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IBRE's Letter

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"Brazil will emerge from the crisis stronger"

Brazil's new role in international affairs

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The tax burden in Brazil rose from 26% of GDP in 1995 to 36% in 2008, following an expansion of the state that was essentially characterized by increased expenditure on services and social benefits. That increase in the tax-to-GDP ratio is commonly seen as a negative point in the country's recent economic development because it holds back growth. This assessment may not be the best way to understand the reality. In the debate on the tax burden in Brazil, it is fundamental to adopt the institutional perspective, taking into account all the particularities of the country. Our redistributionist state has many distortions. However, those distortions arose out of a historical process, where uncountable interests, ideas, programs, and negotiations intertwined to shape outcomes. As there are no definite institutional models to help a country develop, the next stage of our institutional evolution should be carried out through incremental changes. An important change would be to eliminate the lack of transparency associated with the various taxes paid by the population.

Interview with Finance Minister Guido Mantega

Brazil will emerge from the global crisis stronger owing to its large domestic market, low inflation, and large international reserves. The country's GDP will increase by 4.5%-5% next year, Finance Minister Guido Mantega affirms confidently in an interview with Klaus Kleber.

Brazil's new role in international affairs

Relations between Brazil and the United States and the countries of South America resemble a cautious and complex political game of chess. Today, thanks to its large vibrant economy, market-oriented policies, and stable democracy, Brazil is seen as a respected interlocutor, skilled negotiator, and independent mediator, able to find shortcuts in search of collaborative solutions among. In this special edition on foreign policy, Brazilian and foreign experts look into the developments, implications and burdens of Brazil's new role in international affairs.

Brazil's economic and financial indicators

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Finance Minister Guido Mantega, in an exclusive interview with *The Brazilian Economy*, affirms confidently that Brazil will emerge from the global crisis stronger owing to its large domestic market, low inflation, and large international reserves. An optimist, he believes that the country's GDP will increase by 4.5%-5% next year. He reaffirms his criticism of private banks that charge high interest spreads and increase their provisioning for nonperforming borrowers: "The institution that charges higher interest rates also increases its risks. Down the line, default becomes an excuse to further raise interest rates." The appreciation of the real, in his opinion, is a consequence of the virtues of the Brazilian economy. And he guarantees: the government will neither relinquish the floating exchange rate nor resort to control of capital.

The relations of Brazil with the United States and the countries of South America resemble a cautious and complex political game of chess. Today, thanks to its large and vibrant economy, market-oriented policies, and stable democracy, Brazil is seen as a respected interlocutor, skilled negotiator and independent mediator, able to find shortcuts in search of collaborative solutions among countries of diverse political persuasion and social background. But Brazil's new role has nevertheless been challenged in South America by other competing political currents such as the more radical Venezuelan-born Bolivarianism. To strengthen its role, Brazil counts on the change of views in Washington, as the Obama Administration is searching for a reliable partner at the negotiating table in a region marked by contrasts and challenges.

The tax burden and our dilemmas

The tax burden in Brazil rose from 26% of GDP in 1995 to 36% in 2008, after an expansion of the state that was essentially characterized by increased spending on services and social benefits. That increase in the tax-to-GDP ratio is commonly seen as a negative point in the country's recent economic development because it reduces incentives to both work and save — in other words, it hampers growth.

This assessment, however, may not be the best way to understand the reality and to help envisage more appropriate alternatives for the future because it disregards some essential aspects of that reality. The expansion of the state has not occurred in a vacuum; it is part of a historical process of sociopolitical choices by the society, starting with Brazil's re-democratization. This means that the tax hike is related to the expansion of social benefits and public services, such as health and education. Obviously, much depends on the efficiency of the increases in such spending. Only when that is clear is it possible to carry out a comprehensive cost-benefit assessment of the state's involvement in the economy.

The redistributive role of the state — Economic theory identifies the elements that leads a country to choose a higher tax burden. The French economist Roland Bénabou has sought to disentangle the relation between equity and the size of the welfare state.[1] Bénabou suggests that the degree of distributivism of a country's fiscal policy is very high in egalitarian societies (where there is little income inequality), it is reduced as income inequality worsens, and it increases again when income inequality widens excessively.

In egalitarian societies whose populations are fairly homogeneous in terms of education and income, citizens tend to understand taxes and public expenditure as an insurance system to support those facing adverse situations. In those countries, the egalitarian socioeconomic structure tends to be reinforced through state mediation, but strictly speaking

there is no redistribution through taxes and public spending because there are no massive transfers from the wealthy to the poor — conforming to the insurance rationale described, most transfers occur between individuals with relatively similar socioeconomic profiles.

In more unequal societies high-income groups feel that the taxes they pay outweigh the public services they consume. Those groups are also in a better position to influence political decisions in order to avoid tax redistribution. Thus, the wealthier succeed in preventing tax increases that would finance the expansion of the welfare state, which perpetuates inequality. A study by Bartels[2] shows that the higher the income of their constituents, the more the votes of US senators serve those interests.

In a third situation, income becomes so enormously unequal that the number of supporters of redistribution grows to the point that they become politically more powerful than the wealthy. In this case, the tax burden tends to be increased to finance services and programs that transfer income from the wealthier to the poorer.

Income redistribution, distortions, and tax burden — The improvement in income distribution in Brazil in the last 20 years is good news, but we are far from the ideal situation of egalitarian societies with a high tax burden and high public spending, where voters support an active public sector that acts more as an insurer than as an agent of redistribution. This is evidenced by a 2006 World Bank study of 126 countries in which Brazil ranks 116th with regard to income distribution.[3] In other words, only 10 countries in the sample had worse income distribution than Brazil. Thus Brazil clearly belongs in the third group of countries where inequality is so high that not even the traditional interests of the wealthy can prevent the state from carrying out redistributive policies through high taxes and increased public spending.

However, the Brazilian formula of redistribution is based on heavy income transfers that are only marginally focused on the poor or the reduction of educational inequality — the exception is Bolsa Família (Household Grant). A prime example of the type of inefficient redistribution that worsens income inequality is the payment of pension benefits resulting from death.[4] In 2006 these benefits represented 3.2% of GDP. The figure is high in international terms. In a study of countries where the proportion of the population about to retire is similar to that in Brazil, they were found to spend approximately 0.2% of GDP in pension benefits resulting from death. Even more striking is that on average the mostly rich nations of the Organization for Economic Cooperation and Development (OECD) spend only

The tax burden in Brazil rose from 26% of GDP in 1995 to 36% in 2008, after an expansion of the state that was essentially characterized by increased expenditure on services and social benefits.

0.8% of GDP on such benefits. These examples underline the peculiarity of the Brazilian case.

Another factor that calls into question the efficiency of the redistributive role of the Brazilian state is the evidence that the increase in the tax burden was unusually regressive. According to Zochun and others (2005),[5] the burden of direct and indirect taxes on the income of households earning up to twice the minimum wage rose from 28.2% in 1996 to 48.8% in 2004 — an increase of 20.6 percentage points. In contrast, for households earning over 30 times the minimum wage, the tax burden in the same period rose from 17.9% of income to 26.3% — a substantial increase of 8.4 percentage points, but less than half the cost to poorer households. Zochun and colleagues point out that between 1996 and 2004 the tax burden declines consistently as income increases.

There are no ready and well-defined institutional models to help a country develop.

Institutional approach — In analyzing the tax burden it is appropriate to revisit studies conducted on how institutions — particularly the extent and quality of state action — affect development. Research on the role of the institutions in development concludes that there are no ready and well-defined models that apply to all countries. Djankov (2003) and Rodrik (2008) suggest that the institutions that work in developed countries are not necessarily the best option for developing countries.[6] An example that had great historical impact is the transition to capitalism experienced by Russia and other former Iron Curtain countries. In the case of Russia, the most representative example, Western consultants were behind extremely rapid changes to the institutional environment, particularly a broad but hasty privatization process and an attempt to create a new class of entrepreneurs overnight. As a result, state companies ended up in the hands of oligarchs, which caused serious damage to the reputation of capitalist institutions in the country and precipitated a return to a more state-controlled and authoritarian model. Transition to capitalism in China took place much more slowly, with incremental changes introduced into an institutional environment inherited from the socialist past. China's 30 years of growth at an average rate of 9% a year suggest that the country's gradualist strategy — under the state's iron fist — was the right choice.

Clearly, simply transplanting institutions does not necessarily improve social conditions. Easterly (2008) observes that institutions are not built from the top down; rather, they are the outcome of the social norms, traditions, and values of a society, as well as a country's degree of

development.[7] Dixit (2009) argues that to bring about changes, the first step must be to understand the reasons for the existence of the institution one wishes to change; only then can the ramifications of projected changes be calculated.[8]

Incremental institutional changes — In the debate on the tax burden and income redistribution in Brazil, it is fundamental to adopt the institutional approach that takes into account all the peculiarities of the country. Our redistributionist state has many distortions, but those distortions did not come from nowhere. The institutional fabric stems from a historical process where uncountable interests, ideas, programs, and negotiations intertwine to shape outcomes for any country. What results from this process may not be the ideal solution and, as in Brazil, may even have some apparent absurdities (such as the pension case). But it is always associated with the way society works and with compromises between social actors, in subtle forms that are not always visible to "scientists" who have ready and definite solutions.

Thus, rather than considering a top-down reform of the Brazilian state, or reversing its expansion following the increase in the tax burden, a wiser alternative would be to seek incremental changes. The new steps should build upon what already exists, seeking to disseminate the gains obtained by the different sectors, or build on developments that point toward the natural next stage of our institutional evolution. Here, there are three possible small steps to improve the Brazilian tax system.

The first step would be to eliminate or at least significantly reduce the lack of transparency associated with the taxes Brazilians effectively pay. It is important to make clearer the contributions each individual makes to financing different state programs. One possible measure would be to show on sales receipts the amount of taxes effectively paid by the consumer — something that is an established practice in many countries. So a typical Brazilian would know exactly how much tax he pays every time he makes a purchase or eats at a restaurant. The important point here is that, in a simple and transparent way, Brazilians become aware of the taxes they pay and take a democratic stand on the issue when electing their representatives. In fact, for the Brazilian democracy model that kind of transparency is indispensable.

The next stage of our institutional evolution should be carried out through incremental changes.

The second step would be to address the current redistribution system. As far as transfers are concerned, one of the most significant institutional developments of the past few years has been to reach the

poorer sectors of society in a focused and large scale way. The Bolsa Família (Household Grant) program reaches about 12 million families at a relatively low cost of about 0.4% of GDP.

It is true that some of the programs introduced before Bolsa Família and still active today had the specific objective of reaching poorer Brazilians. An example is the pension program for rural workers. At the time, the conviction (later proven in practice) was that by addressing the needs of the elders in the rural population, it would be possible to transfer income indirectly to poor youth. The pension paid to seniors in rural areas became the main source of income for households in many of the country's pockets of poverty.

It would be important to create instruments to eliminate the lack of transparency associated with the various taxes effectively paid by the population.

Notwithstanding the importance of the rural pension, it is clear that the redistributive element of the Bolsa Família is immensely superior because it considers the poor in a context other than old age. The program transfers money directly to poor mothers whose children attend school. That seems to be a better solution than having those mothers depend on the good will of the family's pensioner — assuming that the household has an elderly pensioner. Would it not therefore be the right moment to revisit the programs that are focused on the less favored sector of the population but that do not adopt the Bolsa Família's data base to target better benefits to the poor? Obviously, the rural pension should be preserved, but there are more effective ways to support younger members of poor households. The institutional development, in this case, would be the realization that it no longer makes sense for the state to approve new social programs whose beneficiaries are not in the Bolsa Família data base, which reaches the poorer sectors of the Brazilian society.

A third step is to introduce incremental changes in the civil service pay policy. The federal civil service wage bill has risen from 3.1% of GDP in 1995 to 5% in 2008.[9] Alone, these figures are not very significant, but they should be examined in terms of the quantity and quality of services provided. Although higher-income classes consider that health and education in Brazil, for example, are of very low quality, those services are better assessed by the poor and the lower middle class, who are the consumers of these services. This does not mean that we should celebrate the results in health and education; rather, it suggests that the issue of assessing public services in relation to the increase in spending is more complex than that it would have seemed at first glance.

Today, there is no transparency about how the civil service wage structure has evolved. As Douglass North has pointed out, a good institution is not one conceived according to a perfect model, but rather

one that manages to address the needs of a particular society; in his words, "The major role of institutions in a society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure for human interaction."[10] One positive way to introduce transparency and predictability into the civil service pay policy that would have immediate gains would be to align it with policies adopted in the private sector. This would help to reduce uncertainty on all sides: the citizen-taxpayer would be reassured, seeing more clearly the policy that orients increases in public sector wages; the change should also be welcomed by civil servants, who no longer would have to depend for fair pay on the good will of whatever administration is elected.

The improvements suggested here are not revolutionary. They are not even what one could call a "management shock." They simply seek to add new bricks to the existing institutional architecture. Their purpose is to introduce greater transparency and rationality into the Brazilian public sector.

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[2] Bartels, L. (2002), "Economic Inequality and Political Representation," Princeton University photocopy.

[3] World Bank (2006), *World Development Indicators 2006*. CD-ROM. Washington, DC.

[4] IBRE's Letter, *Conjuntura Econômica*, April 2008.

[5] Zockun, M.H., H. Zylberstajn, S. Silber, J. Rizzieri, A. Portela, E. Pellin, and L.E. Afonso (2005), "Simplificando o Brasil: Propostas de Reforma da Relação Econômica do Governo com o Setor Privado," Textos para Discussão FIPE Nº 03, Fundação Instituto de Pesquisas Econômicas.

[6] Djankov, S., C. McLiesh, and R. Ramalho (2006), "Regulation and Growth," *Economics Letters*, vol. 92, pp. 395-401; and Rodrik, D.N (2008), "Second-Best Institutions," *American Economic Review: Papers & Proceedings*, vol. 98, pp. 100-104.

[7] Easterly, W. (2008), "Institutions: Top Down or Bottom Up?" *American Economic Review: Papers & Proceedings*, vol. 98, pp. 95-99.

[8] Dixit, A. (2009), "Governance Institutions and Economic Activity," *American Economic Review*, vol. 99, pp. 5-24.

[9] State and municipality civil service wage bills have not been taken into account in the figures provided.

[10] North, D. (1990), *Institutions, Institutional Change, and Economic Performance*. Cambridge: Cambridge University Press, p. 6.

"Brazil will emerge from the crisis stronger"



Guido Mantega

Finance Minister

Klaus Kleber, from São Paulo

Because of its domestic market potential, and because inflation has been kept under control and the country's foreign accounts were unshaken, Brazil will emerge from the global crisis stronger, says Guido Mantega, the Brazilian Minister of Finance. He assures us that the third quarter started with growth already at about 4%, and year-end GDP will be positive, close to 1%. In 2010 the Minister expects that real Brazilian GDP will grow 4.5% to 5%: "There's a new world ahead." In this interview, Mantega reaffirms his criticism of private banks that charge high interest spreads and increase their provisioning for nonperforming borrowers: "The institution that charges higher interest rates also increases its risks. Down the line, default becomes an excuse to further raise interest rates." The appreciation of the real, in his opinion, is a consequence of the virtues of the Brazilian economy. Mantega also states unequivocally that the government will neither relinquish the floating exchange rate nor resort to capital controls.

The Brazilian Economy — **In a recent article the chief economist of the International Monetary Fund, Olivier Blanchard, suggests that the global economy is beginning to recover but that the process will be neither simple nor painless. The economic turnaround will be sluggish and will depend, to a great extent, on US exports and increased consumption by Asian countries, expressed in imports. What is your view?**

Guido Mantega — On a global scale, indeed, there are signs that the recovery has already started, not only in the US but also in some countries in Europe and in Japan after four or five quarters of negative growth rates. Unemployment in the US is receding after having crested at 9.5%. This does not mean that the more advanced countries will not confront many other troubles, such as trade imbalances and fiscal problems. And although activity may begin to intensify in the more developed countries from the third quarter of this year, their growth rates will continue to be low.

It is expected that the emerging countries will stand out, growing faster. China grew 7.9% in the second quarter of this year.

China is leading growth, but India has also performed very well during this transition period — it could grow as much as 5.4% this year. Russia, despite its dependence on oil, is starting to recover. As far as Brazil is

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concerned, after two consecutive quarters of negative growth, the country is rapidly recovering; the first signs of the turnaround became clear in the second quarter of 2009, though pockets of poverty remain. Growth started in the third quarter at a pace of about 4%, and year-end GDP in Brazil will be positive, close to 1%. The perspective for 2010 is that real Brazilian GDP will grow 4.5% to 5%. There's a new world ahead.

You have mentioned the dynamism of the emerging countries. In a recent edition *The Economist* noted that Brazil has been spared the worst of the crisis because it is somewhat "backward" compared to the rest of the international financial system....

That is a joke. In fact, precisely because of the severe problems we had in the past, the Brazilian financial system is well regulated and sound; its institutions cannot and could not operate with the excessive leverage practiced by the international banks. We have not experienced the problems associated with subprime mortgages or toxic assets. We have public banks whose actions were decisive in overcoming the crisis.

In contrast, in the US, because of the systemic risks that threatened the financial system, the government was forced to at least temporarily nationalize banks and even companies like General Motors. In Brazil we acted swiftly, applying counter-cyclical measures such as reducing reserve requirements for banks and lowering interest rates. Tax exemptions were granted on home appliances and building materials; individual income tax was reduced with the introduction of a revised tax rate table; and the social contributions (PIS/Cofins) from motorcycles, wheat, flower, and bread were eliminated. All this was done without compromising the fiscal balance or cutting social programs. We have also extended the reduction of IPI (federal excise tax) to capital goods.

Furthermore, the Brazilian economy is diversified and dynamic; Brazilian agriculture is expanding, and R$107 billion has been directed to the 2009/2010 harvest plan. Industry can respond rapidly to the stimulus, as we see in the sales of automobiles and home appliances; and the retail sector is active and well-structured. In the 12 months leading to June, retail sales have shown an accumulated increase of 5.7% compared with the same period the previous year.

In addition to the stimulus to the domestic market, Brazil and other raw-material-exporting countries in Latin America have been helped by importing by China and other Asian countries.

China has played a fundamental role in this process and it must be stressed the Chinese — even before the eruption of the crisis — had adopted measures to stimulate domestic demand and investment in production. Because demand increased in the Asian countries, particularly in China, our exports were not hit as severely due to good revenues from commodity trade. Our sales to the Chinese market expanded by 60%. By virtue of its domestic market potential, and because inflation has been kept under control and the country's foreign accounts have remained unshaken, Brazil will emerge from the crisis stronger.

In connection with the fiscal balance you mentioned that the primary surplus in the

In the medium term, the central bank policy rate could fall to 7% yearly, which corresponds to a real rate of about 3%, if inflation remains under control.

12-month period leading up to June was 2.04%. Is this year's 2.5% target still valid?

Yes. It is obvious that the tax exemptions we granted as part of the countercyclical policy and the ensuing decline in revenues had to bring the primary surplus down. Moreover, the positive operating results of Petrobras (the state oil company) have recently been excluded from the primary surplus calculations. Petrobras accounts for 0.5% of GDP. However, even excluding Petrobras we intend to achieve our 2.5% target in 2009, and we are counting on the economic recovery bringing us increased tax revenues in the second half of the year. For 2010 the primary surplus target is 3.3%. We should keep in mind that the US only recently started its stimulus program for purchasing automobiles. Brazil started granting excise tax breaks for purchasing automobiles in December last year and the program is still on. It is also worth pointing out that the five-point reduction in the central bank interest rate — from 13.75% yearly in December last year to the current 8.75% — is reducing domestic public debt service. Also, Brazil has a sovereign fund that represents 0.5% of GDP in primary savings.

In the present circumstances, reserves tend to grow. They could very well end up at about US$250 billion or higher.

Despite all this, the business community is discontented. With a 12-month inflation projection of 4.07%, the real base interest rate is 4.50%. Businesspeople, as well as some economists, consider this real interest rate too high when compared with rates in other countries. With inflation at about 4%, the policy rate could be lowered to 7%, which would mean a real rate of about 3%. How do you see this issue?

For many years Brazil had to live with excessively high interest rates, be it the central bank policy rate or the effective rates on bank loans. That is no longer justified. Within the next 18 months we will be able to move our base interest rate close to that in other emerging countries. In the medium term the central bank policy rate could fall to 7% yearly, which corresponds to a real rate of about 3%, if inflation remains under control. This is about the same level as Mexico's under normal circumstances. We are heading in that direction.

As far as public banks are concerned, what exactly was their concrete influence during the crisis?

Some results can already be celebrated, namely the reduction in the cost of credit to businesses and individuals borrowing from public banks, which operate in line with the government's direction. They also play a very important role in carrying out countercyclical policy. Starting in September 2008, with the crisis deepening, the credit operations of public banks increased by 25.2%, significantly above national private banks (19%) and foreign banks (2.6%). The share of public banks in the total balance in the national credit system reached 38.6% in June this year.

Banco do Brasil, Caixa Econômica, and the other public banks have reduced their spreads, which the private banks believe to be a reckless measure considering the default rates. Commercial banks, on the other hand, have been raising their provisioning for nonperforming loans. Have the risks increased or decreased today?

Banco do Brasil's loan default rate is low, and operations are conducted according to strict technical criteria. Inexpensive credit is easier

to repay. By increasing the supply of credit and making it cheaper, the public banks help to inject oxygen into the economy and business in general. Their margin is lower, but the banks make more money on a greater volume of loans. It is obvious that when a bank raises provisioning and interest rates for fear of default, it is increasing the nonperformance risk. In other words, banks that do so are fuelling default, and when it happens, that gives them another excuse to raise interest rates further.

Exporters, particularly those exporting manufactured goods, often complain about the exchange rate. The Central Bank's market report, "Focus," projects the exchange rate of the real against the US dollar to be R$1.85 by year-end, which would render sales impossible. What measures could the government take in this situation?

This is a consequence of the Brazilian economy's virtue, and a problem that existed before the crisis. With the sound fundamentals of the Brazilian economy and with the quality of the adjustments made, we have the potential to grow at about 5% a year, in contrast with other developed or developing countries. Brazil is an attractive destination for new foreign investment, be it direct investment, stock exchange investment, or to a lesser degree investment in government bonds; the country's foreign accounts are in good order. Exports will decline this year, but they should remain between US$158 billion and US$160 billion, generating a trade surplus of US$23–US$25 billion. The current account external deficit is estimated to be about US$15 billion, which could be covered easily by foreign revenues of about US$50-US$60 billion, allowing for an increase in official international reserves.

In 2008, according to the Growth Acceleration Program (PAC), the federal government invested 0.9% of GDP and Petrobras 1.3%. In 2009, the federal government will invest 1.2% of GDP and Petrobrás 1.7%.

Could the government introduce any changes to the current exchange policy?

One thing is certain: We will not abandon the floating exchange rate policy and will not resort to artificial measures like capital controls. What we can offer exporters are incentives to enhance competitiveness, better credit conditions, and a substantial improvement of infrastructure, which in Brazil accounts for significant costs. When our foreign trade stagnated, infrastructure became secondary. Today, this is no longer acceptable. We need to modernize our infrastructure substantially to remain competitive in international markets.

Excessive accumulation of foreign reserves, which as of early August were about US$213 billion, has also met with criticism, because it puts pressure on domestic public debt which according to market projections could reach 42.5% of GDP at the end of this year.

In the present circumstances, reserves tend to grow. They could very well end up at about US$250 billion or higher. Foreign exchange reserves will certainly be higher than precrisis levels. We are vigilant to avoid an increase in the debt-to-GDP ratio, which by the end of the year could be about 39.5%. But we are projecting a declining path: From 2010 onward, this ratio should fall to 36.5% and should be at most 33.4% in 2011 and 30.1% in 2012. It must be noted that the net debt-to-GDP ratio in other countries is

much higher than in Brazil, something which was aggravated by the crisis.

To sustain growth without inflationary consequences, investment in increasing capacity is needed, which most companies still hesitate to carry out, at least for the moment. Can this trend be reversed?

If foreigners see opportunities, Brazilian businesspeople will also know how to take advantage of them. A survey conducted by the Getulio Vargas Foundation found that the confidence index in industry, which sank to its lowest level in the last few months of 2008, is now rising, as is capacity utilization in industry. The National Bank for Economic and Social Development (BNDES) today has US$80 billion available for investment, four or five times more than the World Bank, and applications for disbursements are increasing. On the other hand, the government has been investing all it can of its own as well as Petrobras resources. In 2008, according to the Growth Acceleration Program (PAC), the federal government invested 0.9% of GDP and Petrobras 1.3%. In 2009, the federal government will invest 1.2% of GDP and Petrobrás 1.7%.

Will investments be led by the building sector?

Construction activity, both small and large projects, is already expanding. In addition to the PAC investments, R$28 billion in subsidies and R$60 billion in investment is projected for the housing program, My House My Life. The contribution of this segment will therefore be significant. The effects are already visible in employment. According to the latest data from the General Registry of Employed and Unemployed Persons (CSGED), the formal labor market created 138,400 new jobs in July, mostly in construction and industry. In industry, the segment most severely affected by the crisis due to the fall of manufactured good exports, 17,300 jobs were created, which indicates that a recovery is underway.

By our estimates, 600,000 to 700.000 new jobs will be created in 2009, which in a year marked by the crisis is certainly positive.

What is your projection for job creation this year?

By our estimates, 600,000 to 700,000 new jobs will be created in 2009, which in a year marked by the crisis is certainly positive. Starting in the fourth quarter of the year, the figures will be even more encouraging because the economy will be much more vibrant.

What lessons can Brazil draw from the crisis?

Brazil has been through a real stress test, and the economy has proved to be solid. We have also shown that we have the capacity to conduct countercyclical policies. In previous crises, the measures were procyclical. It is interesting that the last countercyclical set of policies conducted in Brazil in previous decades was the second National Development Plan (II PDN), launched in 1974. During the current crisis, we have been able to conduct an expansionist monetary policy, reducing base interest rates significantly. And government fiscal policy has been proactive. The Brazilian economy was put to the test and has overcome the obstacles.

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BRAZIL
UNITED STATES
SOUTH AMERICA

Movements on the international chessboard

Brazil and the World

	Rank	2008 GDP Billions of US dollars	Rank	Population 2008 Millions	Rank	Income per capita 2008 US dollars	Exports 2007 Billions of US dollars	Imports 2007 Billions of US dollars
United States	1	14,204	3	304	11	46,970	1,162	2,020
South America		4,016		385		10,425	440	350
Argentina	22	572	32	40	76	14,020	56	45
Bolivia	88	41	82	10	141	4,140	4	3
Brazil	9	1,976	5	192	95	10,070	161	127
Chile	45	242	57	17	81	13,270	68	47
Colombia	27	396	29	44	103	8,510	30	33
Equador	61	108	65	13	111	7,760	14	14
Guiana	155	2	157	1	161	2,510	1	1
Paraguay	101	29	100	6	133	4,820	3	7
Peru	43	245	39	29	106	7,980	28	20
Suriname	146	4	163	1	115	7,130	1	1
Uruguay	84	42	130	3	84	12,540	4	6
Venezuela	30	358	41	28	83	12,830	69	46
World		69,698		6,692		10,415	13,950	14,244

Sources: World Bank (www.worldbank.org), World Trade Organization (www.wto.org); and IBRE/FGV staff elaboration.

Brazil's relations with and the United States and the countries of South America resemble a cautious and complex political game of chess. Today, thanks to its large and vibrant economy, market-oriented policies, and stable democracy, Brazil is seen as a respected interlocutor, skilled negotiator and independent mediator, able to find shortcuts in search of collaborative solutions among countries of diverse political persuasion and social background. Bulmer-Thomas believes that "Having Brazil as a permanent member of the UN Security Council, with or without a veto, should be very beneficial." In particular, "Brazil could serve as a center of development and political stability in Latin America," as Walter Mead pointed out. But Brazil's new role, according to Cervo, has been nevertheless challenged in South America by other competing political currents such as the more radical Venezuelan-born Bolivarianism. To strengthen its role, Brazil counts on the change of views in Washington, as the Obama Administration is searching for a reliable partner at the negotiating table in a region marked by contrasts and challenges.

Brazil and the World

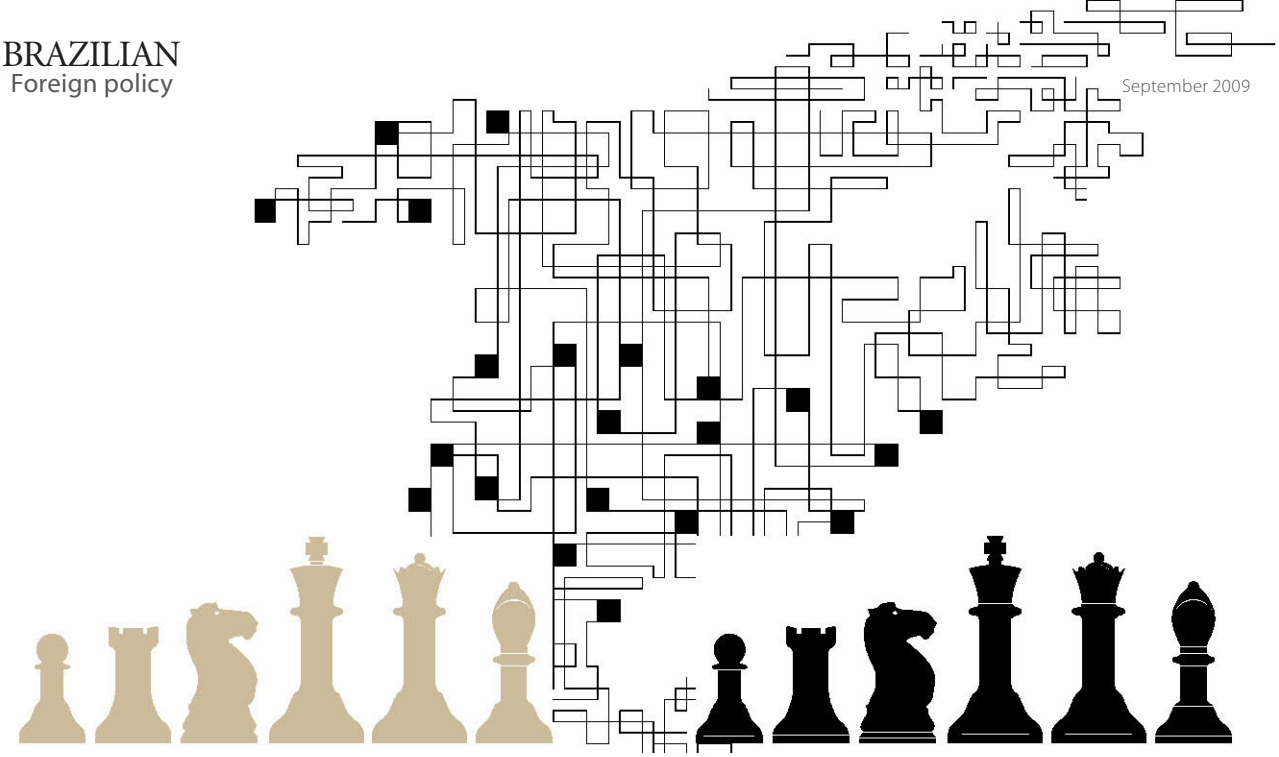
(percent of the total)

	GDP	Population	Income per capita	Exports	Imports
United States	20.38	4.54	450.99	8.33	14.18
South America	5.76	5.76	100.10	3.15	2.46
Argentina	0.82	0.60	134.61	0.40	0.31
Bolivia	0.06	0.14	39.75	0.03	0.02
Brazil	2.84	2.87	96.69	1.15	0.89
Chile	0.35	0.25	127.41	0.49	0.33
Colombia	0.57	0.67	81.71	0.21	0.23
Equador	0.15	0.20	74.51	0.10	0.10
Guiana	0.003	0.01	24.10	0.005	0.01
Paraguay	0.04	0.09	46.28	0.02	0.05
Peru	0.35	0.43	76.62	0.20	0.14
Suriname	0.01	0.01	68.46	0.01	0.01
Uruguay	0.06	0.05	120.40	0.03	0.04
Venezuela	0.51	0.42	123.19	0.50	0.32
World		100.00	100.00	100.00	100.00

Sources: World Bank (www.worldbank.org). World Trade Organization (www.wto.org); and IBRE/FGV staff elaboration.



[1] Interview, *The Brazilian Economy*, February 2009.

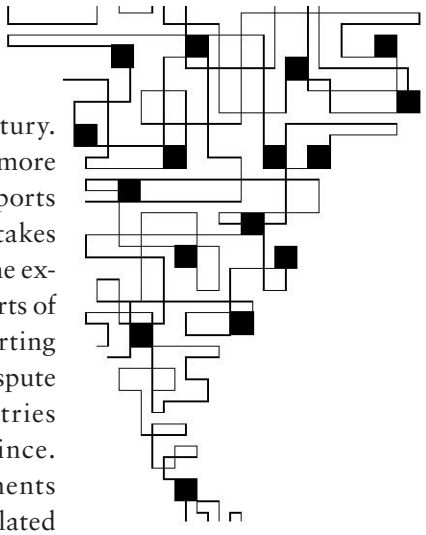


Brazil's relations with Latin America and the United States



Sebastião do Rego Barros

Since the beginning of the republic Brazil has sought to build a special relationship with the United States. In foreign policy matters, it pursued a position of automatic alignment that lasted until the second half of the past century. But the US market took more than half of Brazil's exports up to the 1950s; today, it takes only about 20 percent. The expansion of Brazilian exports of manufactured goods starting in the 1960s began a dispute between the two countries that has only grown since. At first, the disagreements were limited to issues related to trade and development; later, after the 1973 oil crisis, they extended to a broad variety of international issues, among them the Middle East, democracy, human rights, the environment, and nuclear proliferation.



Relations between Brazil and Latin America for most of the past century were proper but reserved, except

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In dealing with Latin American problems, the United States and Brazil have, perhaps for the first time, positions that if not completely identical are at least converging.

for the River Plate Basin countries — Argentina, Uruguay, Paraguay, Bolivia — and to a certain extent Chile. Until the 1970s Brazil's trade with the region was rather modest. The scenario changed significantly with the rapprochement between Brazil and Argentina in the 1980s. With the defeat of Argentina in the Falklands War, the decline of military interventions into civil affairs in the Southern Cone countries, the debt crisis, and the accelerated expansion of international trade, the conditions were in place to advance regional cooperation. The 1988 Treaty for Integration, Cooperation, and Development between Brazil and Argentina and the understanding between the two countries in the nuclear field opened the way for the creation of Mercosur in 1991. The consolidation of the country's geographical identity was even captured in the Brazilian 1988 Constitution: "Brazil shall seek economic, political, social, and cultural integration of the Latin American peoples with a view to creating a Latin American community of nations."

To better grasp the impact of the rapprochement of Brazil with Argentina, Paraguay, and Uruguay, note that Brazilian trade with those three countries increased from $2.8 billion in 1988 to $18.3 billion in 1998 and to $36.7 billion in 2008. Brazilian trade in Latin America as a whole, including Mercosur, accounted for little more than 10% of all Brazilian exports in 1988 but reached almost 20% in 2008. Trade with the United States, our almost exclusive market in the past, went in the opposite direction: It dropped from 20% in 1988 to 14% in 2008. Moreover, Brazilian exports to Latin America, particularly to Mercosur, have higher added value than its exports to the rest of the world.

When Fernando Henrique Cardoso took charge as Minister of Finance in 1993 before later becoming president, Brazil had just come out of years of chaotic economic management, and Latin America suffered constant pressure from its large foreign debt and the recommendations of the Washington Consensus — a set of neoliberal measures directed to fiscal discipline, opening of trade, abolition of barriers to direct foreign investment, privatization, economic deregulation, and protection of intellectual property rights.

During the Cardoso administration, if relations with the US were not perfect — issues like access to the American agriculture market and a lack of enthusiasm on the part of Brazil for the Free Trade Area of the Americas (FTAA) still divided the two countries, as had happened before as well as today — at least the negative and most politically loaded issues, such as democracy, human rights, the environment, and nuclear proliferation, had disappeared from the agenda.

The internationalization of Brazilian interests has caused Brazil to become concerned about stability and order in the Latin America region; in the past these were exclusive concerns of the US.

On Brazil's part, elimination of foreign debt as a political problem, economic stability, and a firm and constructive role on the international scene all helped lend more respect and maturity to relations between Brazil and the US.

On the Latin American front there has been progress, such as the expansion of Mercosur, good relations with Argentina, the efforts of the Brazilian foreign office to bring about a lasting peace between Peru and Ecuador, and the first summit of the South American presidents. Nonetheless, internal problems, the lack of concrete results from the neoliberal recommendations, and the financial crises that erupted between 1994 and 2003 in different parts of the emerging world — in Mexico, Asia, Russia, Brazil, and Argentina — led to the rise of several leaders, led by Hugo Chávez, who were willing to run against the prevailing political and economic ideas. In 2004, as an alternative to FTAA and under the Venezuelan initiative, the Bolivarian Alternative for the Americas (ALBA) was created. Today it comprises nine countries: Antigua and Barbuda, Bolivia, Cuba, Dominica, Ecuador, Honduras, Nicaragua, Saint Vincent and the Grenadines, and Venezuela. Bolivarianism is a movement whose purpose is to recreate Latin America, where supposedly independence movements have failed in their objectives because the ruling classes remained in power. Among the many and ambitious objectives of Bolivarianism are the expropriation and nationalization of a significant part of the economy; redistribution of property and revenues; control of the press; cessation of the privileges of the bourgeoisie; and re-establishment of the Great Colombia as idealized by Simon Bolivar.

Meanwhile, President Lula has been able to preserve and even improve the level of understanding between Brazil and the United States. His good personal relations with President George Bush; American concern about the radicalism of Hugo Chávez, Evo Morales, and Rafael Correa; and Argentina's instability compared with Brazilian stability have turned Brazil into a privileged interlocutor of the US in Latin America. The Fourth Summit of the Americas, which took place in Argentina in 2005, was a moment of great tension in the hemisphere, and countries were divided into two camps: for and against the FTAA. Immediately after that meeting in Mar del Plata, President Bush met with Lula in Brasilia. During that encounter the two leaders agreed on a series of priorities, including biofuels, cooperation in Africa, the peace mission in Haiti, and ways to deal with the radical leaderships in South America. Thus a strategic dialog was established between Brasilia and Washington.

Brazil has insisted on South American integration and intends to use Unasul (the Union of South American Nations) and the South American Defense Council as a sort of decompression chamber, or as a bulkhead against Bolivarianism. Admittedly, no progress has been made in recent years in economic integration forums such as Mercosur or Aladi, but in times of radical political change in parts of the region mere preservation of the status quo is a gain in itself, particularly when the most important economic partners of Brazil in the region, Argentina and Mexico, are going through a critical period of political and economic instability. Dealing with the aggressiveness and demands of Hugo Chávez, Evo Morales, Rafael Correa, and Fernando Lugo; acceding to some claims while dismissing others; and preserving a good relationship with those difficult interlocutors is a feat that must be acknowledged and credited to President Lula's political talent.

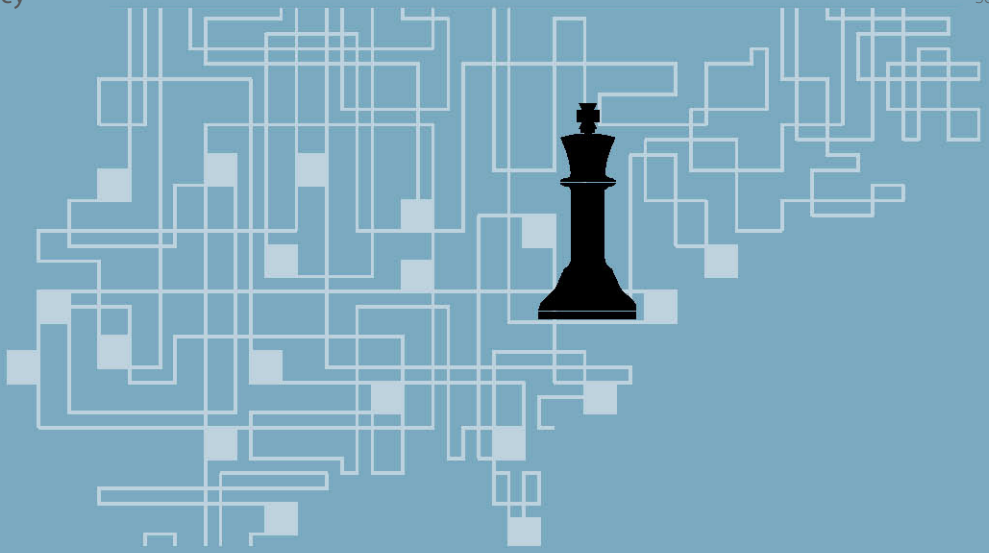
In early 2009 Barack Obama took office with an intent to improve relations with the Latin American region. The atmosphere of the Fifth Summit of the Americas last April, attended by Obama, was completely different from that of the previous meeting. Although no concrete decisions were announced, the first meeting between the new American president and his counterparts proved that there is a general willingness to try to develop a more constructive agenda for the Americas than that of the Bush administration. Furthermore, in the Organization of American States the United States has shown a disposition to change by accepting the reintegration of Cuba.

Brazil plays a crucial role in this effort because of its size, democratic conditions, political stability, and prospects of economic growth and social achievement. Whether at the bilateral, regional, or international level, there is room for good relations between Brazil and the United States. The environment and renewable sources of energy, financial reconstruction, defense, oil and gas, and the fight against drug trafficking are all issues on which the two countries could find ways to work together constructively.

There is no indication, however, that the American protectionism that particularly affects Brazil is to be reduced. Brazilian exports of ethanol, sugar, orange juice, tobacco, chicken and beef, steel products, and other goods will continue to encounter a wall of protectionism. At the World Trade Organization Brazil and the US will continue to defend different positions on the issues that have prevented the Doha Round from advancing.

The reconstruction of a new world financial order is a vital issue where Brazil could play a useful role; on this there should not necessarily be a conflict between the developed and the emerging world. Perhaps it is here that the United States and Brazil will find room for significant cooperation, postponing the debate on issues related to market access and the Doha Round to a more opportune date.

In dealing with Latin American problems the United States and Brazil have, perhaps for the first time, positions that if not completely identical are at least converging. The internationalization of Brazilian interests — owing to significant investments and credit abroad, the presence of Brazilian peace forces abroad, and the future exposure of Brazil's large offshore "pre-salt" oil reserves to international insecurity — has caused Brazil to become concerned about stability and order in Latin America; in the past these were exclusive concerns of the US. President Obama will need to work hard to avoid the errors of his predecessors, who treated Latin America as a homogeneous entity as seen from north of the Rio Grande. Brazil's dimension and importance on the one hand, and the birth of Bolivarianism on the other, will no longer allow for simplistic views from the past.



Time for a New Brazil-US Partnership



Walter Russell Mead

Brazil today stands before what could well be the greatest opportunity in its long history. Three factors have come together to create this moment. Two of them are well understood in Brazil and need little commentary from abroad:

First, the dramatic economic development of Brazil, combined with the increasing maturity and capability of Brazilian democracy, has substantially increased Brazil's influence in the region and beyond. Brazil has become an engine of growth, an important source of capital, and a model for many of its neighbors.

Second, Latin America today is divided between countries like Brazil and Chile that seem to have found a relatively stable approach to long-term development and countries still trapped in alternating cycles of ineffective oligarchy and authoritarian populism. Brazil's experience of finding a new and more

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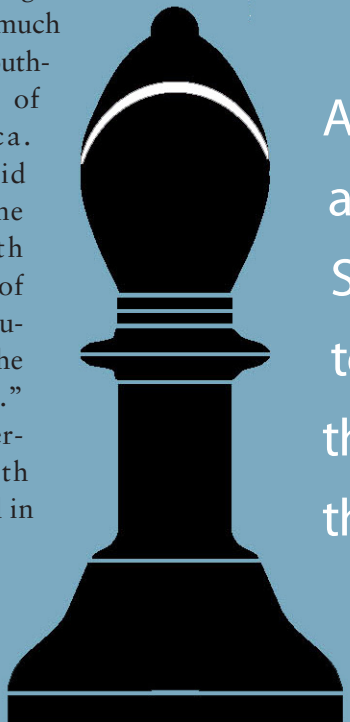
stable development path and avoiding the uncritical adoption of foreign economic and social models, whether manufactured in Washington or elsewhere, offers real hope to citizens in neighboring countries looking to achieve similar success.

The third, less well understood, factor creating a moment of historic opportunity for Brazil stems from changes in the role of the United States in the region. The changes in Washington's hemispheric priorities stem from deep historical forces and are likely to last. From the 1940s until very recently, the US was deeply engaged in the politics not only of the Caribbean and Central American countries close to its territory and to the Panama Canal but also of countries throughout the South American mainland.

Before 1940 it was rare for Washington officials to give much thought to the southern two-thirds of South America. Washington did not at that time consider South America part of what Vladimir Putin would call the "near abroad." Britain and Germany were both more influential in many South American countries than was the United States, and from Washington's perspective, this was not a problem. When Brazil was selected as a permanent member of the Council of the League of Nations (the equivalent of a permanent seat on the UN Security Council today), the US did not perceive this as a challenge to its position in the hemisphere.

Competition — This changed during World War II because the US believed that Axis influence anywhere in the hemisphere could endanger US security. The Cold War saw a dramatic and sustained increase in US interest and concern with the entire hemisphere. Engaged in a global ideological contest with a Soviet communism that, potentially, could find armed allies throughout the world, Washington policy makers in the Cold War believed that the prevention of communist rule in Latin America was an important national interest. They acted accordingly. Some of the policies adopted in these years were farsighted and effective, others less so. However, whether the US was engaged in ventures like the Kennedy-era Alliance for Progress or whether it was supporting military juntas with dismal human rights records, it was more deeply and intimately involved in South America than ever before.

That unusual degree of political interest coincided with an exceptional level of US economic interest and influence. During World War II Germany and Britain had both lost most of their economic power in the region; in the aftermath of the war, US capital quickly



A Brazil that is increasingly willing and able to lead facing a United States that has a new openness to a wider Brazilian role offers the hemisphere an opportunity that is too important to miss.

came to play a dominant role there.

Today, things are changing again. The United States has fewer security interests in South America and, with the rise of Asia, it is once again only one of a number of investors in and trading partners for South American countries.

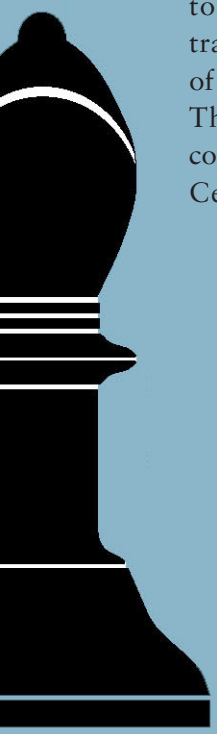
The United States is, in some ways, very pragmatic. When its vital interests are seriously engaged, it is capable of enormous and sustained engagement. But it does not seek power for power's sake; it does not usually seek influence or predominance in regions or on issues where its core interests are not involved.

Return — With the end of the Cold War the US began to move back toward its traditional bifurcated view of its hemispheric interests. There is a zone of intense concern embracing Mexico, Central America, and the republics of the Caribbean. Beyond this historic focus of American interests, the US seems disposed to return to its historically lower profile in much of South America.

This new approach — or this revival of an older one — can open a new era both in Brazilian foreign policy and in US-Brazilian relations. At a moment when Brazil has a greater capacity to lead, and when there is a greater need than ever before for Brazilian regional leadership, the United States seems ready to take a more benign view of Brazilian power than previously. Managed wisely on both sides, the process of leveraging Brazil's experience and success into a force for regional transformation could bring Washington and Brasilia closer rather than drive them apart. Indeed, managing the bilateral relationship well could enhance Brazil's prospects for playing the kind of regional and global role it has historically sought.

Even farther north, in the Caribbean region of greatest interest to the United States, strong and steady Brazilian leadership can contribute to the economic and social development of the hemisphere in ways that provide the stability that Washington seeks even as authentically regional institutions and approaches replace the current more US-centric models.

This new configuration of forces — a Brazil that is increasingly willing and able to lead facing a United States that has a new openness to a wider Brazilian role — offers the hemisphere an opportunity that is too important to miss. A new and deeper dialog between Brazil and the United States, one that extends well beyond official government channels to include intellectual, political, and social leaders from many walks of life, can help us all explore the new and exciting possibilities opening before us.





The "find five errors" game

Marco Antonio Villa

Brazil's economic weight is a problem for the country's diplomats. The Ministry of Foreign Affairs seems to be uneasy with the size and international relevance of the Brazilian economy. When a dispute arises (as is completely normal in international relations) between Brazil and a neighboring country, the reaction of the diplomats is to take a step backward, as though any more assertive reactions would be seen as a wish to exert imperialist hegemony. Resolution in negotiations, without ever neglecting the defense of national interests, has become, for the Foreign Relations Office, synonymous with coercion, dominance, and imposition. Nothing could be more untrue.

For instance, Argentina has systematically violated the Mercosur trade agreements. The Brazilian diplomatic response has been timid, seeking to avoid confrontation. This attitude boosts the Argentine policy of putting the interests of its own producers and market first, at the expense of the Mercosur agreements. Although this has been evident for years, it has intensified since 2003. A recent example is Argentina's economic rapprochement to China, which causes heavy losses to Brazilian industries, such as shoes, but did not provoke any action by the Foreign Ministry. It is as if the neighboring country were a sort of younger sibling, still not fully responsible for its actions; it is up to Brazil to forgive provocations because what is important is the preservation and expansion of Mercosur. This policy has turned out to be a failure. It has generated serious problems for sectors of the Brazilian economy that export to Argentina. What is worse is that it incites neighboring countries to make trade demands on Brazil without offering anything in return.

Misconceptions —The most serious case is that of Paraguay. Not only did the Foreign Office support all of President Lugo's demands, it also adopted Paraguay's policy toward Brazil as its own. In other words, rather than understanding that the problems with Paraguay were the result of its own domestic processes, the Foreign

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Brazilian foreign policy toward Argentina, Paraguay, Venezuela, and Bolivia has accumulated a number of defeats. The relentless search for agreement at any cost has undermined Brazilian interests in South America.

Office adopted the rhetoric of resentment typical of that country, as though Paraguay's economic backwardness were a consequence of Brazilian exploitation, a mere continuation of the imperial expansionist policy that led to the 1864 war. A double mistake: Paraguay's severe social problems are the outcome of actions by the Paraguayan political elite, and the 1864-1870 war was essentially the result of the aggression of Solano Lopez, who invaded Brazil and also took a series of clearly provocative measures. Accepting President Lugo's impositions should be recognized as the harmful consequence of a foreign policy based on unsound historical and political foundations. This in itself is worrying.

Brazilian diplomacy has also adopted an extremely tolerant policy with regard to Venezuela. More concerned about the business of Brazilian companies operating in that country and the exports that are increasing year after year, the Foreign Office has been systematically silent before the constant violations to freedom of the press perpetrated by the Chávez administration. Brazil has also failed to pay due attention to the expressive rise in Venezuela's military spending. Venezuela is today the largest purchaser of weapons in the southern hemisphere, which might well trigger an arms race in the region. It cannot be overemphasized that Venezuela has serious political problems with Colombia and a pending territorial claim with Guyana; in addition, it borders Brazil in the Amazon region.

Expropriation — Bolivia in its turn has imposed new conditions for the sale of its gas. And the Foreign Office has acquiesced. Bolivia occupied and expropriated property belonging to Petrobras, the Brazilian state oil company. The Brazilian government did nothing — a firm reaction would have been regarded as support to Evo Morales's opponents. The Brazilian Foreign Office has replaced defense of the national interest with ideological support for a political current in Bolivia. National assets or bilateral treaties were ignored for political and partisan interests.

Oddly, the only country that has tried to build a friendly relationship with Brazil is Colombia, a country that also shares a long Amazonian border with us — but no signs of friendship or good will came out of the Foreign Office, although it had plenty of opportunities. Instead, during the negotiations for the release of hostages held by the armed revolutionary forces of Colombia, Brasilia criticized the Colombian government on several occasions, showing no deference toward the country. Likewise, it joined President Chávez in denouncing the military cooperation agreement recently signed by Colombia and the United States.

Brazilian foreign policy toward Argentina, Paraguay, Venezuela, and Bolivia has accumulated a number of defeats. The relentless search for agreement at any cost has undermined Brazilian interests in South America. None of the four countries is an ally of Brazil in international forums. The Brazilian Foreign Office has made substantial concessions and received nothing in return. What is worse: it has shown that there is an inverse relation between the weight of the country's economy and its foreign policy.



Brazil in South America: Three conflicting ideas

Amado Luiz Cervo

In the 21st century South American governments see themselves as leftist governments replacing neoliberals. They are concerned with social inclusion, and they speak with respect for elections and democracy. These common perceptions foster a certain degree of solidarity that allows Brazilian diplomats to function as a regional stabilization force.

Dispersion — The left does not articulate conditions for governability throughout the region. The relationship between state and society and social inclusion programs evolve outside integration processes and foreign policies, and are at times removed from the development paradigm.

Social programs are introspective: each nation seeks to apply its own prescriptions to mitigate domestic society's ills, using its own resources and strategies. The bolder countries, such as Venezuela, Bolivia, and Ecuador, have opted to "recreate the nation" by means of constitutional reforms designed to prevent the comeback of conservative leaders, preserve the current leaders in power, and hence complete income redistribution, which has recently been affected by the decline in commodities exports. Others, such as Brazil, Argentina, Chile, and Uruguay, introduce reforms to attain the same social inclusion, without cursing the past. Throughout the continent, the functions of the state are going through a metamorphosis, becoming so diverse that traditional political science cannot explain them.

The fact is that the cohesion and consistency of the neoliberal cycle are not repeating themselves in South America. In general, monetary stability and fiscal balance tend to be seen as positive outcomes that deserve to be preserved, and social inequality is seen as a negative consequence to be deplored. Brazil and Chile seek to raise systemic productivity by opening up their economies. Since Mexico chose to join the American bloc, the Brazilian project to transform South America into a political, economic, and security union has gained renewed force.

South America — Three concepts compete for political intellect and government strategies in South America. The Venezuelan-born Bolivarian concept is equivalent to a socialist project, based on a historical ideal of political union, on the doctrine of 21st century socialism, and on geopolitics for the choice of allies and foreign and domestic enemies. The Argentine-born commercialist concept advocates control of foreign trade as a means for re-industrialization. Finally, the Brazilian development concept envisions South America covered with factories, employment, income, and welfare for the masses — a modernization to be carried out preferably by Brazilian enterprises, which are considered superior structurally to those of neighbors, or by traditional transnational enterprises.

Why has none of the three concepts won general acceptance?

Our research has identified the concept of political conceit as best fitting the regional political culture and explaining, to some extent, the South American dispersion better than the concept of nationalism. Its features are imbalances between domestic means and external objectives, between actual regional or global roles and the planned role, between diplomatic arrogance and national substance. Nationalism opposes the domestic with the foreign; political conceit instead overestimates sovereignty and echoes the arrogance of the caudillo. This is why there are different models of international insertion.

International insertion — The Bolivarian model — introspective and nationalizing, driven by the Venezuelan leader Hugo Chávez and his Bolivarian Alternative for the Americas (Alba) — has supporters in Evo Morales in Bolivia and Rafael Correa in Ecuador. The two globalist models of international insertion cause mutual antipathy: the Chilean commercialist model and the Brazilian industrialist model. Based on free trade agreements, the commercialist model perpetuates the structural inequalities between an advanced economy and a primary-export-oriented economy. Chile is the example of this model, which gains supporters where neoliberalism is still admired, as in Peru and Colombia. The Brazilian industrialist model, on the other hand, adopts as a value the industrial vocation, seeking to foster and protect steps toward the country's structural maturity; it rejects agreements that might jeopardize this vocation. Brazil is the best example of this model, followed by Argentina.

But the project moves forward, nonetheless. It all started in 1993, when the Brazilian President Itamar Franco advanced the idea of the South American Free Trade Area (Alcsa) as an alternative to the American proposal of the America Free Trade Area (Alca). It persisted through the South American summits that began in 2000 and culminated in 2008 with the creation of the Union of South American Nations (UNASUR). Following these steps toward institutionalization, Brazilian projects and exports are expanding to the neighboring region — as much as the mishaps of course allow.

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Brazil's ambitions and the new world order



Victor Bulmer-Thomas

Brazil, although for much of its independent history a reluctant member of the Latin American club, has always been a regional power. Comparing itself with the United States rather than with other Latin American states, Brazil played a leading role in the Pan-American Union (PAU) from its foundation in 1889. When the PAU was replaced in 1948 by the Organization of American States (OAS), Brazil — now more comfortable in its Latin American skin — was once again a leading member.

With US administrations having been distracted since September 11, 2001, Brazil has been very effective at filling the space made available at the regional level by greater US focus on other parts of the world. Brazil, which in the 1990s was tempted to consolidate its position in South America alone, is now heavily engaged in the Caribbean and Central America as well and is likely to remain so.

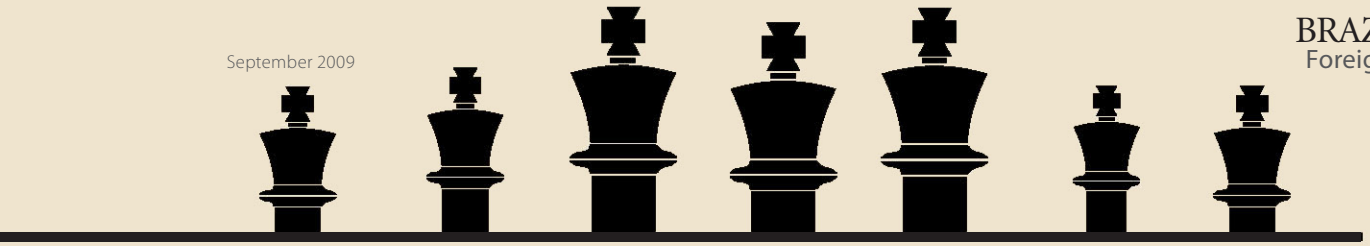
Brazilian engagement at the regional level is currently at a historic peak, helped not only by US priorities elsewhere but also by the self-inflicted wounds of Argentina, its once great rival. And though the outside world may focus on the histrionics of President Chávez, Venezuela is more like an unruly member of the family than a serious threat to Brazilian regional aspirations.

Leadership — Yet Brazil wants more. Starting in the 1990s, it began to aspire to a global leadership role. Although Brazil had played a very significant role in World War II and was one of only nine developing countries to join the GATT in 1947, its global leadership aspirations were of necessity postponed by a combination of inward-looking development, military government, and hyperinflation. It was only in the mid-1990s, when Brazil had finally tamed inflation, opened its economy, and consolidated its democracy, that a global role could again be considered.

Aspiration is one thing and achievement is another. Fighting for a place at the top table is not easy when those already there are not keen to share the banquet. However, Brazil has made impressive progress in 15 years. It is now a member of the G-20. It is also a regular participant at summits of the G-8, the club of rich countries founded in 1976 as the G-7, which Russia was invited to join in the 1990s. And if reform of United Nations institutions is ever agreed, Brazil is likely to join the Security Council as a permanent member alongside the five "official" nuclear states (US, China, Russia, UK, and France).

To the Brazilian elites and perhaps most Brazilians, all of this is self-evidently desirable. Brazil will be much better able to defend its national interests and shape the global agenda if it is at the top table. Future negotiations on climate change, for example, and the measures taken to mitigate the effects of

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Global warming will be crucial for Brazil. But what do Brazil's global aspirations mean for the rest of the world? To put it crudely, what is in it for all those countries whose support in the United Nations Brazil is so assiduously courting?

Many of the architects of the United Nations system hoped that it would be a step toward global governance and a step away from Great Power politics. Sadly, it did not turn out that way. The interests of the Great Powers were enshrined in their permanent seats with veto power on the Security Council, and the Cold War soon divided the permanent members among themselves. Furthermore, the end of the Cold War did not herald a move back toward global governance; instead it led to a brief period in which the United States thought it could change the rules of the game to establish global hegemony for at least a generation.

The Council — Most of the countries aspiring to a permanent seat on the Security Council would make little difference to the current world order if they were invited to join. Japan may not be a nuclear power, but its dependence on the United States for its security in the face of a rising China makes it extremely reluctant to play a truly independent role in international affairs. India, on the other hand, is a nuclear power acknowledged as such by the United States, but it is obsessed with security on the subcontinent and the threat of being eclipsed by China. In addition, India is the least progressive of all big states on the question of climate change and will be a drag on negotiations for many years to come.

That leaves Brazil, a non-nuclear state with an impressive international pedigree to its own credit. Having Brazil as a permanent member of the Security Council, with or without a veto, should therefore be very beneficial. Brazil has demonstrated on numerous occasions its independence from the current permanent members; it will work to free the world of nuclear weapons; it will be constructive on climate change negotiations; and it is not tied down by security concerns in its own region. Brazil's permanent membership of the Security Council is something that the rest of the world should welcome.

I share this view — but a word of caution is in order. Like other aspirants, Brazil will not move to permanent status without serving a long apprenticeship in the rich man's clubs. Yet these clubs (G-8, G-20, etc.) have no legitimacy in the eyes of many around the globe. These self-appointed unelected bodies, meeting under ludicrous security arrangements, pronounce at the end of each summit a long list of "promises" that are usually broken before the ink is dry. Brazil will not change the way these clubs operate. Yet it has no choice but to participate, for otherwise it will be branded a second-rate power. For Brazil's sake we must all hope that the apprenticeship it is forced to serve on these bodies is a brief one, and that Brazil, once elected a permanent members of the Security Council, will no longer feel the need to participate in this G-circus.

Having Brazil as a permanent member of the Security Council, with or without a veto, should be very beneficial.

Brazilian foreign relations with South America and the USA



Paulo Roberto de Almeida

The 15-year period from the early 1990s to the mid-2000s of US-Latin American economic relations was marked by the American project for a hemisphere free trade area. The project began as a hub-and-spoke structure to promote trade liberalization, with the US at the center of the "Initiative for the Americas," fathered by George Bush senior in 1990, and moved on to become the so-called Free Trade Agreement of the Americas (FTAA) in December 1994. In reality, though, the US government conceived it simply as a gradual extension of the North American Free Trade Agreement (Nafta) to the whole region. Following preliminary consultations from 1995 to 1999 — during which Brazil supported a building-blocks model, i.e., preserving existing structures, among them Mercosur (the Southern Common Market) — real negotiations started thereafter, when substantial differences among the main players became evident.

Brazil was always suspicious about the US real commitment to trade liberalization, especially in agriculture, where the powerful Brazilian agribusiness sector has its main competitive advantages. Those fears were fully justified when the mandate to negotiate approved by the US Congress in 2002 — the *Trade Promotion Authority* (TPA) — confirmed both the extremely modest US opening in areas considered most relevant for Brazilian export competitiveness, and the maintaining of restrictions in traditional industrial segments (usually labor–intensive sectors, but also steel). Brazil's sensitivities related mostly to industrial segments with high-technology intensity, the services sector, and investments and intellectual property rights. Both countries became co-chairs of the negotiating process in November 2002, thus having the power to determine the success or failure of the whole undertaking. Protectionist obstacles from both sides, compounded by the ill will of the new Worker's Party (PT) administration in Brazil toward the FTAA project, brought negotiations to a standstill at the November 2005 Mar del Plata summit. Meanwhile, the US had already

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initiated the "minilateralization" of its trade strategy, offering alternate models to different groups of countries and consolidating a network of trade agreements that, while excluding Mercosur, started to link a large number of economies in the hemisphere, including Chile, to the American model of free trade.

In the political sphere, the scenario was plagued by negative issues, such as drug traffic — and related 'spin-offs', such as narco-guerillas and organized crime — and illegal immigration, both tackled unilaterally by the US, and earning the antipathy of its main allies in the region. US attempts to settle the issues on the supply rather than the demand side did not stimulate the search for cooperative solutions to those problems. They ended up creating misunderstandings, acrimony, and accusations at bilateral or regional meetings. Some of the US initiatives, such as the Colombia Plan to fight narco-guerillas in that country, with billions of dollars in financial and technical support from Washington, aroused more suspicion than support — in Brazil and elsewhere. Political developments throughout the continent made a further major contribution to the deterioration of relations, as there emerged new leftwing political leaders clearly unsympathetic to the hegemonic center, and certainly opposed to the American goal of hemispheric integration based on trade opening and guarantees for American direct investment.

Notwithstanding this, Brazilian relations with the US on the one hand, and Latin American countries on the other, evolved positively. In spite of the expansion of investments and exports of manufactured goods, integration schemes behaved more erratically, while political frustrations arose about specific aspects of the double relationship. Changes in Brazil-US relations have been scarcely perceptible: there was no change at all in trade disputes. Personal relationships between the leaders evolved, from the real empathy of the Fernando Henrique Cardoso-Clinton era — the American president went so far as to invite the Brazilian head of state to his Camp David residence, and they maintained substantive dialogue — to the false cordiality of the Lula-Bush era, when there were careful manoeuvers to minimize disagreements on FTAA, the Doha Round, the environment, sectoral protectionism, security issues, etc.

The Brazilian concept for South American integration is being challenged by the alternate political and economic model of the Bolivarian countries led by Hugo Chavez.

In its relations with continental neighbors, the Brazilian government strengthened the policy, initiated by the previous administration, that privileged the South American perspective over the more politically vague and geographically too broad idea of Latin America. The government launched a series of initiatives, primarily aimed at overcoming the American "imperial tutelage" over the southern part of the hemisphere. Although the Mercosur crisis only deepened after the 1999 devaluation and floating of the Brazilian

currency, and the 2001-2002 severe crisis in Argentina that increased its protectionism against Brazilian exports, Brazil launched ambitious projects for physical integration and political coordination; so far they have failed to deliver the desired results. Even with the relative resumption of commercial flows, trade in Mercosur lost its former importance; the bloc survived only thanks to cultural, social, and educational projects, and to initiatives that were essentially political in nature, such as the Mercosur Parliament. The Brazilian proposal for a South American Community of Nations (CASA) launched in Peru in December 2004 has been transformed into a Union of South American Nations (Unasul), with a secretariat in Quito, thanks to manoeuvers by Brazil's major competitor for regional leadership, President Hugo Chavez of Venezuela.

The issue of alleged Brazilian regional leadership was not perceived positively by

Lula's diplomacy with the



Marcelo Fernandes

To better understand Brazil's relations with the United States and with South America under the Lula administration, we must refer to the foreign relations mantra chanted by the PT (Labor Party). When they were in opposition, PT members always spoke to the need for more fairness and justice in international relations. They stressed the need for a more humane and less excluding globalization, to be created in the context of Latin American regional integration. They further affirmed the belief that peace, security, and development could not be dissociated from the whole: national political autonomy and economic development, upon which a safer and more stable international order ought to be built.

The concrete manifestation of these PT values in Lula da Silva's administration was adoption of the fundamental premise of "autonomy through assertiveness." That postulate implied that contemporary Brazilian diplomacy should design and follow a more assertive and aggressive foreign policy in defense of the country's interests in the world. Only then would Brazil enjoy both political autonomy and guaranteed economic development.

Multilateralism — In adopting that course of action, the Lula administration chose to reinstate multilateralism as a viable organizing principle for foreign policy. That principle should be understood as part of a broad movement toward decentralization and regulation of power in international society.

The practical implications of Brazil adopting this political option are apparent in the creation of IBSA (the initiative of India, Brazil, and South Africa to promote South-South cooperation and exchange); participation in the creation of the G-20 (the group of developing countries established in preparation for the 5th World Trade Organization Ministerial Conference; rapprochement with African and Arab countries; participation in the G-4 (the group comprising Germany, Brazil, India, and Japan that supports reforms at the UN Security Council and gaining a permanent seat on the Council); leadership of the UN peace mission in Haiti; participation in the BRIC group (comprising the four major emerging countries — Brazil, Russia, India, and China); Brazil's active engagement in the debates on the international financial crisis; and the supposedly strategic partnership with China (which in reality has meant increasing costs in terms of trade for South America).

Together, those multilateral initiatives, primarily in the South, have distanced Brazil from classic partners like the United States and the European Union and have served to mitigate the effects on it of the international crisis that erupted in the developed world; they have also earned Brazil and its partners in the South a privileged position as new international rules to

neighboring countries. Despite Brazil's efforts, projects aiming at physical integration and at trade liberalization have not been realized to the extent. As expected Unasul has been charged with the tasks of security and coordination of strategic issues through the South American Defense Council; however, the institution still lacks recognition as a central institution for South American integration. In December 2008, Brazil launched a new initiative: a Latin American summit in Bahia, said to be the first ever held without the presence of the "imperial power." Brazil has also been active in the reintegration of Cuba into regional schemes like Aladi (the Latin American Integration Association) and the Rio Group, and is leading the charge for its reintegration into the OAS. Notwithstanding, the choices made by the "Bolivarian" countries led by Hugo Chavez, and their alternate political and economic models, continue to challenge the Brazilian concept of regional integration.

US and South America

promote the resumption of global economic and social growth are being discussed. This has secured Lula both Obama's appreciation ("I love this guy") and an invitation to be a governor of the World Bank once his mandate is over! But notwithstanding those achievements, and despite significant investment, Brazil has failed to gain the support of the Chinese for a permanent seat on the UN Security Council.

Costs of leadership — Another important factor in the Lula administration's relationships in the world are its willingness to take on the costs of leadership in the world, especially in Mercosur (the Common Market of the South) and in South America, where Brazil has been prominent in seeking peaceful solutions to regional crises. Brazil has been exerting its regional leadership, with US consent, particularly since the implosion of the FTAA (Free Trade Area of the Americas). Some concrete facts help illustrate this trend: The cancellation of the debt of smaller South American countries that President Lula has announced; acquiescence by the country's diplomats to Bolivia and Paraguay when strategic interests (gas and electricity) were at stake, to the Chavez administration's assaults, and to Argentina, a country that frequently breaches Mercosur external tariffs against Brazil's trade interests in certain industrial segments; and the peace mission in Haiti.

Those positions could have eased Brazilian relations with its South American counterparts, lending Brazil legitimacy to seek a more equitable dialogue with the United States about Latin America's destiny. Nonetheless, the Brazilian stance that "the principle of non-intervention must be seen in the light of another norm based on solidarity: non-indifference," has generated regional uneasiness. This new principle has been interpreted as a sign that, if need be, Brazil could play an "imperialist" role in the region. That has been raising difficulties in the negotiations to broaden the Unasul project (the Union of South American Nations) — a project that would benefit Brazil most.

To sum up, assertiveness as a diplomatic tool to secure political autonomy and economic development has brought about both positive and negative results for Brazil. The positive consequences include the enhanced importance of Brazil in major international debates, contributing to a fruitful dialogue with the United States. But it has also imposed economic and political losses in the immediate region that will translate into significant costs in the future. In fact, we have traded our intermediary position in the developed world for an unstable leadership position in the poor world.

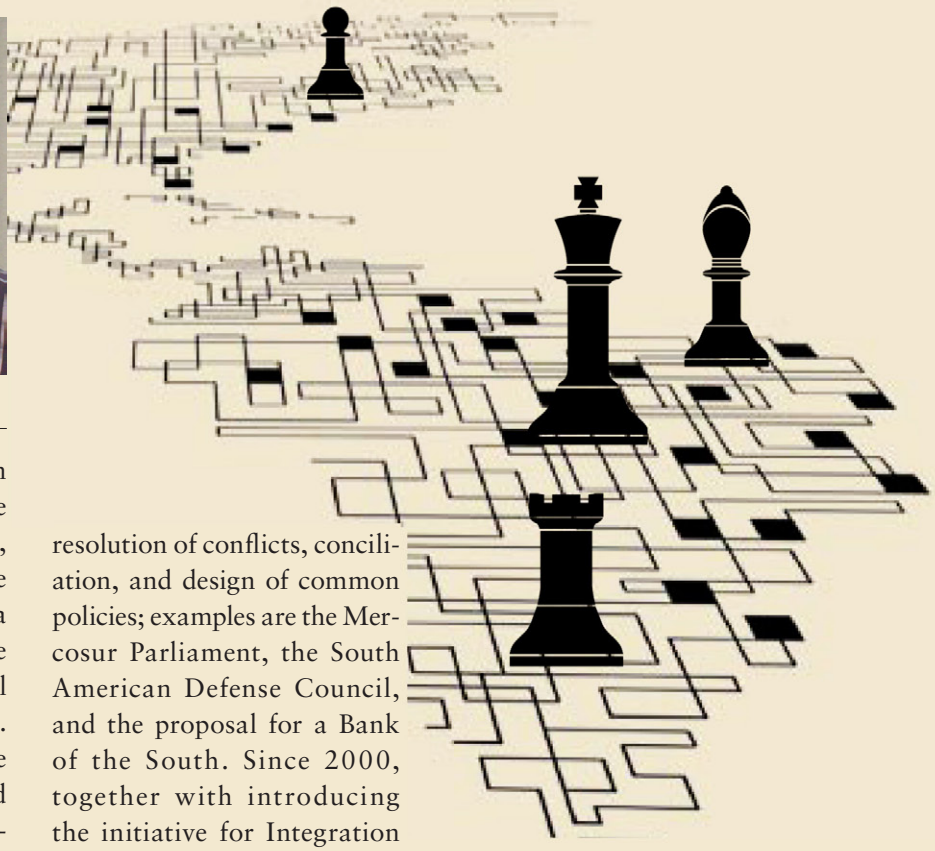
> Lula's administration has been willing to take on the costs of the country's leadership in the world, especially in Mercosur and in South America.

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Brazil and its regional challenges



Cristina Soreanu Pecequilo



The growing role of Brazil in summits of the G20 group, the IBSA trilateral (India, Brazil, and South Africa), and the BRICs (Brazil, Russia, India and China) has raised the issue of whether Brazil's regional policy should remain as it is. One argument is that the sole privileged relationship should be the one with the US; another is that Brazil's presence in South America should be reduced because it represents an obstacle to Brazil's growing global role. Those mistaken conceptions overlook the historical and strategic elements of the horizontal and vertical axes of Brazilian regional policy.

On the horizontal dimension — South America — the agenda is to firm up bilateral partnerships and integration. These complementary efforts both point to strengthening multilateralism as well as building institutional consultation mechanisms for the resolution of conflicts, conciliation, and design of common policies; examples are the Mercosur Parliament, the South American Defense Council, and the proposal for a Bank of the South. Since 2000, together with introducing the initiative for Integration of Regional Infrastructure in South America (IIRSA), Brazil has been playing a constructive role for development and for the reduction of asymmetries through BNDES (National Bank for Economic and Social Development) financing of infrastructure projects. Meanwhile, the summits between South America and the African, Middle Eastern, and Asian nations represent unprecedented initiatives. From a political, diplomatic, and economic perspective, those projects are evidence of the capacity of an emerging nation to contribute positively within the region and to strengthen its status. Yet it would be an illusion to believe that those initiatives are sufficient to eradicate once and for all neighbors' fears, existing pressures, or competing initiatives

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such as those of Hugo Chávez. Paragh Khanna's *The Second World* expresses this dilemma of how Brazil should relate to the US and to South America: "Brazil is the equivalent of the US in South America (...). Latin America's geopolitical ambitions depend almost entirely on that country."

Clashes of interest and the defensive reactions of smaller partners are normal. They reflect domestic demands that tend to increase before elections or when the popularity of leaders is sinking. For pragmatic reasons, those interchanges — from trade disputes with Argentina to conflicts with Chávez or the demands imposed by Bolivia and Paraguay in terms of higher prices for gas and energy from Itaipu — should not be exacerbated. Agreeing on higher prices has been seen as "defeat"; nonetheless, in negotiations solutions stem from mutual concessions, from the more as well as the less powerful. If in the short run differences become severe, in the real diplomatic-strategic timeframes, the medium and long terms, conflicts tend to be resolved in acceptable terms for Brazil, which comes out as the South American stabilizing force.

As far as the vertical relationship with the US is concerned, this position was crucial to raise bilateral relations to the level of a strategic dialog. Because of the policies pursued in the Bush era, US action declined in the region; that, compounded with the Latin crisis in the 1990s, created power vacuums and fragmentation that led to mounting radicalism. In this space, the relevance of Brazil as a point of equilibrium increased. The adjustment was further aided by the understanding that US foreign policy respects nations that are sound and autonomous and conduct assertive diplomacy, like China and India.

From Bush to Obama, there have been frequent demonstrations in favor of these initiatives. Once again, the process has not been tension-free. Although the US recognizes Brazil's political and diplomatic efforts in global forums and its balancing presence both at home and as a spokesman for the developing world, economic and trade obstacles still remain: the competition of agreements like NAFTA, CAFTA, bilateral treaties, and the FTAA (on stand-by); the stagnation of World Trade Organization talks; and the difficulty Brazilian competitive segments such as bio fuels, steel, farming, and meat have in accessing US markets. Strategic convergence does not eliminate actions that may affect Brazilian interests, such as the reactivation of the US Fourth Fleet in the South Atlantic, the installation of military bases in Colombia, or delays in reforming institutions like the United Nations and the International Monetary Fund.

If today Brazil projects legitimacy, credibility, and power in the global arena, that is because the hemispheric platform is supporting this new position.

Even within the Organization of American States, opposing political views persist, as is evident in the disagreements over issues like the environment, international borders, immigration and human rights (not to mention concerns such as arms race, nuclear proliferation, and joint exercises like the ones carried out by Venezuela and Russia).

Difficulties do not, however, do away with partnerships, and differences between North and South should be seen as natural and part of a continuous maturing process. Over the course of history, no nation has been able to aspire to an active global foreign policy without a stable regional space. Brazil could not be — and is not — any different. If today the country projects legitimacy, credibility, and power in the global arena, that is because the hemispheric platform is supporting this new position.

Industry recovering on the strength of the domestic market

For the first time in a decade, Brazilian industry recovery has been driven mostly by the domestic market, supported by the ongoing fiscal stimulus. Last August, the FGV industrial confidence index of exporting companies (50% or more export sales) was well below its historical average, while the total industrial confidence index (ICI) was already above its historical average. In July and August, the export upturn seems to have gained some strength, but it continues hesitant as foreign markets remain a major factor of uncertainty in the short term.

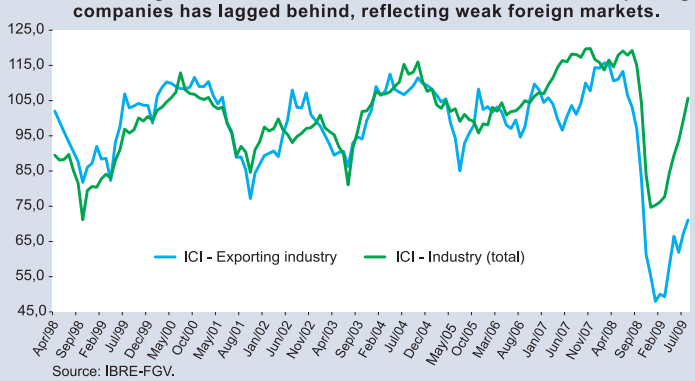
Uneven industrial recovery

Measured by the FGV confidence index of industry, the capital goods sector was hit most by the international crisis. Low levels of capacity utilization suggest that the capital goods sector will recover to its pre-crisis production levels only in the second half of 2010. The durable goods sector has been in a relatively better position owing to tax exemptions on durable goods since early this year, while the confidence of the nondurable goods sector remains relatively stable. In the past two months, the confidence index of intermediate goods has improved significantly. This segment represents over 40% of Brazilian industrial output and a large share of exports.

Resilient services sector

If it were only for the services sector, the Brazilian economy would not have gone into recession. After declining 0.5% in the fourth quarter of 2008, the sector grew by 1.5% for two consecutive quarters. Accounting for two-thirds of GDP, the services sector has offset part of the fall in industrial activity. Second quarter data, however, leaves no doubt that the industry began recovering strongly, posting growth of 2.1% compared with previous quarter. Apparently, the Brazilian recession will be one of the shortest compared to most countries affected by the crisis.

While the confidence index of Brazilian industry has recovered on the strength of domestic market, the confidence index of exporting companies has lagged behind, reflecting weak foreign markets.



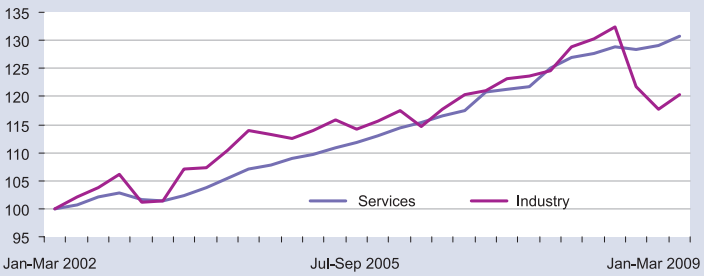
Source: IBRE-FGV.

Uneven industry recovery: Confidence index by sector

	Fall in the forth quarter of 2008	Rise in 2009	Post Crisis
Consumer goods	-34.6%	44.5%	-5.5%
Nondurable	-13.0%	5.5%	-8.2%
Durable	-42.3%	60.7%	-7.3%
Capital goods	-54.1%	34.6%	-38.3%
Construction materials	-38.2%	19.5%	-26.1%
Intermediate goods[1]	-35.3%	43.2%	-7.3%

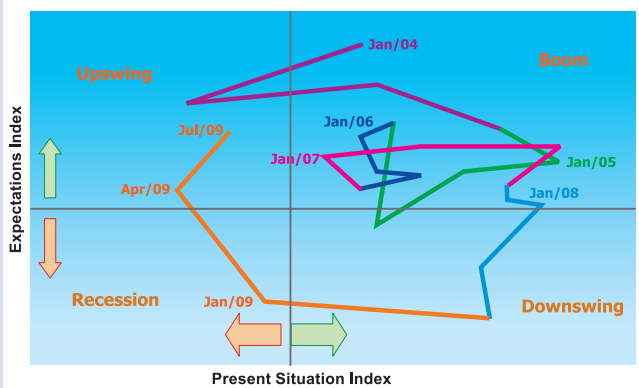
Source: IBRE-FGV.
[1]Metallurgy, pulp and paper, chemical and wood products.

Despite the international crisis, the services sector has remained resilient.



Source: Institute of Geography and Statistics (IBGE).

Brazil: Business cycle clock



Brazil heading out of recession

According to the opinion poll of 30 experts consulted last July for the Ifo-FGV Economic Survey of Latin America, Brazil is expected to resume the phase of accelerated expansion ("boom") in the last quarter of this year. The business cycle clock shows that the country was in recession only in January this year. Since April, Brazil has been in the recovery phase ("upswing"), and should return to the quadrant of economic boom as early as October 2009. Sources: Ifo (Institute for Economic Research, University of Munich) and Brazilian Institute of Economics of Getulio Vargas Foundation (IBRE-FGV).

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.