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The inevitable foreign savings
As a country with low domestic savings — but with a healthy economy full of investment opportunities — Brazil should consolidate an institutional environment that allows foreign capital to continuously supplement our excess consumption and investment relative to national income. External financing should be principally in the form of share purchases or direct investments. Also, controlling current government spending would help, as would additional domestic savings and removing some of the pressure on the exchange rate.

The Brazilian development model: Australia rather than China
Samuel Pessôa assesses the extent to which low savings is related to the build-up of an extensive social safety net after the return to democracy in the early 1980s.

Big government in question
The debate over the size of the government and how it interferes in the economy is back. Consuming about 40% of GDP, the government is far larger than those of our competitors. It grew to pay for the major expansion of public spending on salaries, transfers of income and pensions, and the cost of its administrative machinery. In contrast, public spending on physical infrastructure fell, pulling down the overall rate of investment. Reporting by Liliana Lavoratti.

Keeping the 'R' in BRIC
For 2000–09, Russia's real gross domestic product grew at an average annual rate of 5.6 percent, considerably less than that of India and China. Meanwhile Brazil chalked up a growth rate of only 3.2 percent. Brazil seems to have lagged behind for a fairly basic reason: low savings and low investment, argues Martin Guilman. It is therefore too soon to write off Russia.

Brazil's economic and financial indicators

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All indications suggest that Brazil has come out of the international financial crisis well, and in some ways is even leading the global recovery. Moderate forecasts project that GDP will grow by about 5% in 2010. But a closer look at this positive scenario raises some doubts about whether Brazil's economic growth is sustainable in the medium and long term. At the heart of these concerns is an old issue: the size of the Brazilian government and the degree to which it interferes in the economy. Consuming about 40% of GDP, the government is much larger than those of our competitors. It grew to pay for the expansion of public spending on salaries, transfers of income and pensions, and the cost of its own administrative machinery. Yet public spending on physical infrastructure has fallen, pulling down the economy's rate of investment. If growth is to be sustainable, the investment-to-GDP ratio needs to increase significantly. To maintain a growth rate of 5%, the annual investment rate should be 22% of GDP — well above the current 17%.

Although foreign investment is pouring back into the country, as The IBRE Letter points out Brazil will again see significant deficits in its external current accounts, produced by the foreign savings we must import to make up for excessive consumption and investment relative to our income. Some economists are uneasy about large current account deficits, which they think represent excessive dependence on the rest of the world; others tend to view low savings less as an insoluble problem than as a structural feature that simply requires institutions and regulation that will continue to attract foreign capital to supplement domestic savings.

The inevitable foreign savings

Because it is central to the debate about Brazil's economic performance, the low level of savings is a recurring theme in these IBRE letters. Yet the issue is far from exhausted. Setting an amazing pace of economic recovery after the acute stage of the global crisis, Brazil is again heading toward significant deficits in current accounts, meaning that we are depending on savings by others to make up for consuming and investing beyond our income.

At a time when the country's attractiveness as a recipient of foreign investment is exalted by globally recognized publications, such as the *Financial Times* and the *Economist*, there is no lack of international enthusiasm for financing the Brazilian economy. In fact, the growth phase that started in 2004 seems to have been only briefly interrupted by the global crisis. Growth has been driven by the increase in total factor productivity, which has accounted for about 40% of GDP growth since 2004.

Investment in turn rose steadily, from 14% of GDP in 2003 to 19% in the third quarter of 2008, when it crashed in the global turbulence. It seems, however, that with the vigorous economic recovery, and rapid reoccupation of installed capacity, investments should again expand as they did in the best years before the crisis.

As consumption takes off along with investment, however, the question of domestic savings arises once again. Economists who fear an excessive dependence on the rest of the world feel uneasy with large current account deficits. But for those economists who tend to view low savings as a structural feature, rather than an insoluble problem, deficits simply require adequate institutions and regulation so the country can continue to attract foreign capital to supplement domestic savings.

The debate

The economists with the structural view argue in general for fiscal adjustment — alleviating the shortage of personal savings by increasing public savings. They believe that controlling current government spending can make room for lower interest rates, which lower Central Bank intervention in the

foreign exchange market. Macroeconomic equilibrium is achieved with a devalued real exchange rate.

However, these economists do not believe that Brazil's real exchange rate will be persistently devalued, as is true for Asian countries. The most to hope for, they think, is to achieve a modest increase in savings by the public sector, slightly easing the tendency to exchange rate valorization. Fiscal adjustment somewhat creates a balance between more savings and a slightly undervalued exchange rate.

Their opponents, the economists who are less enthusiastic about development dependent on foreign savings, argue that growth itself brings about more savings that enable further growth. Thus, the government needs to launch a rapid expansion to pull Brazil out of the trap of low savings. Thus the fiscal impulse theory challenges the fiscal adjustment theory.

In analyzing empirical data, the argument that faster economic growth raises the saving rate cannot be ignored. Some time ago a World Bank study[1] assessed both policy and nonpolicy determinants of savings. It found that there is a strong component of inertia in savings, and that savings and national income tend to grow together, although the direction of causality could not be determined. Fiscal restraint (increased public savings) was positively related to higher domestic savings — half the increase (present or expected) in private income as a result of lower government spending is spent, and half is saved. Urbanization reduces domestic savings, while the perception of greater risk in the economy and an increased rate of inflation raise domestic savings.

Despite the empirical positive association between growth and savings, Brazil's savings and growth seems to have operated in the opposite direction: As growth rose from 2004 to 2008, domestic savings fell, leading to a expansion of use of foreign savings.

Concurrency — A possible explanation for this lies in the mechanism that seems to be behind the general trend of simultaneous growth and rising domestic savings. China, with its vigorous expansion, may be a useful example. Its fast GDP growth has increased the real income of active workers, but retired workers can at best keep up with rising living costs. Thus, with very high rates of economic growth, rising incomes increase the savings from active workers, but the dissavings of the retired were minimal because their working incomes were lower when the country was much poorer.

This does not work the same way in Brazil. In Brazil, the policy of increasing wage-linked pensions along with the minimal wage has neutralized the mechanism by which GDP growth boosts domestic savings, which are very vigorous in

With the amazing pace of economic recovery Brazil is again heading toward significant deficits in current accounts, meaning that we are depending on savings by others to make up for consumption and investment beyond our income.

In Brazil, the policy of increasing wage-linked pensions along with the minimal wage has clearly neutralized the mechanism by which GDP growth boosts domestic savings.

China. The savings of Brazilian active workers do not outperform the dissavings of retirees and pensioners because the income of the two groups grows concurrently — and in some cases retiree incomes grow faster.

In fact, the generosity of the Brazilian social security system creates a direct disincentive to saving in the active phase of life. That is clear from a study of how pension reform in Italy in 1992 affected individual consumption and savings.[2] Italy had traditionally had high levels of saving (for a developed country), mainly because of a poorly developed financial market and strong intergenerational altruism.

With domestic savings low but with healthy economy and plenty of investment opportunities, Brazil should consolidate an institutional environment that allows foreign capital to continuously supplement excessive consumption relative to our income.

However, the rate of domestic savings had fallen significantly, from 24% of GDP in 1960 to about 10% in early 1990, perhaps because pension benefits had been made more generous in the 1950s. The 1991 reform was in fact intended to correct some excesses of generosity by raising the retirement age and minimum years of contribution to Social Security and by calculating pension benefits on average salary during the worker's entire active life rather than just the last five years of employment. Similar reforms have been made in the Brazilian social security system since the 1990s. The Italian study shows that for workers in the middle of their working years, aged about 40, the fall in the present value of future pension benefits pushed up personal savings almost one to one. Clearly, in Italy and quite possibly in Brazil, expectations about future Social Security benefits affect individual decisions about saving.

Generosity

In Brazil, where the pension system is particularly generous and the future trend may well be to expand benefits, a surge in private savings is highly unlikely. And economic growth by itself will not increase savings because there is not the differential income growth between active and inactive workers that occurs in most countries when GDP growth accelerates.

With domestic savings low, but with healthy economy and plenty of investment opportunities, Brazil should consolidate an institutional environment that allows foreign capital to continuously supplement our excessive consumption relative to income. This does not mean borrowing more from the rest of the world; external financing should be principally acquisition of shares or direct investments.

Even as foreign capital is absorbed and the exchange rate is valued correspondingly, concern about excess is always appropriate. Better controlling government current expenditure would push up domestic savings and remove some of the pressure on the exchange rate.

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[1] N. Loayza, K. Schmidt, and L. Serven, "What Drives Private Savings Across the World?" *Review of Economics and Statistics*, May 2000: pp. 165-181.

[2] Orazio P. Attanasio and Agar Brugiavini, "Social Security and Households' Saving", *Quarterly Journal of Economics*, August 2003: pp. 1075–19.

The Brazilian development model: Australia rather than China

Samuel Pessôa

Recently, the view that low domestic savings is a structural feature of the Brazilian economy has been prominent in the study of conditions for development. One important question is the extent to which the low rate of savings is due to the welfare network built up since Brazil was democratized in the early 1980s.

According to World Bank data, between 1995 and 2004 domestic savings in Brazil averaged 18% of GDP; the average for 134 economies was 21%, with a median of 20%; and the average for Asian countries in the last 15 years was about 35%, compared to 20% for Latin America. Even compared to OECD countries, with a rate of 23% in that period, Latin America saves much less. Thus, Brazil's low savings may be part of a more general Latin American phenomenon.

Savings and growth

Moreover, national savings have not reacted much to the acceleration of economic growth, although elsewhere in the world savings are usually positively associated with growth. From 2001 to 2004, a period of low growth in Brazil, the savings rate increased from 14% of GDP to 18%, yet when growth accelerated dramatically from 2004 to 2008, savings actually dropped, from 18% to 17.5%. In the third quarter of 2008, just before the international crisis put the brakes on the Brazilian economy, the investment rate reached 20% of GDP, for a savings rate of 17.8%. In other words, the use of external savings (the current account deficit) rose to 3% of GDP.

As discussed in the IBRE Letter in this issue, high public spending on the social safety net set up after democratization in the early 1980s explains the low level of savings. Because of broadened eligibility and increases in the real value of social security benefits — foremost among these the policy of raising the minimum wage — savings have not reacted to economic growth. While the savings rate in Brazil has always been low, the generosity of the social safety net is a relatively recent phenomenon.

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Savings and demographics

Studies using data for several countries have identified several factors that determine how much each country saves. In particular, at different times in history, demographics may explain periods of high and low savings. Indeed, throughout the 1970s Brazilian society was at the height of a population boom. Population growth between 1955 and 1975 was about 3% a year. This high rate of growth meant that the working age population (PIA) was relatively small. Countries with many children, like aging societies, tend to save less.

After democratization, Brazil greatly increased access to health, basic education, and pensions. The build-up of the huge social safety net (huge in terms of Brazilian per capita income) has offset the trend of higher savings as a function of demographic change.

Since the mid-1970s, Brazil has no longer been a young society. The proportion of people 25 to 64 years in the total population increased from 44% in 1970 to 63% in 2010, and is projected to reach 65% in 2025. Thereafter, the growth of the elderly population will more than offset growth in the number of children, so PIA as a fraction of the total population will again decline.

Another measure used is the ratio between the PIA and the inactive population (mainly children and elderly). This ratio hit a low of 1.2 in 1965. From 1965 through 2000, it grew rapidly, reaching 1.8, where it is expected to remain until 2035. This is what demographers call the demographic bonus. Thus, the savings rate in Brazil should have been very high since the 1970s. Apparently, the build-up of the huge social safety net (huge in terms of Brazilian per capita income) has more than offset the trend of higher savings as a function of demographic change.

After democratization, Brazil greatly increased access to health, basic education, and pensions. Moreover, most post-secondary education is free in public universities, or is indirectly funded by the state. Although the quality of health and basic education is poor, public spending on them as a share of GDP is high by international standards. Raising the quality thus will depend more on improving management than on increasing resources.

Social generosity

International comparisons show clearly how generous the national pension system is. Brazil spends 12% of GDP on social security, including pensions, death benefits, and permanent disability benefits. A simple regression analysis of World Bank social security data for a total of 113 countries, taking into account Brazil's demographics, suggests that rather than 12%, Brazil should have spent only 3%. In contrast, the countries of East Asia under spent in pensions by 6.1 % (Japan), 3.8%, (Singapore), 3.5% (South Korea), and 1.2% China.

A dissimilar comparison

Many think it useful to look to China, the society that to some extent can be considered the opposite of Brazil in its very high savings. In the 1990s the Chinese savings rate was 35%–40% of GDP and in 2006 it reached an unimaginable 50%. Of the 50%, 22.5% was household savings,

22.5% enterprise savings, and 5% public savings. The rise in China's savings in the last decade was mainly because households had to provide for their own health and education as well as buy homes. The public social spending figures in China speak for themselves: The public sector spends 3% of GDP on education, 1% on health, and 2% on social security! So China is spending only 6% of GDP while Brazil is spending 21% (12% on social security, 5% on education, and 4% on health).

The high household savings in China and the low household savings in Brazil reflect to a large extent differences in their social safety nets. The enterprise savings gap is much smaller. While Chinese households save approximately 22.5% of GDP and Brazilian households only 5%, Chinese enterprises save 22.5% and Brazilian ones 15%. The high savings rate of Chinese enterprises is associated with a high rate of profit, which in turn reflects China's notoriously low salaries, compared to worker productivity. China labor market institutions would be incompatible with Brazil's democratic institutions, such as the right to go on strike and to organize unions.

A similar comparison

A country that saves little needs foreign savings to finance the difference between its savings and its investment rate. With savings of 18% of GDP and the need to invest 23% of GDP to achieve sustainable annual growth of 5.5%, Brazil will need to use foreign savings comprising 5% of GDP — and indeed, it is possible to absorb that amount of foreign savings; Australia demonstrates that relatively high external current account deficits can be sustained for long periods so long as certain conditions are met:

1. Adopting a floating exchange rate, with mechanisms for automatic correction of external imbalances;
2. Maintaining fiscal balance;
3. Having net external liabilities in the form of equity — foreign direct investment or stock market inflows — or denominated in domestic currency; and
4. Ensuring sound institutions and regulation that will attract foreign capital to supplement domestic savings.

Rather than comparing itself with China, Brazil should therefore look to Australia, which has democratic and market institutions that are much more similar to Brazil's.

An economy that adopts this pattern of external financing is not likely to suffer sudden stops in capital flows. Exchange rate changes cushion rather than amplify external shocks. Rather than comparing itself with China, then, Brazil should look to Australia, which has democratic and market institutions that are much more similar to Brazil's.



BIG GOVERNMENT IN QUESTION

Liliana Lavoratti, from São Paulo

Brazil is helping lead the global recovery: dollars are pouring in, foreign direct investment has remained stable, and interest rates have declined. It is conservatively projected that, after a year of stagnation, GDP should grow by 5% in 2010 — better than many other economies. The most optimistic are betting on 7% growth and talking about a new "economic miracle."

But is the current positive scenario sustainable? The main concern is familiar: the size of the Brazilian government and its intervention in the economy. Consuming about 40% of GDP — tax revenues plus the nominal deficit — our government is much bigger than those of our international competitors and of many developed nations. Government grew to pay for much greater spending on civil servant salaries, income transfers, and administrative costs. But spending on infrastructure and human capital has plunged, pushing the total investment rate down.

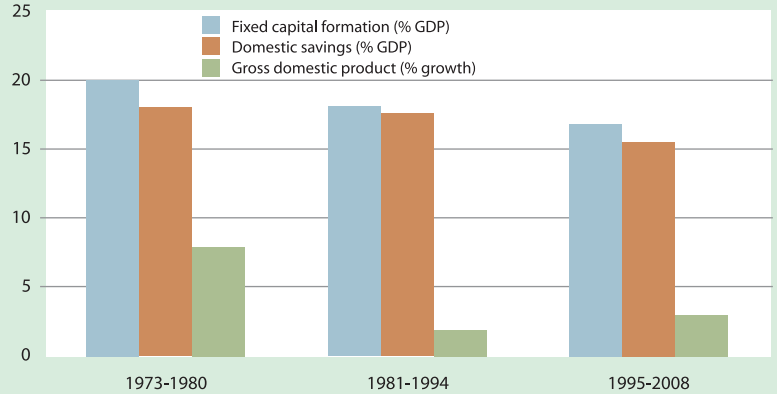
Resources

So there is an impasse: to sustain economic growth, the country needs to promote investment, say experts consulted by The Brazilian Economy. "To be able to grow by 5% a year, an investment-to-GDP ratio of 22% of GDP — against the current 17% — will be required," says Regis Bonelli, an economist at the Brazilian Economy Institute (IBRE) of the Fundação Getulio Vargas. Where would the necessary resources come from?

The private sector may very well seize the opportunities that available foreign resources open up. But in the public sector, investment of any size must be financed by the government's own resources (public savings) or through loans. "Public savings today represent only about 1.5% of GDP, an irrelevant figure," Bonelli says. To move forward, he argues, governments must cut primary current expenditure.

Economist Raul Velloso, an analyst in public finance, agrees: "If the ambition is to return to the rhythm of the 1960s and 1970s, when Brazil was the world's growth star ... the only way out is to increase the

Brazil: High domestic savings and investment were associated with higher GDP growth rates



Consuming about 40% of GDP, our government is much bigger than those of our international competitors and of a considerable number of developed nations.

"To be able to grow by 5% a year, a investment-to-GDP ratio of 22% of GDP — against the current 17% — will be required."

Regis Bonelli

"Public savings today represent only about 1.5% of GDP, an irrelevant figure. To move forward, the governments must cut primary current expenditure."

Regis Bonelli

To compensate for its insignificant investment rate, Brazil needs vigorous technological progress and increased productivity, Raul Velloso says.

investment-to-GDP ratio." Between 1975 and 2003, the investment rate dropped from 26%of GDP to 16%; the 17% projected for 2009 is still far from ideal.

Standstill

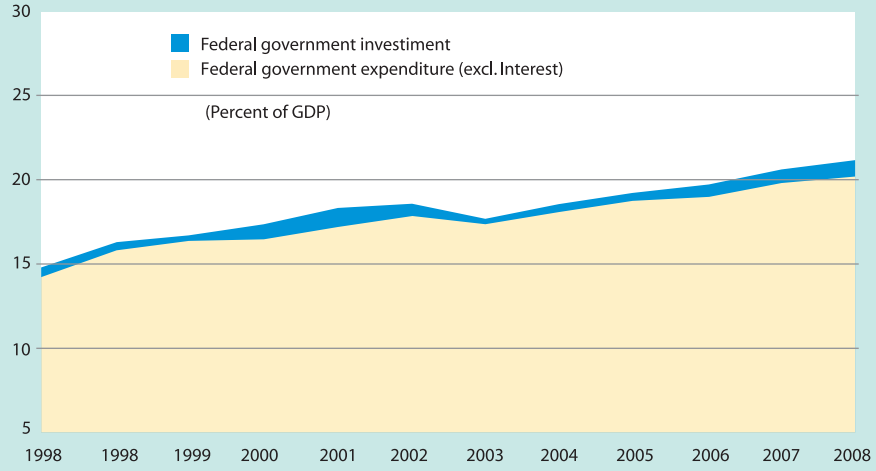
According to Velloso, to compensate for its low investment rate Brazil needs vigorous technological progress and increased productivity. Because investment and productivity go hand in hand, expanding capital stock will push up productivity. Thus one of the challenges awaiting the government elected in October 2010 is to sustainably increase investment for an extended period.

Former Finance and Planning Minister Antônio Delfim Netto says that the government cannot invest because it has allowed current expenditures to grab 40% of the nation's wealth to provide services of the worst quality. Correcting this type of distortion by cutting expenditures is not in our DNA, he thinks. The best situation would be for the economy to grow 6% a year, while the government grows 3%, so that within 10 to 20 years the government would again be a reasonable size. Then, he says, Brazil would no longer need tax revenues 10 times those of Sweden to provide services comparable to those offered in Ghana.

Social Security time-bomb

To control public expenditure, however, laws will be necessary that force civil servants to contribute more to

Brazil: Increasing public expenditure and meager public investment



Source: Central Bank of Brazil.

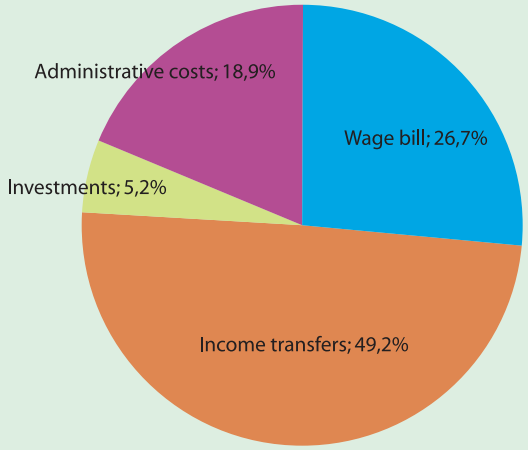
their own retirement. "Half the Social Security deficit is caused by the current civil servant pension system," says Delfim Netto. He believes the Social Security deficit "time-bomb" is the biggest obstacle to development. "Brazil will get old before it gets rich," he says. "By 2020 14% of the population will be over 65, twice today's number. There is no way this can be financed."

Bonelli points out another problem: the evolution of public investment. The government's average gross fixed capital formation (excluding state-controlled companies) declined from 4.5% of GDP in 1970 to 3%–3.5% in the early 1990s and to just 1.5% in 2003–05.

Meanwhile, since the early 1990s public expenditure has exploded, mainly due to the social benefits created by the 1988 Constitution. Velloso points out that primary spending by the federal government soared from 14% of GDP in 1997 to 18% last year. Salaries, social security benefits, bonuses and unemployment payments, subsidies and grants, other current expenditure, and investment together have quadrupled, from R$ 132 billion in 1997 to R$ 512 billion in 2008.

"We are confronted with a scandal of monumental proportions," Delfim Netto concludes. He points out that civil servant salaries are 100 times higher than salaries in the private sector, Executive branch pensions are 12 times higher and Legislative and Judicial branch salaries are 30 times higher.

Brazil: Composition of federal government expenditure



Source: Brazilian National Treasury.

Tax burden

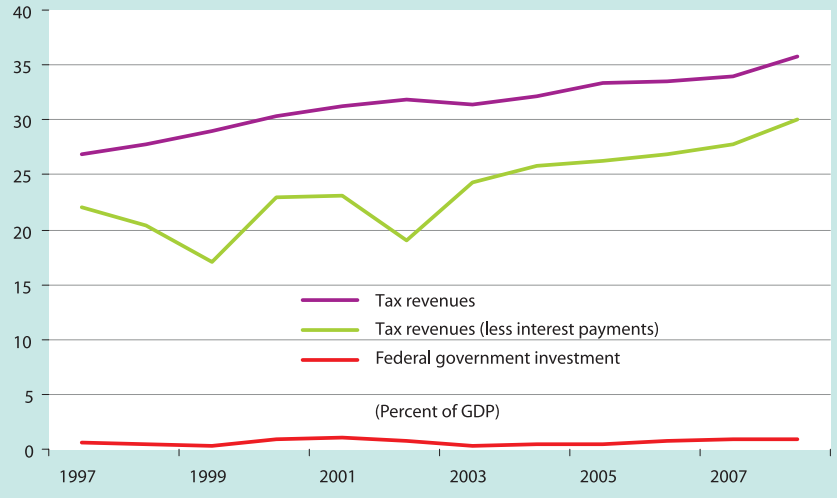
Naturally, taxes have shot up, from 27% of GDP in 1995 to 36% in 2008. This period coincided with the fiscal adjustment the Fernando Henrique Cardoso (FHC) administration introduced to offset external shocks and meet International Monetary Fund program targets. "Expenditures swelled to the point of forcing the contraction of fixed investment. Thus, reduced public investment was the negative consequence of the expansion of public expenditure combined with the need to generate a primary surplus in the government accounts," Bonelli explains.

Primary expenditure (excluding interest payments on public debt) increased by 3.7 percentage points of GDP from 1997 to 2008, while federal government investment increased by only half a percentage point, to 1% of GDP. Interest payments on public debt take up another 6% of GDP yearly.

Brakes to growth

"The starting point to untie that knot is contracting public expenditure," Bonelli says. "The current size of the government, with an expenditure composition that privileges current expenditure over investment, works like brakes applied to economic growth," he argues. Economist and IBRE researcher Samuel Pessôa agrees: "The tax burden imposed by the government inhibits productive activity." However, in his opinion, the government is correct when it claims there is no squandering of resources. "These policies should be

Brazil: Increasing tax burden and low public investment, 1995-2008



Source: Brazilian National Treasury

regarded as more or less adequate to fulfill medium- and long-term objectives. The major cause of the increase of the tax burden since the FHC administration is the expansion of income transfers."

Nor does Pessôa think the wage increases for the civil service are a waste: "The administration says that the impact of this increase will be absorbed in a few years' time; and civil service careers have been restructured to render the government more effective. This administration has credibility: it has cleaned house, reduced interest rates, and introduced adjustments to fiscal policy."

Whatever the merit of these policies, however, "GDP has grown between 10% and 15% less from 1994 to date because of the taxes and social contributions the economy must bear to finance the government," Pessôa said, based on a study he conducted with Bonelli and economist Armando Castellar Pinheiro. Brazil's tax burden should be about 24% of GDP to bring it in line with other emerging market countries with the same per capita income and at the same development stage.

The Constitution

Another problem relates to features intrinsic to the Brazilian federation. By forcing the federal government to assign half the tax revenues to the states and municipalities, the 1988 Constitution pushed the public sector to use social contributions to promote fiscal adjustment. Bonelli explains that "The astronomical level of expenditures that government leaders are forced to execute makes it difficult to introduce fiscal adjustment by cutting expenditure, so the solution is always the same: increase taxes."

Today, it is time, says Velloso, to start "reviewing the model of current expenditures, restructuring planning and execution procedures, and getting public-private partnerships [PPPs] and concessions up to full speed." The previous model of maximizing GDP growth has been replaced by a model to increase current expenditure, he says. Now, "it is essential to find room for public investment."

Politics

Private companies have adopted a different rationale from the government. They first assess whether the climate for expanding investment is favorable and then weigh obstacles imposed by the public sector. Government decisions are arbitrary and politically driven.

Despite privatization, the business community still feels that the government is too

"The major cause of the increase of the tax burden since the Fernando Henrique Cardoso administration is the expansion of income transfers."

Samuel Pessôa

big, particularly considering state-controlled companies and deficient infrastructure in harbors, roads, airports, telecommunications, health, and education.

In recent years, the two critical influences on business decisions were the exchange rate and the interest rate. The international boom from 2003 to 2008 was the only period in Brazil's recent history when interest rates fell systematically — so investment increased. Risk also goes hand in hand with exchange and interest rates. During the boom all three variables fell simultaneously. The recovery of commodity prices mitigates the negative effects of the exchange rate for Brazilian industry and agriculture.

In Velloso's assessment: "Brazil will continue to be flooded with dollars because it is perceived as a country where consumers have a good financial situation, unlike the Americans, who are broke. The international reserves guarantee a certain degree of exchange rate stability." Thus, there is no reason to be concerned about the private sector. The problem is how to push up public investment, particularly in roads, harbors, and railways, which have been neglected for 30 years. Yet alternatives that could help fill this gap are not being contemplated: the administration has reduced its emphasis on PPPs and concessions.

"Brazil will continue to be flooded with dollars because it is perceived as a country where consumers enjoy a good financial situation."

Raul Velloso

Minimum savings

Increasing domestic savings, as the Asians do, or using foreign savings have costs as well as benefits, Pessôa stresses. "It seems that Brazil has already made an option for low levels of savings," he says, so growth must depend on foreign savings. But to attract them, Brazil needs major institutional reforms, such as a predictable court system and respect for contracts, as well as sustaining its current sound economic policies.

However, this would make it harder to create large Brazilian companies funded by domestic capital. "You cannot be nationalist in this model. Furthermore, there will be less industrialization ... It appears that Brazil will specialize in export of primary goods. And there is no evidence that would be a bad thing," Pessôa stresses.

In Pessôa's opinion, until Finance Minister Antonio Palocci's administration, the policy was to keep the house in order so as to create the conditions to absorb foreign savings. That seems to have changed. "Proof of that is the decision to assign resources from the BNDES [the National Bank for Social and Economic

Development] to conduct industrial policy. This costs dearly," he says. "It is not a recommended industrial policy for a country that saves only 17% of GDP. "

Pessôa estimates that the annual fiscal costs of capital transfers by the administration to the BNDES (US$140 billion between 2008 and 2010) are about US$6 billion. Most of the capital has been transferred by issuing public bonds. The government pays the difference between the market interest rate paid and what it receives from the BNDES. Pessôa says, "If we had monumental savings like China and Japan, we might consider playing the game of promoting industrial policy. But we are far from that." He adds provocatively, "Why is lending US$6 billion to the private sector better than investing in education?"

Pessôa does not believe domestic savings will rise anytime soon. "The current political balance in Brazil generates the minimum level of internal savings. Society makes that option when it elects its lawmakers. Public policy approved in the National Congress always leads the population to save less," he points out. Recently, for instance, the Senate Constitutional and Justice Affairs Committee unanimously approved draft legislation that extinguishes the social security factor — one of the most important mechanisms in the reform the legislation introduced to delay pensions in the 1990s.

Social generosity

In a democracy, those who decide are the majority who elect legislators, who in turn let private salaries increase faster than productivity and guarantee a relatively generous social security system that reduces the savings of both companies and households. Pessôa says, "Most likely, the grandchildren of the current generations of Chinese will enjoy a better life than my own grandchildren. The Chinese have chosen to lead a harder life today and to leave a more promising future to their descendents. It is a question of choice."

According to Delfim Netto, one thing is certain: Development based on foreign savings never works. "It is useless to cite Australia as an example. ... It has 20 million inhabitants; we will reach 240 million shortly. We have to find jobs and pay decent salaries to 150 million people. We are a special case; our market is robust, our industry and agriculture are highly sophisticated, and they need a level playing field to continue competing," he stresses.

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"There is really no issue of minimum, maximum or ideal government. What matters is a government capable of serving society."

Delfim Netto

Empowerment

Delfim Netto believes it is not so important to discuss whether the state is small or large, but rather what course it follows: "The Program for Growth Acceleration (PAC) and the acceleration of expenditures during the crisis are examples of empowering government. But it was not the acceleration of public expenditure alone that shortened the crisis. It was the conviction that President Lula managed to convey to the private sector that if the country did not consume, all jobs would be lost. And he succeeded."

Delfim Netto sees two other factors as having helped the recovery: the debt-to-GDP ratio declined to 38%, and foreign currency reserves increased to US$200 billion. Monetary policy, however slowly, worked in the right direction by lowering interest rates.

The market, with all its defects, is the most effective way to allocate an economy's resources. "The administration's role is to be the empowering government, to fire up the 'animal spirits' of the business community, and as far as possible to facilitate credit and create conditions for this mobilization to take place," Delfim Netto says, "because growth is simply innovation plus credit". He explains that "empowering governments, those where the government works to spur growth, such as the US — which has invested US$ 800 billion in research to replace fossil fuels with renewable energy sources — are successful."

There is really no issue of the minimum, maximum, or ideal government. What matters is a government capable of serving society. The former minister explains that in economic theory, there is one certainty: that the external current account deficit is equal to the difference between investment and internal savings. Therefore, he says, society has to choose between accelerated growth and more generous social policies. "The government does not need to invest where the private return rate stimulates private investment," Delfim Netto says. But "if savings are nonexistent, no government can mobilize them."

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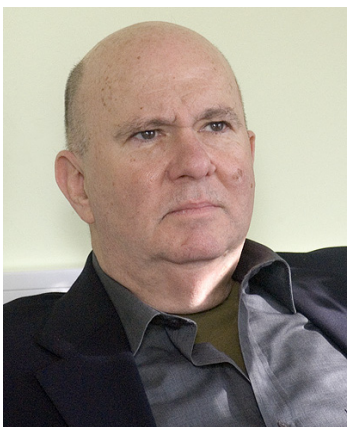
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Keeping the 'R' Where It Belongs in BRIC



Martin Gilman

Whether we find it useful or not, we seem to have been stuck with the acronym BRIC ever since Goldman Sachs created it in 2001. The idea was that Brazil, Russia, India, and China had so much economic potential that they could become among the most dominant economies by 2050. Although the idea seemed incongruous at the time, the name stuck.

Each of the four countries has since demonstrated that indeed they, and perhaps other emerging market economies, might challenge the pre-eminence of the advanced countries by midcentury, if not before. Although the BRICs were not immune to the fallout from the international crisis, they have shown resilience. Even Russia, the worst affected, seems to be poised for a strong recovery in 2010, although the advanced economies will still be languishing.

Trying to rank countries is a mug's game. Arguments and data can always be aligned to confirm a predetermined view — history is rife with examples. Unfortunately, there has been an onslaught of articles explaining why Russia should not be included in the BRIC — the most recent by economists Nouriel Roubini and Anders Åslund — and why Brazil is the up-and-coming star of the BRICs and Russia is simply an outlier. For example, *The Economist* recently observed, "Sometime in the decade after 2014 — rather sooner than Goldman Sachs envisaged — Brazil is likely to become the world's fifth-largest economy", behind only the United States,

Martin Gilman, former senior representative of the International Monetary Fund in Russia, is a professor at the Higher School of Economics in Moscow.

China, Japan, and India. Pointedly, Russia was not even mentioned.

Of course, Brazil has come a long way and deserves to be commended. At the same time, I suggest that it is not Russia that is the outlier among the BRIC countries. When it comes to economic dynamism, that designation should go to none other than Brazil.

While all the BRICs have had their problems, it is Brazil, not Russia, that has been and is likely to remain the outlier for some time to come. Using 2000 as a base — starting just after the major crises in Russia in 1998 and in Brazil early in 1999 — and using estimates for 2009, Russia's real GDP grew at an average annual rate of 5.6 percent. True, this was considerably less than that of India and China for the same period — and although the Brazil did manage to grow slightly faster than advanced countries, it still only chalked up a rate of 3.2 percent.

Why the surprising disparity? Perhaps there is no simple explanation, but it seems likely that Brazil lagged behind for a very basic reason: low savings and low investment. Since 1995 China has annually saved 42 percent of its GDP and invested 39 percent; India saved 26 percent and invested 28 percent; and Russia saved 30 percent and invested 22 percent. In Brazil the corresponding average figures were a more anemic 17 percent for both savings and investment, a level well below that in most advanced economies. This gives Brazil a higher real cost of capital than its BRIC colleagues and makes it harder for it to generate anywhere near the same headline growth.

Of course, it could be argued that Russia in particular used more leverage and foreign inflows to generate its outsized growth, which helps explain the much sharper contraction in 2009. But that still does not come close to erasing the cumulative gap between the two economies. In any case, there are growing indications that in 2010 recovery, both nominal and real, will be faster in Russia.

Brazil is an outlier in other ways. Many in Russia are, or should be, embarrassed that the country ranks 120th in the World Bank's "Doing Business for 2010." But Brazil comes in at an even

Russia's performance has been in some ways more impressive, and over the next few years Russia is poised for significantly higher growth.

more embarrassing 129. Russia also has stronger public finances, a more solid balance of payments, larger external reserves, and lower public debt than Brazil. It is also far richer in terms of per capita income.

How does this translate into mid-term performance? International Monetary Fund projections show Brazil with a respectable 3.7 percent annual growth by 2014, but that is well below the 5 percent projected for Russia, the 8.1 percent for India, and the roughly 9.5 percent for China. The major drag is the low level of domestic savings in Brazil, which ran about 19 percent of GDP in 2008.

To become a global growth engine, Russia needs to cut its excessive and inefficient spending to reduce inflation and interest rates.

Thus, despite all the attention showered on Brazil, its economic performance has been relatively sluggish. This is not to denigrate the substantial achievements Brazil has made in absolute terms in raising its standard of living (although the Gini coefficient suggests it has much greater income inequality than Russia), and even relative to other countries. Looking at the facts from a macroeconomic perspective, however, Russia's performance has in some ways been more impressive, and over the next few years Russia is poised for significantly higher growth. But to become a global growth engine, Russia needs to cut its excessive and inefficient spending in order to reduce inflation and interest rates. This in turn will promote a more robust recovery. For sustainable growth, Russia needs to address its reputation, and the reality, for corruption and its arbitrary legal regime. Still, by about 2020 Russia is quite likely to be in third place among the BRICs in terms of nominal GDP, with Brazil being the outlier.

Of course, conventional wisdom does not appreciate having its underlying assumptions challenged. In this case, what happens may involve merely an innocent game of projected rankings in a world where a great deal can change in 10 years. To the extent that real savings and investment are allocated based upon these perceptions, however, the game becomes more serious — and the conventional wisdom needs to be reconsidered.

Manufacturing capacity utilization upturn

Since industry inventory adjustment ended in the second quarter, the rise in domestic demand has caused a solid increase in manufacturing capacity utilization in Brazil. Associated with the resumption of confidence and credit availability, capacity utilization of 82% since September points to the recovery of productive investment and an incipient upturn in capital goods production.

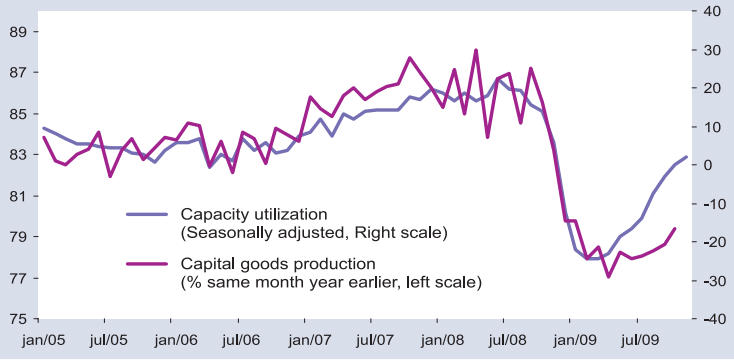
Neutral monetary policy

As expected, in its last meeting of the year on December 9, the monetary policy committee (COPOM) unanimously decided to keep the policy rate unchanged at 8.75%. In its statement COPOM noted that excess productive capacity remains and that the current policy rate is "at this time" consistent with a noninflationary recovery. The need to stimulate economic activity has definitely been left behind as economic indicators point to a strong recovery. The accompanying statement gave no hints about future directions; analysts generally believe that COPOM will not tighten until the second quarter of 2010. However, the central bank may start increasing the policy rate in the first quarter in preparation for the presidential elections in October.

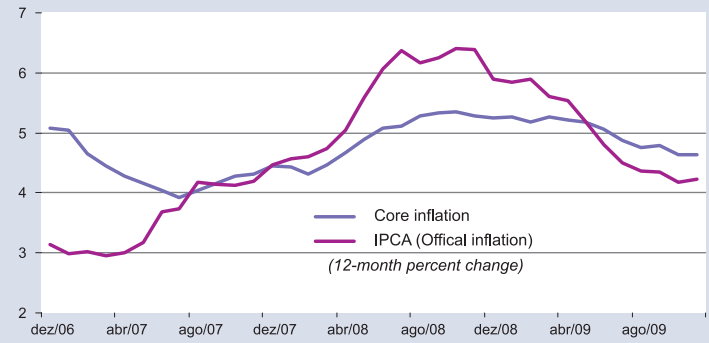
Emerging market countries coming out of recession

Between July and October Brazil consolidated its recovery and has entered a region that suggests the fastest growth phase (boom). Although its rates do not compare to those of China and India, Brazil stands among those who came out of the crisis quickest. Among the BRICs, the country most affected was Russia because of a fall in international demand for oil. In the first half of 2010 Brazilian growth will continue on the strength of domestic demand and the resumption of productive investment. Forecasts for Brazil point to growth between 0% to 1% for 2009 and 4% to 5% in 2010, higher than is expected for Latin America generally.

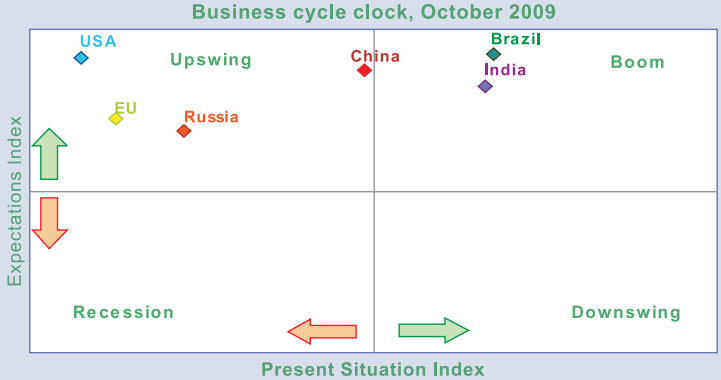
Solid increase in manufacturing capacity utilization has been followed by an incipient upturn in capital goods production



Central bank has adopted a neutral stance as economic activity is recovering strongly and inflation continues tame

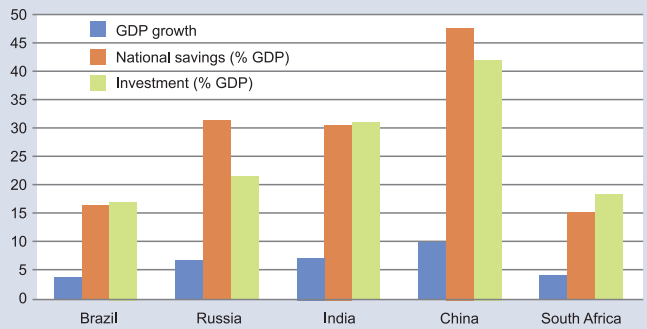


Business cycle clock, October 2009



Source: Ifo (University of Muncih), and IBRE (FGV).

Emerging market countries: Savings, investment and growth
(Average 2000-2008)



Source: *World Economic Outlook*. International Monetary Fund

Brazil's low savings hold back long-term growth

For 2000–08, Brazil grew on average only 3.7% a year, while Russia and India grew by 7% and China by 10%. Even South Africa grew by 4.1%. Why the surprising disparity? It is probable that Brazil lagged behind for a very basic reason: low savings and low investment. In the same period, China saved 47.5% of its GDP and invested 42%; India saved 30.7% and invested 31%; and Russia saved 31.5% and invested 31%. In Brazil the corresponding average figures were an pale 17% for both savings and investment.