THE BRAZILIAN ECONOMY

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IBRE Economic Outlook
Business and consumer confidence still declining

Politics
The moderating power of Lula

Fiscal squeeze

Investors are concerned about the direction of fiscal policy and Brazil's economy. If the country is to grow sustainably, the government must make a difficult choice between social programs and the tax burden.

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The BRAZILIAN ECONOMY

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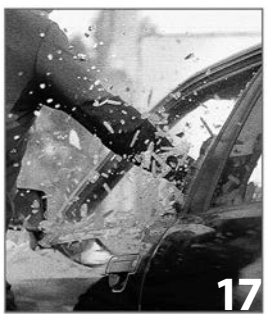
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Treasury Secretary Arno Augustin reveals to Kalinka Iaquinto why he is optimistic about Brazil's fiscal situation, stating that the main government expenditures—wages, interest payments, and social security pensions—are under control and falling. He is reassuring, stating that the tax benefits and incentives are necessary because of the international crisis are over with.

IBRE Economic Outlook

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ECONOMY

Brazil adds 260,823 jobs, but unemployment is up

Brazil's economy added 260,823 payroll jobs in February, the Labor Ministry said. Last year the Brazilian economy added 730,687 jobs, the smallest number since 2003. Job creation has slowed in Brazil after three years of meager growth. (March 17)

Despite Brazil's sluggish growth since 2011, though higher than the 4.8% in January, at 5.1% February's jobless rate was the lowest for a February since 2002. Helping keep the rate low is that population growth is slowing, so fewer young Brazilians are looking for jobs. (March 27)

Trade balance deteriorating

After two months of deficit, the trade balance did have a small surplus of US$112 million in March, said the Ministry of Development, Industry and Trade, but this is still the worst March result since 2001. For the first quarter, exports totaled US$49.6 billion, down 4.1% from the same period in 2013. Imports were down 2.2%, to US$55.7 billion. (April 1)

Stock exchange and exchange rate up in March

March brought some respite for Brazilian assets. The Ibovespa stock exchange index reached 50,414 points, up 7.1% from February, and the real appreciated 3.6% against the U.S. dollar. It may be that market apprehensions about Brazil have calmed down, having factored in uncertainties about US monetary policy and the S&P downgrade of Brazil's debt. State-run companies rallied on the argument that they may benefit from a possible change in government after the elections. (April 2)

Inflation up in March

IPCA inflation came in at a higher-than-expected 0.92% month-on-month, 6.15% year-on-year, mainly driven by a surge in food and agricultural prices. The annual rate is well above the midpoint of the 2.5%–6.5% target range. (April 10)

ECONOMIC POLICY

US$5.1 billion for electricity sector

The government has announced a US$5.1 billion aid package to utilities to shield consumers from sudden price increases. Electricity distributors largely rely on hydroelectric power but have had to switch to expensive thermal power after the worst drought in at least four decades. Rather than pass on the higher costs to consumers so close to presidential elections when Brazil's economy is barely growing, Finance Minister Guido Mantega has announced measures to spread the costs between the utilities, the government, and consumers, putting off electricity rate increases until 2015, until after the elections. (March 14)

Agribusiness giants plan to build railways

Bunge, Cargill, Dreyfus, and Maggi, which together account for 70% of Brazil's grain exports, are forming a company to bid on new railway concessions in Mato Grosso state. The coalition also intends to carry third-party rail freight. (March 23)

S&P cuts Brazil credit rating

Standard & Poor's has lowered Brazil's long-term foreign currency sovereign credit rating to from BBB+ to BBB-, S&P's lowest investment grade, stating that "The downgrade reflects the combination of fiscal slippage, the prospect that fiscal execution will remain weak amid subdued growth in coming years, a constrained ability to adjust policy ahead of the October presidential elections, and some weakening in Brazil's external accounts." It also said that fiscal credibility had been "systematically weakened" by reduction in the government's primary surplus target, and that loans by state-run banks had "undermined policy credibility and transparency." Finance Minister Guido Mantega rejected S&P's arguments and said the downgrade ignored Brazil's solid economic fundamentals and healthy standing compared with other major economies. (March 24)

Policy rate again rises

As expected, the Central Bank Monetary Policy Committee

unanimously hiked the policy rate by 25 basis points to 11%, bringing cumulative tightening to 350 bps since last April. The committee said it will monitor the macroeconomic scenario in order to decide on next steps. (April 3)

Confidence in Brazil is low, says IMF

In view of low growth, low investment, and lack of investor confidence, Brazil's priorities should be to fight inflation, restore public finances, and strengthen infrastructure, said Alejandro Werner, director, Western Hemisphere Department, International Monetary Fund. For Brazil, like much of Latin America, the IMF is recommending tighter fiscal policy. IMF expects economic growth in the region to fall from 2.7% in 2013 to 2.5% this year, and for Brazil from 2.3% to 1.8%. (April 12)

POLITICS

Congressional inquiry on Petrobras deal

Opposition lawmakers plan an inquiry into allegations of irregularities in a refinery purchase by state-run oil company Petrobras. President Dilma Rousseff said the Petrobras board she headed in 2006 approved the US$370 million purchase of a 50% stake in Pasadena Refining System Inc. without knowledge of a put option that in 2012 forced the company to buy the remaining stake as part of a US$820.5 million legal settlement. (March 20)

The Pasadena deal and crises involving the electricity sector have given the political opposition an opportunity to attack the image of good management President Rousseff has exploited since she was Minister of Energy under President Luiz Inácio Lula da Silva. Candidate Senator Aécio Neves asked on the Senate floor: "Since this administration took over the presidency, state-owned companies Petrobras and Eletrobras have lost US$100 billion in market value. Is this efficient management by someone who knows what she is doing?" (March 23)



Photo: Jose Cruz/Agencia Brasil.

Senator Aécio Neves criticizes Rousseff's management.

President Rousseff falls 6 points in Datafolha

Approval of President Rousseff has fallen 6 percentage points in Datafolha poll since February, to 38%. If elections were held now, the president would still be re-elected in the first round, the poll found. However, a survey by the National Confederation of Industry (CNI)/Ibope, found approval of her administration fell from 43% in November to 36% in March.

Lula backs Rousseff

Former President Luiz Inácio Lula da Silva stated in an interview that he will not run for president this year and backed President Rousseff, saying she has "competence" and "all the technical capacity" to make Brazil go forward." Dismissing calls for his return, he said, "It is a privilege for the country to have Rousseff as a candidate. She has character." But recognizing the fall in approval rates, Lula recommended that the administration adopt an "aggressive communication policy." (April 8)



Photo: Ricardo Stucket/Lula Institute.

Former President Lula was interviewed by bloggers.

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FGV

The great fiscal debate: Social programs versus the tax burden

IF FORECASTS FOR INFLATION and the economy were not particularly promising earlier this year, the first quarter has further clouded the outlook. Inflation refuses to yield despite fuel and other price controls. But inflation is not the only worry. The disorder in the electricity sector and the risks of rationing, the government's deteriorating fiscal situation, and the exhaustion of consumer-led growth make the economic outlook very difficult not only for this election year but for years to come.

Fiscal policy is the theme of this issue. Although gross public debt has held steady at 60% of GDP for the last 10 years, tough measures are necessary if Brazil is to keep public debt under control and still move to a sustainable growth path.

The main problem is this: The government spends a lot, and most of that spending is for social programs. So an effective fiscal adjustment will necessarily challenge entitlements that Brazilians see as indisputable rights. As Samuel Pessôa correctly points out, Brazil's 1988 constitution embodies the desire of Brazilian society to build a comprehensive welfare state of the type adopted by European countries. Ever since, that desire has been endorsed in every election and public opinion poll.

That desire also explains the rise in taxes over the last 20 years, and the resulting increase in the tax burden. Although a welfare state is a legitimate goal, society cannot indefinitely increase taxes without consequences for growth and productive investment. The tax burden stands at 36% of GDP, one of the highest among emerging countries. It has long been a drag on growth, to the point where it now raises a question of the viability of the commitment to a comprehensive welfare state.

Reconciling social spending and taxes is the great debate of fiscal adjustment. How much governments should spend on this or that—or whether to spend at all—depends on the collective choices of the people, which often are not consistent with the resources available. What policy makers need to do is find ways to give spenders an incentive to save. Setting global spending limits is one such incentive. Former Central Bank Governor Arminio Fraga has argued for a legal limit on public spending relative to GDP, so that government spending must always grow the same or less than nominal GDP. A formal spending limit would help reconcile social spending and taxes by forcing on spenders and vested interests awareness of the composition and quality of budget items, which would minimize inefficient across-the-board cuts in spending. Also, a limit would slow spending gradually, over an extended period of time, which arguably would help lessen opposition.

Ultimately, the legislature and the administration must come to terms with how much social spending is reasonable and to a common understanding on how much taxation is tolerable without choking growth.

Are global spending limits desirable? That depends. The greater the preference for equality, the more is spent on social programs and consequently the higher the tax burden and the less the economy grows. Ultimately, the legislature and the administration must come to terms with how much social spending is reasonable and to a common understanding on how much taxation is tolerable without choking growth. The future of Brazilian economic growth and the welfare of future generations depend on the outcome of the debate.

The moderating power of Lula

João Augusto de Castro Neves

IN BRAZIL'S POLITICAL SYSTEM, a great amount of power is concentrated in the executive branch. Presidents dictate policies, control much of the budget, and even legislate. Due to their capacity to steer the political agenda and draw much of the public's attention, presidents personify power.

Much like most of her predecessors, President Dilma Rousseff has resorted to this extra power to govern. And much like her political benefactor, former President Lula, she has enjoyed a sizable ruling coalition in congress and high popular support throughout most of her time in office, further enhancing the aura of invincibility around the presidential palace.

Yet unlike Lula, Rousseff has stubbornly ignored some of the basic rules of Brazil's presidential politics. Despite a ruling majority in congress, the president has unnecessarily made coalition management more difficult because of her aversion to politics and her reluctance to distribute power—or cabinet posts—more evenly among allied parties. In addition, Rousseff's stint as Lula's chief of staff ingrained in her a propensity to micromanage, from centralizing policymaking to plotting her pilot's flight plans.

What many saw as a breath of fresh pragmatism in a country of commonly dysfunctional politics has so far produced frustratingly second-rate results. After a somewhat promising start, the administration appears to have all but given up on structural reforms. Important policies have been mired either in poor planning or inefficient execution. Even the more obviously urgent projects, like those in transport infrastructure that are directly or indirectly related to the upcoming World Cup, have been inexplicably protracted; some projects have been abandoned altogether.

Even in Brazil's foreign relations, an area that generated much controversy during Lula's tenure, Rousseff's governing style has

While the economy still protects Rousseff from attacks, this shield is likely to erode along with her political capital, especially if economic activity remains sluggish.

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translated into a tongue-tied and unsettling retrenchment. While the current silence might be considered a symptom of an ongoing restructuring of the foreign policy apparatus, it is increasingly evident that much of Brazil's previous assertiveness in the international stage was a function of presidential charisma and statesmanship. It is true that every president shapes foreign policy his or her own way. But for a country that was in the middle of a long process of building up international muscle, a sudden retreat seems to be more the result of weakness or indecision than a calculated strategy to regroup.

As Brazil's impressive economic gains of the last several years taper off, the notion of a lame duck president starts to pervade Brazil's political landscape. The upcoming presidential election could force some much-needed change. But with Rousseff still favored to win reelection while the opposition must grapple with how to appeal to the discontent of the new middle classes, ironically the incentives push her to maintain the course despite mounting political and economic uncertainties—not only for the remainder of this term but possibly into her likely second term.

Even if Rousseff defeats the opposition by a wide margin, however, the situation will be far from stable. While the economy still protects Rousseff from attacks, this shield is likely to erode along with her political capital, especially if economic activity remains sluggish. Features that both friends and foes accepted as quirks could then be seen as weaknesses. And even if the president was willing to change her governing style, paradoxically she would probably have less room to do so, given the mounting political and economic challenges.

But there appears to be an antidote to this hollow pragmatism within the government's camp itself, and his name is Lula. While the odds of the former president replacing Rousseff on the ballot this year are very slim, he is likely to play a more important role if she is reelected. Figures closely associated with Lula have already been making their way back into the administration. As a result, however reluctantly, the president is starting to delegate more authority to stronger ministers. In addition to helping manage the ruling coalition in congress, Lula also seems to be operating backchannel negotiations between the government and the private sector, trying to steer economic policymaking onto more credible ground.

While Lula's greater influence is unlikely to usher in a new era of reforms, it may be the next best thing to pressure Rousseff to improve the overall quality of policymaking.

Lula is now poised to be the "moderating power" of a second Rousseff administration.

Figures closely associated with Lula have already been making their way back into the administration. As a result, however reluctantly, the president is starting to delegate more authority to stronger ministers.



Fiscal squeeze

Investors, analysts, and economists who are concerned about the direction of fiscal policy are becoming ever more skeptical about the direction of Brazil's economy. Though all is not yet lost, if the country is to grow sustainably, the government must make a difficult choice between social programs and the tax burden.

Kalinka Iaquinto

LOW GROWTH, HIGH INFLATION, the recent downward revision of Brazil's credit rating by Standard & Poor's (S&P), a crisis in the electric power sector, control of fuel prices and public transportation fares—threats to the economy are everywhere. The only way out of the current predicament seems to be a robust and transparent fiscal adjustment. However, that can only be done by reducing social expenditure, which is politically contentious.

Analysts of a variety of persuasions agree that current fiscal policy is not working well, if at all. For 2014, the market expects that inflation will be close to 6.1%, up from 5.9% in 2013, and gross domestic product (GDP) will grow only 2%, compared to 2.3% in 2013. An external current account deficit of 3.5% of GDP and the primary surplus target of 1.9% will not do much for Brazil's solvency for the long term. Yet year after year the federal government has increased its spending.

CREATIVE PUBLIC ACCOUNTING

Last year the government managed to achieve a fiscal primary surplus of 1.9% of GDP, but not without criticism: It was accused of using "creative" accounting, such as extraordinary and nonrecurring revenues to meet the primary surplus target, mainly dividends paid through early redemption of government bonds held by state-owned enterprises, proceeds from concessions, and recovery of tax arrears.

Although Secretary of the Treasury Arno Augustin insists that Brazil follows International Monetary Fund standards for government accounting, Renato Fragelli, professor, Brazilian School of Economics and Finance of the Getulio Vargas Foundation (EPGE), says the market is not convinced, which is one reason the government must now pay higher interest on its borrowing. "When there is mutual trust between the government and the market," he explains, "it costs less to roll over the public debt." He points out that the real interest rate on national Treasury notes has almost doubled just since 2012 and considers the government's creative accounting to be partly responsible.

"When there is mutual trust between the government and the market, ... it cost less to roll over the public debt."

Renato Fragelli

Meanwhile, gross public debt has grown from 56.4% in 2006 to 57.2% last year. Gabriel Leal de Barros, Brazilian Institute of Economics (IBRE) researcher, thinks the large rollover of public debt this year will put heavy pressure on the federal budget: about a fourth of Brazil's public debt, some R$494 billion, matures in 2014. That will force the government to issue new bonds at higher interest rates, which, Barros points out, will heighten the budget deficit.

SHRINKING THE GOVERNMENT

"The mistrust of domestic and foreign markets has to do with two things: creative accounting and reduction of the fiscal primary surplus, and expansion of subsidized loans by the National Development (BNDES)," says economic consultant Raul Velloso. In three years BNDES has quadrupled its loan portfolio from 2% of GDP to about 8%, which "had a large impact on gross public debt."

Many urge reducing the BNDES share in financing the economy, and the government has announced that it will no longer subsidize such state-owned banks. That can help curb the growth of public debt, as BNDES loan interest rates were far below those the Treasury has been paying to get the money for the subsidies. "The interest rate differential and the large amount of resources [transferred to the BNDES] increase the cost of carrying out this policy. Ending it will reduce gross public debt fast," says IBRE's Barros.

IBRE consultant Nelson Barbosa adds, "The financial cost [of Treasury transfers to state-owned banks] is 0.7% of GDP. This cost is now expected to stabilize and fall. But the transition will take more than a decade."

Tax exemptions and benefits granted to various industries in recent years have cost Brazil over R$80 billion in lost revenues. Samuel Pessôa, also an IBRE consultant, believes the tax exemption policy was particularly clumsy; it generated a large loss of revenue without any cuts in public

spending being made. He explains that the failure of the policy was due to a misdiagnosis of the economic slowdown: "The premise was that the slowdown was cyclical. What we have learned over the years is that it was the result of a structural reduction of potential growth." He adds that rather than stimulating growth the misdiagnosis "only makes the situation worse because the fiscal stance deteriorates, increasing the country risk with little impact on growth."

FINE LINE

Is there a risk that Brazil will become insolvent because of its public debt? The answer is no. "We will always have government debt maturing. I do not see any risk. If there is any difficulty in rolling over debt, the Treasury will raise interest rates on public bonds," says IBRE's José Roberto Afonso. However, he is convinced that the maturing of so much public debt heightens the urgency for more attention to fiscal policy. Felipe Salto, an economist at Economic Trends Consulting, agrees about the lack of risk. Although in recent years the Brazilian economy has not grown vigorously, gross public debt has held steady, so that "even with the fiscal expansion, the risk of public debt insolvency is very low."

"The financial cost [of Treasury transfers to state-owned banks] is 0.7% of GDP. This cost is now expected to stabilize and fall. But the transition will take more than a decade."

Nelson Barbosa

But the consensus is that the government needs to show how it expects to hit its fiscal primary surplus target of 1.9% of GDP. In February, the government announced a budget cut of R$44 billion. "The announcement helps a little," Velloso says, "but if not achieved it will destroy the country's credibility." Although the market in general seemed indifferent to the announcement, it did not prevent S&P from reducing Brazil's credit rating from BBB to BBB-. "Everyone knows that cutting public expenditure, in most cases, is cutting wind," Velloso says. "The big question is whether the government will be able, as in previous years, to raise enough revenues to pay for its spending."

HIGH EXPECTATIONS

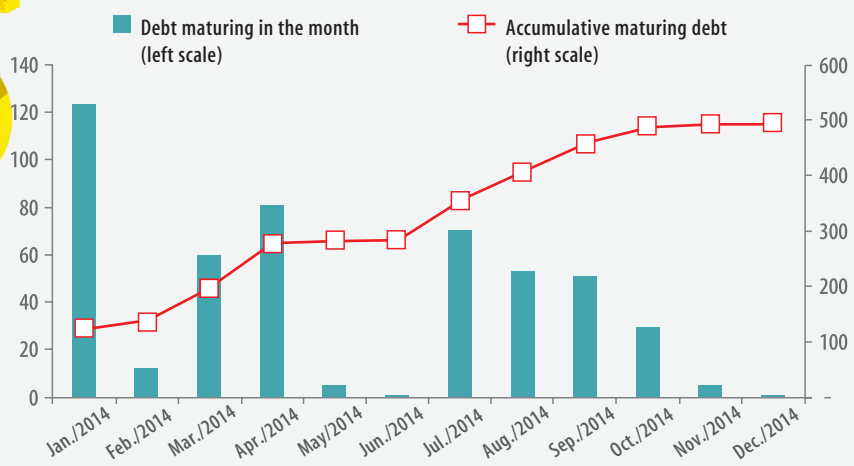
Most analysts agree that without changes in fiscal policy, the country will not achieve sustainable growth. Because of presidential elections this year, the market and analysts expect no major fiscal adjustment for Brazil until 2015. But what kind of adjustment should there be eventually? It is no longer possible to ignore the fact that the government spends a lot, and that most of the spending is social. This means that a fiscal adjustment will necessarily have to change entitlements that Brazilians see as indisputable rights, such as the minimum wage, social security, salary bonuses, and unemployment insurance. Will Brazilians accept changes to social spending?

Last year, a CNI/Ibope survey found that 91% of respondents consider the tax burden, at about 36% of GDP, to be very high. This seems to suggest there is no political space to raise taxes. At the same time, fiscal experts see no way to get more revenues to provide the social spending required by the constitution.



A significant share of Brazil's domestic debt will mature in 2014 and will need to be rolled over.

(Billions of reais)



Source: Public Debt Monthly Report, Central Bank of Brazil.

A CNI/Ibope survey this year has found that 58% of respondents consider health care to be Brazil's main problem, followed by combating violence and crime (31%) and improving education (28%). "Voters are in favor of higher spending in those areas, but when questioned about where the money comes from, they say from the fight against corruption. People think the government can greatly increase social spending without increasing taxes. That is not possible," says Mansueto Almeida, a specialist in public sector accounts.

IBRE's Pessôa agrees. He believes that even if the problems of corruption and mismanagement are successfully resolved, they will not generate enough resources to anchor fiscal and social policies in the medium and long term. "Social spending is supported by society and it explains the bulk of the tax increases in the last 20 years. Spending related to social programs is a consequence of the rules that were created. … All this legislation was passed by Congress, which was elected by the people," he notes.

"Everyone knows that cutting public expenditure, in most cases, is cutting wind … . The big question is whether the government will be able, as in previous years, to raise enough revenues to pay for its spending."

Raul Velloso

The current government follows the same social spending course as those of Presidents Fernando Henrique Cardoso and Lula. "What weighs heavily on the growth of public spending is income transfer programs," Almeida says. He explains that the economy is growing much more slowly today than under

Brazil's gross public debt is high compared to most other emerging countries.

(% of GDP)

	2009	2012	Change in percentage points
Emerging economies	**36.0**	**36.5**	**+0.5**
Ásia	**31.4**	**34.5**	**+2.9**
China	17.7	26.1	**+8.4**
India	72.5	66.7	**-5.8**
Europe	**29.5**	**25.9**	**-3.6**
Russia	11.0	12.5	**+2.5**
Turkey	46.1	36.2	**-10.1**
Latin America	**53.5**	**52.0**	**-1.5**
Brazil	57.4	58.7	**+1.3**
Mexico	43.9	43.5	**-0.4**

Sources: Central Bank of Brazil, and International Monetary Fund.

previous administrations. "We had an economy that was growing at the rate of 4% per year. So spending rose, but was partly offset by the growth of the economy. Now government spending continues to grow as much as before, but the economy is only growing at half the speed."

The policy that defines the rules for the minimum wage will be discussed next year and most experts argue for a new rule that takes into account labor productivity. In recent years, the minimum wage increased by 70% more than inflation. "The minimum wage law is exhausted," Pessôa says. "It cannot grow above inflation indefinitely. Instead of the minimum wage being indexed to inflation in the previous year and GDP growth in the previous two years, it should be fixed on the previous year's inflation and growth in GDP per capita of the previous two years." Treasury Secretary Augustin argues instead that "The policy has worked. Many people said it was not possible to have unemployment falling and a policy of

"The premise … was that the slowdown was cyclical. What we have learned over the years is that it was the result of a structural reduction of potential growth."

Samuel Pessôa

raising the minimum wage. We have more than proven that it is possible."

One of the problems is that when the minimum wage goes up, it becomes the basis for increases in a number of social and welfare benefits like pensions. "Social security outlays account for about 11% of GDP and 60% of government spending. If we do nothing, social security outlays as a percentage of GDP will double by 2040," Velloso notes.

"People think the government can greatly increase social spending without increasing taxes. That is not possible."

Mansueto Almeida

But changes in social security are always difficult. Experts think many other points should also be evaluated—the retirement age, for example. "In a country whose tax burden is 36% of GDP, it is unacceptable that one-third of taxes are used to pay pensions," says EPGE's Fragelli.

The government has also presented a proposal to change how salary bonuses and unemployment benefits are calculated, but in an election year it will be very hard to get congress to vote on such matters. Salary bonuses, says IBRE's Barbosa, have soared, and "this is a program that can and should be

Central government social expenditures have increased substantially over the years.

(% of GDP)

Year	Personnel	Social Security	Subsidies	Administrative costs	Goods and services	Social programs	Investment	Total
1999	4.47	5.50	0.24	1.43	1.75	0.59	0.50	14.49
2000	4.57	5.58	0.31	1.27	1.76	0.59	0.66	14.73
2001	4.80	5.78	0.35	0.73	1.82	0.90	1.17	15.57
2002	4.81	5.96	0.16	1.05	1.83	0.96	0.95	15.72
2003	4.46	6.30	0.36	0.91	1.71	1.00	0.40	15.14
2004	4.31	6.48	0.29	0.98	1.71	1.21	0.62	15.59
2005	4.30	6.80	0.48	1.10	1.78	1.29	0.64	16.38
2006	4.45	6.99	0.40	1.14	1.70	1.56	0.72	16.96
2007	4.37	6.96	0.38	1.18	1.78	1.63	0.82	17.12
2008	4.31	6.58	0.20	1.01	1.75	1.64	0.93	16.42
2009	4.68	6.94	0.16	1.05	1.89	1.89	1.05	17.66
2010	4.42	6.76	0.25	1.06	1.96	1.84	1.15	17.43
2011	4.34	6.81	0.44	0.88	2.04	1.93	1.09	17.52
2012	4.24	7.21	0.55	0.86	2.22	2.15	1.10	18.32
2013	4.22	7.43	0.86	0.99	2.24	2.27	1.02	19.02
1999-2013	**-0.26**	**1.93**	**0.61**	**-0.44**	**0.49**	**1.68**	**0.52**	**4.53**

Source: Ministry of Finance of Brazil.

reformed so that other social spending can grow without pushing the tax burden up." But he warns, "This will involve a discussion with the unions, and they will demand something in return."

To escape the current low growth and income distribution model, EPGE's Fragelli calls for the country to increase its domestic savings, currently about 16% of GDP. How to generate more savings? He believes pension reform is the key: it will relieve the state from costly obligations, and require the private sector to save more because people will retire later. He noted that increasing savings takes at least 10 years. "If the country decides, democratically, to have low savings because people want to retire earlier, one implication is that Brazil will not have industry. Which sectors of the Brazilian economy will support the high tax burden to pay for all social benefits?" he asks, and concludes, "Only those in which the country has stupendous comparative advantages, such as commodities, will survive."

The government has also presented a proposal to change how salary bonuses and unemployment benefits are calculated, but in an election year, it will be very hard to get a congressional vote on such matters.

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Are UPPs enough to contain crime in Rio?

Thais Thimoteo

EVERY DAY THOSE WHO LIVE IN RIO DE JANEIRO leave home ever more afraid. The sense of insecurity that haunts the streets in the metropolitan area is not just an impression. It's real. Attacks by criminals on the Police Pacification Units (UPPs), the rising numbers of police officers who are dying on duty, and the increase in robberies and thefts in the state have brought many to question the government's public safety policy—questioning that is undermining the authority of the state government and the police. In late March, State Governor Sérgio Cabral asked the federal government to send troops to occupy the Rio slums with the highest crime rates.

A survey by Joana Monteiro, Brazilian Institute of Economics (IBRE) researcher, based on data from the Institute of Public Security (ISP), found that although robberies and thefts had been declining since 2009, there was a setback in 2013. The survey data cover the city of Rio de Janeiro, with about 6.4 million inhabitants, and the counties surrounding the capital, with another 6.4 million residents. In both, residents

"We are renewing the curriculum of police academies. … We have also created seven Integrated Public Safety Regions that, since 2009, have been integrating planning, intelligence, resources and operations [of state troopers and police]."

José Mariano Beltrame.

complain constantly about the activities of criminals, Monteiro says. In 2013, there were 37,416 street robberies in the state capital, compared to 31,496 in 2012, a rise of about 20%, and street robberies in the rest of the metropolitan area went up 30%, from 24,127 to 30,884.

The number of robberies in the other municipalities of the Metropolitan Region is higher than in 2007 (23,855), the year before the UPPs went into action. Together, in 2013 street robberies and vehicle thefts explain 64% of the growth of crime in Rio and 57% of crimes in surrounding municipalities.

Neglected areas

The numbers make it clear that those living around the city of Rio are more victimized by violence. This is a warning that crime may have relocated from Rio to surrounding regions. In Nova Iguaçu city, for example, car thefts jumped from 81 per 100,000 inhabitants in 2008 to 150 last year, an increase of 85%, and the number of homicides went up 35%, from 47.3 per 100,000 inhabitants in 2007 to 64.1 in 2013.

"There are areas of … high crime in which there are not enough police patrols. High-crime areas are the eastern metropolitan region and Niterói and São Gonçalo municipalities. Those regions are penalized by a perverse deficit of government services,"

Number of street robberies / **Number of vehicle thefts**

Year	Capital	Metropolitan region	Counties	Capital	Metropolitan region	Counties
2002	18,582	7,891	1,847	18,375	6,626	784
2003	22,828	9,948	2,521	22,030	7,893	922
2004	25,237	10,975	2,324	23,788	8,011	811
2005	33,117	15,039	2,304	24,646	8,093	773
2006	40,519	19,230	3,035	24,658	9,370	913
2007	47,869	23,855	3,709	21,509	9,409	931
2008	52,393	28,092	4,147	17,726	9,368	1,119
2009	53,486	30,364	4,645	14,834	9,127	1,075
2010	46,176	28,041	4,312	11,791	7,455	805
2011	37,576	25,495	3,464	9,727	8,162	884
2012	31,496	24,127	3,140	10,913	10,258	894
2013	37,416	30,884	4,173	12,384	14,489	1,191

Source: Institute of Public Security (ISP).

says Paulo Baía, sociologist and political scientist at the Federal University of Rio de Janeiro (UFRJ). But José Mariano Beltrame, Secretary of Public Security of the State of Rio de Janeiro, cautions against hypotheses about criminals migrating. Although there may be some relocation of criminal activity, Beltrame believes there is no evidence that it has significantly impacted some areas: "There is no indication of migration on a large scale," he notes. "For example, last year, between January and August, 232 of the people arrested in São João de Meriti city, 67.2%, were residents of the city itself, 13% from other municipalities in the eastern region, and just 4.3% resided in Rio de Janeiro."

Lack of a comprehensive strategy

UFRJ's Baía also does not believe that criminals are migrating from areas with UPPs to ones without. Burglars, he says, are typically local. He attributes the increased incidence of crimes to more people reporting thefts—something that had not happened before. Baía explains that "This is happening because of the mobilization and awareness of the population. It was known that only some crimes were reported, mainly motor vehicle thefts and murders, but people have started giving more importance to reporting burglaries and pickpocketing."

José Vicente da Silva Filho, former Colonel of the Military Police and now professor at the Center for Advanced Security Studies of Military Police in São Paulo state, says the fragility of Rio's public security strategy based on the pacification of slums is intensifying. He believes that the scenario will worsen in the coming years because the state does not have a comprehensive security strategy. Rio authorities, he says, "have been applying a single remedy that should have been a composite of treatments. A global strategy means a strategy that covers all state regions." He adds: "It is no use to prioritize the South district of the capital and areas with more tourists due to major sporting events like the World Cup and fail to make adequate investments in operations across the eastern region and in Niterói and São Gonçalo. … The UPPs were eventually prioritized by political expediency."

"It is no use to prioritize the South district of the capital and areas with more tourists due to major sporting events like the World Cup and fail to make adequate investments in operations across the eastern region and in Niterói and São Gonçalo."

José Vicente da Silva Filho

Eroding government authority

IBRE's Monteiro cites two issues that have undermined confidence in state government ability to contain crime: the reputation of governor Sérgio Cabral was shattered by the attacks on UPPs and having to ask the federal government for help, and the consequent suggestion that the policy of pacification is close to its end because no one knows what the security strategy of the next state government will be.

"It may be that, as we are in an election year, the state government has lessened

"Hunting out corrupt police officers has increased significantly in recent years. That may be leading many officers to wash their hands of the effort."

Joana Monteiro

its efforts. Drug lords may be gaining more confidence to attack, disputing territory, and trying to make the population question the pacification policy," Monteiro says. She also suggests that some state troopers themselves may be sabotaging the strategy: "Hunting out corrupt police officers has increased significantly in recent years. That may be leading many officers to wash their hands of the effort."

UFRJ's Baía does not rule out the possibility that political tensions among state troopers responsible for patrolling may be pushing up the robbery rate. "The state troopers have many groups and internal disputes. In addition, there is the issue of a Proposed Constitutional Amendment that would establish a national base salary for police and firefighters that is mobilizing many state troopers," he says, adding that "consumption of crack, a relatively new drug in Brazil, and more discreet drug trafficking in the streets, has also encouraged burglary and thefts."

According to a Datafolha survey, only 11% of the population of Rio state trust the state troopers—the third worst among 27 states—and 7.1% were victimized by police extortion, compared to 2.5% on average in Brazil and 1.5% in São Paulo. "The numbers show that police in Rio are the most corrupt. And this culture has not improved. There is a background of impunity in Rio," Silva Filho says.

Lack of cooperation between state troopers and police is also an issue in Rio. There is, according to da Silva Filho, very little integration between state troopers and police intelligence, which has criminal data and information to guide police operations. "The state troopers receive monthly statistical reports from police but do not have immediate and unlimited access to databases as we have here in São Paulo state," he says. He also points out that poor training of military police of Rio has created a serious structural problem of public safety. Pressed to replace a large number of state trooper retirees, the authorities have loosened the criteria for selecting police officers and eliminated psychological examinations.

Secretary Beltrame refutes such criticisms: "We are renewing the curriculum of police academies. … We have also created seven Integrated Public Safety Regions that, since 2009, have been integrating planning, intelligence, resources and operations [of state troopers and police]."

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Where does Brazil stand on trade facilitation?

Lia Valls Pereira

THE FIRST AGREEMENT approved by members of the World Trade Organization (WTO) since its origin in 1994, the Bali package was signed at the ninth Ministerial Conference. It demonstrated that WTO member countries are willing to find a way to finish the Doha Round, which began in 2001, and thus preserve the multilateral trade system. As regional agreements proliferate, such as the proposed agreement between the United States and the European Union and the Trans-Pacific Agreement endorsed by 12 countries (among them the United States, Japan, Mexico, Chile, and Peru), it is still not clear that the multilateral system will have the capacity to discipline trade in future. Nevertheless, Bali marked the possibility that a new phase of negotiations has opened in the multilateral trade system.

And negotiations will still be necessary. The Bali package consists of decisions and declarations dealing with agriculture, cotton subsidies, less developed economies, and trade facilitation. The trade facilitation agreement is particularly noteworthy because it was more detailed and member countries made firm commitments.

What trade facilitation means

Trade facilitation was part of the multilateral trade agenda in the 1990s, a time when regional agreements also started to make provision for it. In the 1990s, 92% of regional agreements had rules on trade facilitation, and between 2000 and 2013 the percentage increased to 95%.[1] Its importance has grown to the extent that import tariffs have been eliminated or reduced, and customs procedures can facilitate or obstruct trade.

Earlier this year Rios and Panzini highlighted 29 commitments by Brazil on the Trade Facilitation Agreement, including advertising and availability of information, cooperation between border agents, and electronic payments; of the 29 Brazil already meets 23.[2] Unfortunately, this is partly because the language of the agreement is flexible and imprecise.

Trade facilitation measures should be on Brazil's policy agenda to reduce transaction costs. The World Bank publishes an annual report, *Doing Business*, that details the costs of and obstacles to doing business in its member countries on such indicators as starting a business, obtaining construction permits, getting electricity, registering property, access to credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency. In *Doing Business 2014*, Brazil ranks 116th out of 189 countries, but on trading across borders, it is 123rd—better than India and Argentina, but behind Chile, Peru, and Colombia. Those three neighbors all have free trade agreements with the United States and the European Union that cover trade facilitation, although all have a worse rating on foreign trade than in the general classification.

Obstacles

The indicators on trading across borders take into account number of documents to export and import, time in days to export and import, and customs and port costs of import and export per container. Brazil's ranking is associated mostly with the costs, especially the cost for ports and inland transport (this is related to the quality of infrastructure, which is outside the scope of trade facilitation strictly speaking). Does this mean that Brazil is doing well in the category of foreign trade?

Rios and Panzini point out that, according to a survey not yet published by the National Confederation of Industry, industry considers customs procedures to be a main obstacle to exports in 2012. Several reforms to facilitate foreign trade have

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1 See Neufeld, Nora (2014), "Trade Facilitation Provisions in Regional Trade Agreements, Traits and Trends," Staff Working Paper 2014-01 ERSD – Economic Research and Statistics Division, World Trade Organization, Geneva.

2 Rios, Sandra, and Fabrizio P. Panzini (2014), "The Packages Bali: Implications for Brazilian Trade Policy, *Brazilian Journal of Foreign Trade*, 26: 40–53.

Selected countries: Trading across borders

	India	Argentina	Brazil	China	Uruguay	Colombia	Peru	Chile	Thailand
Number of documents to export	9	6	6	8	6	4	5	5	5
Time to export (days)	16	12	13	21	16	14	12	15	14
Cost to export (US$ per container)	1,170	1,650	2,215	620	1,125	2,355	890	980	595
Number of documents to import	11	8	8	5	7	6	7	5	5
Time to import (days)	20	30	17	24	16	13	17	12	13
Cost to import (US$ per container)	1,250	2,260	2,275	615	1,440	2,470	1,010	930	760

Source: Doing Business 2014, www.worldbank.org.

Brazil: Export and import costs.

	Exports		Imports	
	Days	US$	Days	US$
Preparation of documents	6	325	8	275
Customs clearance	3	400	4	450
Port	3	500	3	500
Inland transport	1	990	2	1,050
Total	13	2,215	17	2,275

Source: Doing Business 2014, www.worldbank.org.

been adopted, including ports open 24 hours and unification of documents to facilitate exports. However, the measures were either not fully implemented or need improvement. The Bali package, though vague in some respects, could be the starting point for reducing foreign trade costs.



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Coup Brazilian style

Marco Antonio Villa

ON THE 50th ANNIVERSARY of the military coup of 1964, it is necessary to go back in history to understand the present. In 1964 Brazil was a politically divided country paralyzed by economic crisis, strikes, the threat of a military coup, and an administrative morass. The climate of radicalization was exacerbated by old adversaries of democracy on the left and the right. The Brazilian right had an incompatible relationship with election polls and could not coexist with mass democracy at a time of profound societal transformations. Fearful of the new, the right sought to resort to an old technique: Bring the armed forces to the center of political struggle, in the tradition inaugurated in 1889 with the founding of the Republic, which was born in a military coup.

To the left the communists did the same. They had always hung around near the barracks, as in 1935 when they tried to overthrow President Getulio Vargas by inciting a military uprising. After 1945, they continued to seek support from the military, the "generals and admirals of the people." Being "of the people" meant communing with the politics of the Brazilian Communist Party (PCB) and being ready to answer the PCB call for an eventual coup. Clandestine cells of the PCB in the armed forces were to be seen as a demonstration of political strength.

To the left even of the PCB there were those supporting the guerrillas, among them the Communist Party of Brazil (PC do B). Because they wanted to start the armed struggle in Brazil, in March 1964 they sent the first group of guerrillas to train at the Military Academy of Beijing, China. The Peasant Leagues, who wanted land reform "by law or by force," organized training camps in Brazil in 1962. Documents that linked Brazilian guerrillas to Cuba were found with imprisoned militants. Already the supporters of Leonel Brizola thought that they had wide support among soldiers, sailors, and sergeants.

Thus, in a radicalized environment ideally the president would have political balance and judgment. Unfortunately, that was not the case. President João Goulart was negotiating his stay in office, which required amendment of the Constitution. He had suggested that he had support from the barracks to impose, if necessary by force, his re-election, which was barred. He organized a "military apparatus" that would "cut the head off" the right. He insisted that he could not rule with a conservative Congress, even though his party, the Brazilian Workers Party (PTB), had the largest number of representatives in Congress and it had not introduced bills to make the president's reforms viable.

Then came the coup of 1964. New interpretations were constructed for political use but were far from being based in reality. Associating the Brazilian military regime



Photo: CEPEDOC, Getulio Vargas Foundation.

President João Goulart, 1961-64, (center) and Prime Minister Tancredo Neves (right). Despite good intentions, the leftist president lacked political balance and judgment.

with the dictatorships of the Southern Cone (Argentina, Uruguay, Chile, and Paraguay) was the main one. Nothing could have been more false. The authoritarian regime in Brazil was part of a solidly entrenched undemocratic tradition born of Auguste Comte's positivism in the late Empire. Contempt for democracy had been part of Brazil for the hundred years of the Republic. Both conservatives and so-called progressives regarded democracy as a serious obstacle to the solution of national problems, especially in times of political crisis—as if extensive discussions of the problems were a barrier to action.

In 1964 Brazil was a politically divided country paralyzed by economic crisis, strikes, the threat of a military coup, and an administrative morass. The climate of radicalization was exacerbated by old adversaries of democracy on the left and the right.

The Brazilian military regime was not a monolithic 21–year dictatorship. It is not possible to call the period 1964–68 a dictatorship because of all the political and cultural movement in those years; much less the years 1979–85, which brought approval of the Amnesty Act and of direct elections for state governors in 1982. What kind of dictatorship was that?

In recent years, the theory that leftist militants of the armed struggle fought the dictatorship for freedom has gained acceptance. In this version, the military would have returned to the barracks thanks to the heroic actions of the militants. In a country without a memory, it is very easy to rewrite history.

The armed struggle was no more than a series of isolated actions: bank robberies,



Prominent right politician Carlos Lacerda (center) and President Castello Branco. Fearful of the new masss democracy, the right supported the 1964 Coup.



President Castello Branco, 1964-67, (right) consolidated the military rule. The authoritarian regime in Brazil was part of a solidly entrenched undemocratic tradition.

Photos: National Archives.

kidnappings, and attacks on military installations. There was no popular support. It is argued that there was no other means of resisting the dictatorship except by force, but another serious mistake was that many of these groups existed before 1964 and others were created shortly afterwards, when there was still room for democracy. That is, the choice of armed struggle, the contempt for political process and for participating in the political system, and the sympathy for Guevara's guerrilla warfare caused military hardliners to take power in 1964. The terrorism of small groups of militants gave the State ammunition for its own terrorism that ended up being used by the far right as a pretext to justify the unjustifiable—repressive barbarism.

In fact, the democracy struggle was fought politically by popular movements, including the movement for the amnesty, the students' movement, and unions. These movements had important allies in sectors of the Catholic Church and among intellectuals protesting against censorship. And did the Brazilian Democratic Movement (MDB) do nothing? Its members and legislators were persecuted, and many were deposed.

The Constitution of 1988 paved the way for construction of an effective rule of law. However, achieving the full and effective functioning of institutions is a long-term task. It takes more than a few years.

Authoritarianism lurked in Brazil into the twentieth century. The country had no democratic tradition. Left and right have both used and abused power. Democratic values were discarded. The distinction between the State and the government of the day was nonexistent.

Today, 50 years after the events of 1964, the country faces different circumstances. The Constitution of 1988 paved the way for construction of an effective rule of law. However, achieving the full and effective functioning of institutions is a long-term task. It takes more than a few years. It's a long process.

Marco Antonio Villa is a Brazilian historian and professor at the Federal University of São Carlos, São Paulo state.



Hope in the future

Arno Augustin

Secretary of the Treasury

Kalinka Iaquinto

TREASURY SECRETARY ARNO AUGUSTIN is optimistic about Brazil's fiscal situation. He notes that the country's net debt declined from 60% of GDP in 2002 to 34% last year and state debt fell from 20% of GDP to 11%. He believes 2015 will be a year of good growth for the country, the favorable trend of fiscal indicators will continue, and the effect of the international crisis will probably be lower. "We are very confident about the fiscal situation for 2014," he says. He is reassuring, stating that the tax benefits and incentives necessary because of the international crisis are over with and in 2014 there will be no new ones. Also, the Treasury will not be transferring significant resources to BNDES or capitalizing state-owned banks. Augustin does report that the Treasury will provide US$1.7 billion to help electricity distribution companies withstand the effects of increased costs due to the prolonged drought. In general, he believes, Brazil can view the future with more confidence.

***The Brazilian Economy*—Considering the very weak economy, what steps does the Treasury plan to take?**

Arno Augustin—We are working with a recovering economy that grew by 2.3% in 2013, a much better result than in 2012. Production of capital goods is recovering. Tax revenue is getting better … . We are very confident about the fiscal situation in 2014. The benefits and incentives the economy needed to cope with the international crisis are over with and for the current year there should be no new benefits and incentives. This certainly will be reflected favorably in tax collections.

How do you think foreign investors view the government's policies?

Foreign investors have seen Brazil very positively; they hold an increasingly larger

share of domestic debt. This means that they trust [the government], and see a country with strong fundamentals.

A cut in public spending was recently announced. Was it positive? How do you see the downgrade by Standard and Poor's (S&P)?

S&P's decision to change the risk rating for Brazil is inconsistent with Brazil's solid fundamentals. S&P itself highlights clearly Brazil's many positive points: its solid institutional structure; the soundness of public accounts, both fiscal and external sector; the composition of public debt, which is almost entirely in local currency and mostly with fixed interest rates or indexed to inflation; and a manageable level of net external debt. The government reaffirms its commitment to meet the fiscal primary surplus target of 1.9% of GDP this year, continue with fiscal consolidation, give priority to investment, and work for sustainable growth.

Foreign investors have seen Brazil very positively; they hold an increasingly larger share of domestic debt. This means that they … see a country with strong fundamentals.

Some say that we have a structural fiscal problem. What is your view?

The main government expenditures are under control and falling. That is the case for wages, interest payments, and social security pensions. Spending on wages and salaries fell from 4.9% of GDP in 2002 to 4.3% in 2013; interest on public debt declined from 7.7% of GDP in 2002 to 5.2% in 2013. The social security deficit is also diminishing. Revenues from concessions and dividends are recurring revenues; they were treated as primary revenues in 2013 and will be so treated in 2014. Dividends rose sharply because state-owned enterprises today are performing better. … We have been able to increase revenue with lower tax rates and reduced taxes; this is an ideal situation. … The same goes for expenses. The expenses that have grown are education and investments. Fortunately, those types of investment have a favorable economic effect. This year and next year, we'll have stronger participation of private investment from concessions without fiscal cost to the government. The concessions for ports, highways, railways, airports, petroleum, and electric power mean a significant improvement in terms of more investment and better infrastructure, at no fiscal cost.

But what about productivity and competitiveness?

The competitiveness of the economy was one of our biggest concerns. … The government promoted the exchange rate devaluation, which in the beginning is not good but in the medium and long term is positive for the economy; a decrease in interest rates; and exemptions from payroll taxes that will have a significant effect in terms of improving company competitiveness.

This year interest rates have gone up somewhat and the expectation of both the Central Bank of Brazil and the U.S. Fed is for higher interest rates in 2015. How will public debt and the primary surplus be affected in this scenario?

The main effect of U.S. interest rate changes on Brazil's domestic interest rates has already occurred. The U.S. increase was intense in 2013. … From now on we should see some increase in U.S. rates, but much smaller. For Brazil, I think the level of the interest rate in general is better. The rate has a tendency to fall and that is what will happen. Net public debt has fallen from 60% of GDP in 2002 to 34% in 2013.

The decision of Standard & Poor's to change the risk rating of Brazil is inconsistent with Brazil's solid fundamentals. S&P itself highlights clearly Brazil's many positive points.

The National Development Bank (BNDES) has expanded its loans significantly in recent years. How should it behave in the future?

The BNDES transfers funds from the government to the private financial system at lower interest rates to support economic policies. … The government opted to transfer to BNDES significant resources to support private investment. The main BNDES operation is the Program for Investment. The BNDES has significant resources at its disposal, and we hope that the international crisis recedes. … What had to be done has been done and for 2014 there should be no significant transfers to BNDES or capitalization of state-owned banks.

How do the measures in the energy sector affect the public budget?

Because the Brazilian electricity system has been suffering from a very severe drought, currently it has lower production of hydroelectric power. This has had a heavy economic impact. …The Treasury will contribute US$1.7 billion and seek funding in the market so that distribution companies can pay their commitments until electricity rates are raised next year.

How does the Treasury contribute to the good performance of the Brazilian economy?

Our role is to work to improve Brazil's economic fundamentals. We have to ensure that the government has solid medium- and long-term fundamentals; better debt management and public bonds to improve the conditions under which Brazilian companies borrow funds abroad. We also have to control public spending and track state finances. Ultimately, the Treasury does all this fiscal analysis to build a framework for medium- and long-term fiscal sustainability. ■

Economic activity continues lukewarm as inflation bubbles up

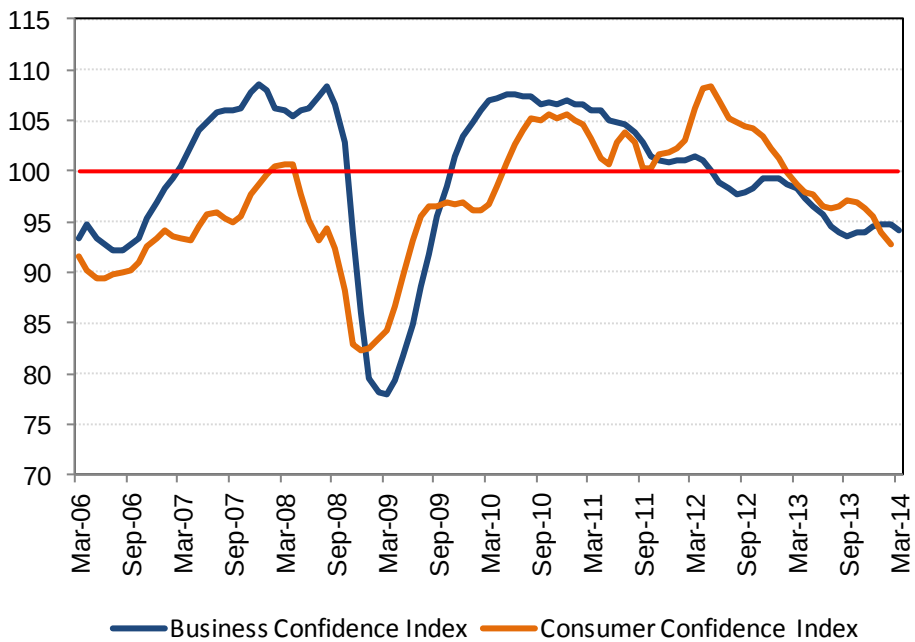
THE EARLY OUTLOOK for the Brazilian economy this year is troubling. Since the previous column in March, a few new positive economic facts have been registered: Brazil's economy added jobs in February and unemployment remains low. In contrast, more negative facts have come up: Standard & Poor's has lowered the country's sovereign credit rating, and electricity supply conditions have been worsening, raising costs and uncertainties for consumers, energy distribution companies, and government. The bad news reinforces the perception that Brazil's economic situation is deteriorating and delays in adjusting economic policy to reality simply heighten the risk to the outlook.

With respect to economic activity, after rising by 3.8% in January industrial production slowed to 0.4% in February, vehicle production fell 3.6%, and retail sales declined by 3.3%. Both business and consumer confidence have been steadily heading downward.

For the first quarter we estimate that GDP growth was only 0.4% quarter-on-quarter, seasonally adjusted. On the demand side, gross fixed investment seems to have slowed. On the supply side, we are counting on good performance in agriculture, mining, construction and electricity production. For the year as a whole, we hold to our growth forecast of 1.8%.

Consumer price inflation was 0.9% in March because of shortages in the supply of food and agricultural items as well as a continuing upward trend in inflation in services prices, which closed the 12 months to March at 9%. It is becoming ever more likely that later this year 12-month inflation will breach the 6.5% inflation target ceiling, despite government controls on the prices of electricity, fuel, and city bus fares. In 2015, controlled prices clearly will have to be adjusted, causing a large "corrective inflation." The government is understandably reluctant to make the necessary adjustments now because of October's presidential election.

Business and consumer confidence is still declining. *



Source: IBRE/FGV.

* Seasonally adjusted.