2007. In all cases, though total losses were minor, for some products Chinese competition explains almost all Brazilian losses.

The exercise was repeated for 2008 and 2007. The effect of the crisis is not fully reflected in 2008, but again, total losses are minor. What stand out, however, are higher losses in some product groups, such as steel products and parts for the automotive industry. The markets analyzed were Argentina, Uruguay, Colombia, Chile, Mexico, the United States, and the European Union. The comparison was carried out for 2008 and 2007, except for Chile,

Table 1
Brazil's export losses to China's exports for same manufactured products

Countries	Brazil's total export losses (%)		China's share in Brazil's total export losses (%)	
	2008	2006-07	2008	2006-07
Argentina	0.4	0.7	45.2	51.5
Uruguay	0.05	...	45.4	...
Colombia	0.2	...	33.3	...
United States	1.3	3.4	30.3	31.6
European Union	1.7	2.6	17.6	35.7
Mexico	0.2	...	22.4	...
Chile*	0.2	0.2	39.1	28.6

Sources: WITS System, and Center for External Sector Studies, IBRE.
* In the case of Chile, losses were calculated between 2006 and 2007 and 2003-04 and 2005-06.

Economist, Center for External Sector Studies (IBRE-FGV)

Table 2
Principal manufactured products in Brazil's total export losses to China
(Percent)

		China's share in Brazil's total export losses	Product's share in Brazil's total loss to China
Argentina			
293100	Other organo-inorganic compounds.	99	34
851780	Electrical equipment for line telephony or telegraphy - other	63	3
390760	Polyethylene terephthalate	80	3
600632	Other knitted fabrics of synthetic fibers	88	3
841430	Air compressors	49	3
841899	Refrigerators, freezers	96	3
281820	Aluminum oxide, except artificial corundum	18	2
720230	Ferrosilicon-manganese	70	2
847160	Machines for processing data	93	2
842920	Levies	93	2
Uruguay			
870899	Devices for control of acceleration, brake, clutch, steering and gear box.	98	29
870322	Special vehicles for transporting people on golf courses and similar vehicles	42	5
870422	Chassis with engine and cab	32	4
851780	Other electrical appliances for telephony or telegraphic	42	3
390760	Polyethylene terephthalate	55	3
870421	Motor vehicles for transport of goods	55	3
732690	Other articles of iron or steel	72	2
610910	Knitted shirts, cotton	75	2
283525	Hydrogen orthophosphate, calcium (dicalcium phosphate)	97	2
870190	Tractors - Other	19	2
Colombia			
721391	Wire rod of iron or steel not linked	92	22
852520	Devices for radio transmitters and receivers	80	21
722790	Wire rods of other alloy steel	93	5
847149	Machines for processing data - presented in the form of systems	34	5
847130	Machines for processing data	80	4
870422	Chassis with engine and cab	13	2
730431	Pipes used in drilling for oil or gas extraction	90	2
730421	Drill pipes used in the extraction of oil or gas (drawn or rolled, cold)	31	2
721049	Other flat-rolled products of iron or steel not linked	57	2
841830	Freezers (horizontal chest type)	90	1

China has increased market share in some products in which Brazil had registered gains, such as steel and automotive products.

where data were available only for 2006 and 2007.

The analysis adopted the six-digit harmonized system of classification. For each country the products chosen for the analysis were the same for both Brazilian and Chinese exports. Then, three groups of products were identified: products where both countries have lost market share (market share = the share of Brazilian or Chinese products in total exports of the product); products for which both countries increased exports; and products for which one country lost and the other gained exports. What follows are the main results in terms of products where Brazil lost and China gained.

Aggregate results — Brazil's total losses in the same products that China exports represent a small share of total Brazilian exports to the

markets selected. For Argentina, for instance, the rate was 0.4% in 2008. The greatest losses were in the United States (1.3%) and the European Union (1.7%). When the results are compared with the data from 2006–2007, losses drop in all markets.

How much of the losses can be attributed to China? Less than half for all markets. Nonetheless, more losses are attributable to a larger Chinese share in South American countries than in the United States, the European Union, and Mexico. In Argentina and Uruguay, 45% of Brazil's market share losses can be attributed to China. Compared with the previous period of analysis, in Chile the losses increased by 10.5% (from 28.6% to 39.1%); this result may reflect the free trade agreement between Chile and China.

Nonaggregate results — The products have been broken down in decreasing order according to their share in the total losses ascribable to China (second column, Table 2). Other organic compounds represent 34% of total losses in Argentina. In Uruguay, braking devices account for 29% of the losses, and in Colombia, machine wire and transmitters account for 43%. In other market, the losses are less concentrated.

The first column in Table 2 shows the percent loss ascribed to China for specific products. Thus, 93% of the Brazilian share in exports of automatic equipment for data processing to Argentina has been lost to China.

Table 2 (cont.)

Principal manufactured products in Brazil's total export losses to China
(Percent)

		China's share in Brazil's total export losses	Product's share in Brazil's total loss to China
United States			
850300	Parts of electric motors and generators	40	12
721049	Other flat-rolled products of iron or steel not linked	43	9
730620	Coating of pipes for wells used in the extraction of oil or gas	77	5
730429	Other tubes and hollow profiles, seamless, of iron or steel	46	4
840790	Other piston engines, spark-ignition	82	3
640399	Other footwear of rubber or plastic	15	3
721061	Flat-rolled products of iron or steel not attached, aluminum-coated silicon	22	2
848180	Other taps, valves (including reducing the pressure and thermostatically)	60	2
720916	Flat-rolled products of iron or steel not linked	25	2
441890	Other works of carpentry and joinery for construction	68	2
European Union			
280469	Hydrogen, rare gases and other non-metallic	55	9
720839	Flat-rolled products of iron or steel not linked, in width equal to or greater than 600 mm	26	6
720916	Flat-rolled products of iron or steel not connected, of a thickness exceeding 1mm but less than 3mm	57	6
722790	Wire rods of other alloy steel	98	5
720838	Flat-rolled products of iron or steel not linked, in width equal to or greater than 600 mm	58	4
720917	Flat-rolled products of iron or steel not connected, of a thickness equal to or greater than 0.5 mm	57	4
722530	Other flat-rolled products, other alloy steel, of width less than 600mm	100	3
940360	Other wooden furniture	42	3
841430	Air compressors	58	3
870322	Special vehicles for transporting people on golf courses and similar vehicles	4	2

The groups of products where losses have been registered vary, but it is possible to identify a few common features. In the United States and the European Union, the most important products

Table 2 (cont.)

Principal manufactured products in Brazil's total export losses to China
(Percent)

		China's share in Brazil's total export losses	Product's share in Brazil's total loss to China
Mexico			
870891	Car radiators	43	10
847130	Machines for processing data	57	6
844390	Parts of printers	41	5
847330	Parts and accessories of machines for processing data	69	4
401110	Tires for passenger cars	35	3
847290	Other machinery and equipment for offices	40	2
691200	Ceramic dishes, other articles of household and hygiene articles or toilet	97	2
870839	Other parts and accessories for cars	25	2
871419	Other parts and accessories for motorcycles	62	2
844359	Other printing machines	60	2
Chile (2006 and 2007)			
720851	Flat-rolled products of iron or steel not connected	97	12
852520	Devices for radio transmitters and receivers	40	9
760429	Other bars and shapes, aluminum	100	6
720852	Flat-rolled products of iron or steel not connected	99	5
847160	Machines for processing data	93	3
852812	TV devices	91	3
870431	Motor vehicles for transport of goods, fully loaded weight not exceeding 5 tons	16	2
842810	And goods passenger lifts	49	2
690790	Tiles and slabs (slabs), ceramic - other	98	2
847149	Machines for processing data - presented in the form of systems	42	2

Sources: WITS System, and Center for External Sector Studies, IBRE.

Blaming China for the fall in Brazilian exports of manufactured goods is a mistake. Instead, Brazil should improve the competitiveness and marketing of its manufacturing exports.

are in the steel sector. In Mexico, automotive products are more prominent. In South American countries, transmitters, data processing equipment, automotive industry products, and home appliances are important.

Blaming China for the fall in Brazilian exports of manufactured goods is a mistake. Instead, Brazil should improve the competitiveness and marketing of its manufacturing exports. Nonetheless, it is essential to monitor the issue carefully. The results indicate that China has increased market share in some products in which Brazil had registered gains, such as steel and automotive products.

Industry

The FGV confidence index of Brazilian industry (ICI-FGV) grew fast for the second consecutive month, showing that the industry is picking up as a result of strong recovery in durable goods, following fiscal stimulus measures adopted early this year. The recovery should gain strength in the third quarter because of expansionary monetary policy and the end of the inventory adjustment in the second quarter.

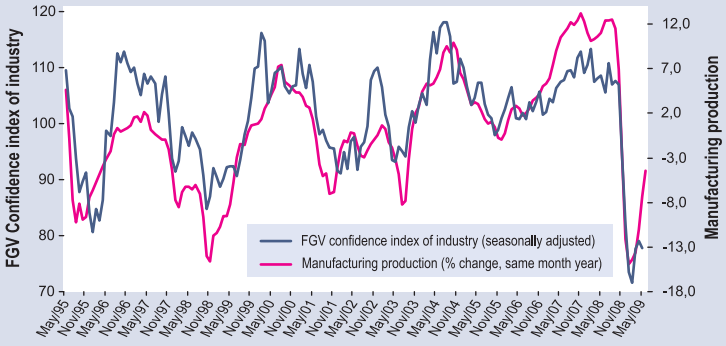
Domestic and external demand

The FGV survey of industry shows that one of the reasons for the slow recovery of industrial production is weak external market demand. In the current crisis, the indicator that measures businesses' assessment of foreign demand (strong, normal, and weak) for their products reached its lowest level since 1983 in February this year. But, the indicator that measures businesses' assessment of domestic market demand bottomed out in December of last year and rose to a level equivalent to its historical average in June 2009.

Inflation at two speeds

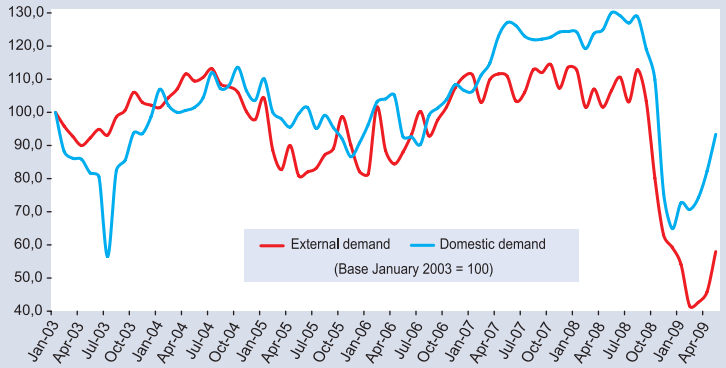
Since last October, industrial product inflation has been declining rapidly: 12-month wholesale industrial product inflation declined from 15.4% in October 2008 to negative 0.43% in June 2009. The result is even more surprising because the exchange rate devalued by 40% in the same period. In the past, a devaluation this large invariably ended in higher inflation. In this crisis, the fall of international prices of commodities has more than offset the exchange rate devaluation. At the same time, despite external conditions, prices of services have continued to rise, reaching 7.2% in the 12 months through June. The mismatch between the two inflation rates is due to the resilience of the domestic market and wages, which have continued to expand, although more slowly than before the outbreak of the crisis.

After sharp fall last October, both FGV confidence index of industry and manufacturing production have been recovering since February

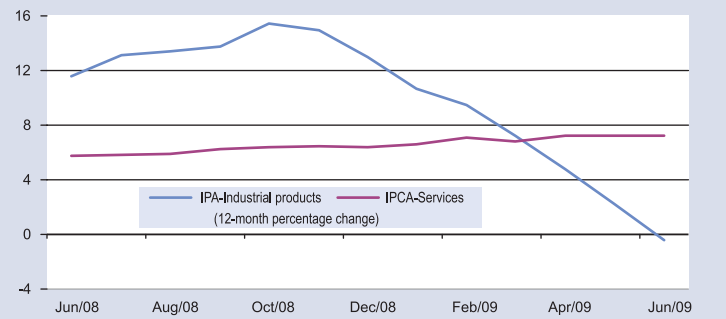


Sources: IBRE-FGV and IBGE.

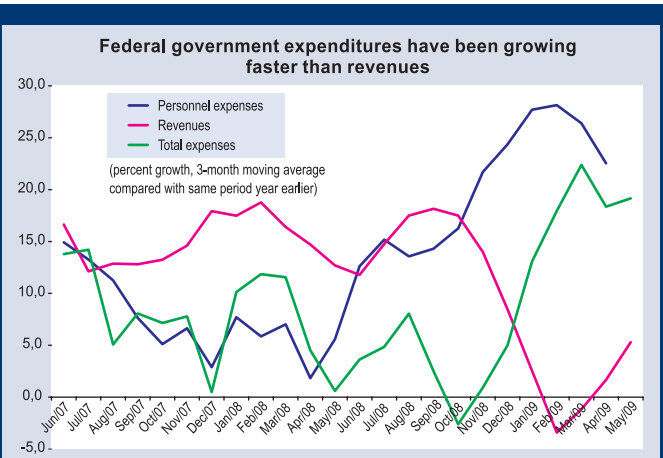
FGV confidence index of the Brazilian industry shows that domestic demand has been resilient , while external demand remains week



Industrial product inflation is falling, while service inflation continues to rise



Federal government expenditures have been growing faster than revenues



Source: Brazilian Ministry of Finance.

Is Brazil bound to have a fiscal crisis in 2010?

The emergence of a fiscal crisis next year is likely. Federal tax revenue has been growing well below total and personnel expenses since last October. The federal government has been neglecting personnel expense management. Although tax exemptions are justified to stimulate demand in a crisis situation, they have a negative effect on tax collections in a country that has not yet attained a sustainable fiscal balance. A loss of tax revenues along with increased current expenditure will jeopardize the primary surplus target, and will result in higher public debt-to-GDP ratio.

For additional series and methodology contact: Industry and consumer surveys: (55-21) 3799-6764 or sondagem@fgv.br; Price indexes and data bank services: (55-21) 3799-6729 or fgvdados@fgv.br.