IBRE Economic Outlook
The growth outlook is better for developed countries, but the risks for emerging economies remain

The 2014 Election
Whoever wins will have to deal with the economy

Interview
Otaviano Canuto, World Bank expert on BRICS



THE BRAZILIAN ECONOMY

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The future of Latin America? Still up in the air

The outlook for Latin American countries becomes more problematic as throughout the world economic growth stays low.

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The BRAZILIAN ECONOMY

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Columnist João Augusto de Castro Neves explains why no matter who wins on October 26th, the landscape will be difficult for the next president. In addition to the obvious fiscal problems, attempts at tax reform must deal with state objections to changes in the VAT and coalitions in Congress will be more fragmented. His conclusion? "It is not likely that a Neves administration would be as positive as many expect or a Rousseff administration as negative."

Cover Story

10 The future of Latin America? Still up in the air

In the last decade, Latin American countries have carried out structural reforms, reduced poverty, and seen a steep rise in domestic consumption, but their economies are now slowing along with the rest of world. Solange Monteiro reports on the IBRE seminar on Latin America and the New World Economic Outlook in September. Much depends on how much the global economy grows, and opinions on that are severely divided. The U.S. seems to be making progress but recovery in the Eurozone is still minimal, and for Latin America the big question mark continues to be China. Experts agree that growth throughout Latin America will depend heavily on domestic adjustments. The story is supplemented by individual analyses of the prospects for Argentina, Brazil, Chile, Colombia, Mexico, and Central America.

Interview

28 For Brazil, "the motto must be pragmatism."

In a conversation with Solange Monteiro, Otaviano Canuto, senior adviser on BRICS to the World Bank, gives his perspective on the past boom in Latin American exports of commodities. He calls for Brazil to take a more pragmatic approach to both external economic relations and domestic policies, to reduce its gross debt in order to increase private investment, and to review public spending.

Seminars

33 How can the infrastructure program be speeded up?

Representatives of the heavy construction industry met with experts at the IBRE Seminar of Infrastructure and Heavy Construction in Brazil," to discuss how to accelerate the Brazilian infrastructure program. Among factors causing problems are low-quality projects, difficulties in obtaining environmental permits, and delays in expropriations, which waste a huge amount of time. Participants also discussed alternative ways to finance projects. Solange Monteiro reports.

37 Gloomy prospects for the economy

At the IBRE Economic Analysis Seminar in mid-September, staff researchers expressed considerable concern about the economy at a point where there is no external crisis to justify Brazil's internal crisis. The mood was pessimistic. To get the primary surplus close to the government target in 2015, it will be necessary to reduce subsidies, eliminate tax exemptions, and make a greater fiscal effort. Solange Monteiro reports numerous telling details.

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41 If the next government can overcome the policy challenges and increase confidence, a new cycle of more sustainable growth and investment is a possibility, but a major question is how willing the rest of the world will be to continue financing Brazil's external deficit.

ECONOMY

Moody's lowers the outlook for Brazil

Moody's kept Brazil's rating at Baa2 but dropped its outlook to negative, warning that "weak growth rates could further erode Brazil's fiscal position and materially undermine its credit profile." The decision follows the Standard & Poor's downgrade of the country's credit rating to one notch above junk in March. On the positive side, Moody's stated that Brazil has high foreign exchange reserves, limited government foreign debt, and a solid banking system. (September 9)

Industry investing less

The slowing economy led more companies to reduce investment in the last 12 months and the number of companies planning to invest more in the next 12 months has stagnated at a low level, according to the third quarter Investment Survey of the Getulio Vargas Foundation. In July-August, the number of companies that invested less (30%) exceeded the number that invested more (29%). In the next 12 months, 30% of companies answered they will invest more and 23% said they will invest less. (September 11)

Retail sales plunge in July

In July retail sales posted their biggest monthly decline in nearly six years. Sales dropped a seasonally adjusted 1.1% from June, government statistics agency IBGE said, and were down 0.9% from the year earlier. (September 11)

Fewer jobs, new and old, in August

The labor market created 101,425 jobs in August, down 20% compared to August 2013, according to the Ministry of Labor, but there was a net loss of 4,111 jobs. In January-August, 751,456 new jobs were created, 32% less than in the first eight months of 2013. (September 11)

Meanwhile, employment in industry fell by 0.4% from July to August, seasonally adjusted, said government statistics agency IBGE. It was the fifth consecutive drop. For the year, jobs in industry declined 2.7% compared with the same period a year earlier. (October 10)

New high for business bankruptcies

Bankruptcies rose by 21.5% in September, compared to August, and 16% over September 2013, according to Serasa Experian; 181 companies filed for bankruptcy. Most were micro and small enterprises (91), followed by large firms (51) and medium (39). (October 6)

IMF cuts Brazil growth forecast

The International Monetary Fund has slashed its 2014 economic growth forecast for Brazil by a full percentage point to 0.3% because "Weak competitiveness, low business confidence, and tighter financial conditions have constrained investment." The IMF expects a moderate pickup to 1.4% for 2015. (October 7)

FAO: Fewer Brazilians hungry

Brazil has reduced the proportion of citizens who are hungry to 1.7%, 3.4 million citizens, concluded *The State of Food Insecurity in the World* 2014 report, released by the Food and Agriculture Organization (FAO). The FAO considers countries where less than 5% of the population is hungry to have beaten extreme poverty. (September 16)

ECONOMIC POLICY

Mantega defends economic policy

According to departing Finance Minister Guido Mantega, a new finance minister does not mean a new economic policy if President Rousseff is re-elected. In an interview with Broadcast of the Agência Estado, Mantega defended current economic policy; he commented on Brazil's responses in response to the international financial crisis in 2008, "Of course we have to make adjustments because the countercyclical policy is ending. We need to raise tax revenues to increase fiscal effort and thus make room for easing monetary policy, which is very, very tight." (September 18)

Massive deficit as government spending rises

The central government posted its fourth straight primary budget deficit in August, making it nearly impossible for the Rousseff administration to reach a key fiscal

target as election-related spending continues. The primary deficit was R$10.4 billion (US$4.2 billion) in August, the Treasury Department said, far above the July deficit of R$2.2 billion. Stagnant tax revenue due to a sluggish economy has forced the government to tap R$3.5 billion from a sovereign wealth fund and seek R$1.5 billion in dividends from state-owned companies to try to meet its 2014 primary surplus target. Brazil's finances are a hot topic in the run-off campaigns. (September 30)

Fraga charges economic melt-down

Former central bank governor Arminio Fraga, economic adviser to presidential candidate Aécio Neves (PSDB), was pessimistic about the health of the Brazilian economy at a video seminar in Washington on October 10. Fraga said that with growth close to zero Brazil's economy is "almost melting." Fraga suggested a "soft" fiscal policy adjustment over two to three years. He said there is "a lot of fat," such as sectoral subsidies granted by the Rousseff administration, which could be cut in order to maintain social programs. He criticized government interventions to control fuel prices and the exchange rate and advocated rapprochement with the United States and greater openness. Fraga attributed Brazil's difficulties in raising investment capital to excessive interventionism and the abandonment of the former President Fernando Henrique Cardoso economic management model. (October 10)

THE 2014 ELECTION

Rousseff and Neves tied in run-off polls

President Dilma Rousseff (Workers' Party, PT) won a plurality in the first round of the presidential election and will face Aécio Neves (Brazilian Social Democratic Party, PSDB), generally considered the pro-business candidate, in the election run-off on October 26. The advancement of Neves to the second round represents a dramatic turnaround from his distant third place in opinion polls as recently as two weeks before the election. Rousseff won 41.59% of the votes, Neves 33.55%, and Marina Silva (PSB) 21.32%. (October 6)

Datafolha and Ibope polls show the two candidates virtually tied. Both polls showed Neves with 46% of the eventual vote and Rousseff (PT) with 44%. With an error margin of 2%, that is a statistical tie. So far, according to Ibope, Neves inherits 67% of voters for Silva in the first round and Rousseff only 18%. (October 9)



Photos: Wilson Dias and Valter Campanato/Agencia Brasil.

President Roussef and Senator Neves have opposite views on economic policies

PSB backs Neves

The Brazilian Socialist Party (PSB) announced on October 8 its support for candidate Aécio Neves (PSDB) in the run-off. On October 11, Neves was endorsed by Renata Campos, widow of former governor of Pernambuco state and presidential candidate Eduardo Campos (PSB). "It has a very great symbolism," said Neves. Neves hopes to attract more votes in Pernambuco state in the northeast, which is a Rousseff stronghold. (October 8 and 11)

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Solving the productivity problem

BETWEEN 2003 AND 2012, thanks to commodity prices Latin America grew 4.1%. Several countries made structural reforms, domestic consumption shot up, and gradually poverty was reduced. Today, with growth in the rest of the world minimal, Latin American countries must now reform their economies to raise productivity so that growth can resume. The IMF estimates in 2015 that the region can be expected to grow only 1.3%—far below the previous prosperity.

Although some countries in the region managed the recent boom in commodity prices well, Brazil and others have been culpably complacent about the need to boost productivity. Productivity growth will be crucial to ensure that growth is sustainable as the boom in commodity prices winds down and the demographic labor dividend fades.

Today, with growth in the rest of the world minimal, Latin American countries must now reform their economies to raise productivity so that growth can resume.

In March the Inter-American Development Bank highlighted the importance of improved productivity in *2014 Latin American and Caribbean Macroeconomic Report*. The report explains the role of productivity in widening the per capita income gap between Latin American countries and the United States. The shortfall in performance was not driven by a shortage of labor and physical capital: in fact, in relative terms the labor force and capital stock expanded faster in Latin America than in the United States. Rather, the problem was a marked relative decline in the region's total factor productivity (TFP)—a measure of how efficiently an economy uses its capital and labor.

For the last 50 years Latin America's economic performance has been characterized by a decline in TFP relative to both the most advanced economies and other emerging economies. Relative to the United States, the typical Latin American country had faster factor accumulation (physical and human capital gaps with advanced economies were reduced) but meanwhile relative TFP dropped from 78% to 53%—a loss of 25 percentage points.

A study by researcher Fernando de Holanda Barbosa Filho of the Brazilian Institute of Economics (IBRE) found that after averaging 1.7% for 2003–10, growth in Brazil's TFP fell to 0.4% for 2011–13. Growth of labor productivity alone was 1.8% in 2011–13, down from 2.2% in 2003–2010. IBRE researchers Regis Bonelli and Julia Fontes call the problem of productivity Brazil's "long-run challenge." They estimate that the Brazilian economy will once again be able to grow 4.4% a year only if productivity increases by 3.4% annually. Sustaining that kind of productivity growth will require tremendous efforts to create new products, invest in education, upgrade infrastructure, and dramatically streamline the business environment.

It is quite possible to have both compassionate social policies and sound economic policies. Social policies well targeted to improve the education and health of the poor in fact have high social and economic returns. As Otaviano Canuto points out in the interview the way to protect social spending is to closely monitor the quality of that spending and eliminate unjustified privileges.

What is clear is that future administrations must patiently pursue the needed reforms over the long run. Too often Latin American countries have succumbed to the populist temptation for ease and quick fixes that do the economy no good. That option must be rejected.

After the election

João Augusto de Castro Neves

BRAZIL IS WITNESSING one of the most competitive and thrilling presidential elections in nearly a quarter of a century. In the last three months, polls had the three candidates alternating in the lead. Now, with the second-round runoff between President Dilma Rousseff (Workers' Party, PT) and Senator Aécio Neves (Brazilian Social Democratic Party, PSDB) close to a toss-up, it's useful to take a step back to get some perspective on the challenges for the next administration. No matter who wins on October 26, the post-election landscape will be as difficult for the next president as the election is electrifying for the candidates.

The Brazilian economy is clearly suffering from low growth and high inflation. Part of the problem stems from the end of a commodity super-cycle and the Chinese slowdown. But a big part is self-inflicted. For the past three years the government has been creating a crisis of investor confidence in its macroeconomic management. For a country that needs a potentially painful rebalancing of its economy away from consumption-driven to investment-led growth, the draining of confidence is a serious problem.

No matter who wins on October 26, the post-election landscape will be as difficult for the next president as the election is electrifying for the candidates.

While investors have been resting their hopes on the potential for an opposition victory, which could usher in the return of sound macroeconomic management and much-needed reforms to heighten Brazil's growth potential, no matter who wins in October, changes are likely to be more moderate—particularly for those needed reforms. In other words, whoever assumes the presidency in January is not likely to be in a position to push through economic reforms in fiscal, tax, or labor policy at least in the first two years.

The macroeconomic policy tradeoffs will be difficult given low growth, high inflation, and a tough fiscal adjustment—a combination that will quickly erode the next president's political capital. While either candidate is likely to push for tax reform in 2015, the odds of success are low. State governments will want compensation

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for any change in the state-based value-added tax (ICMS), and Congress will be calling for more spending, even though spending has been growing since last year.

Moreover, even though coalitions in the next Congress will not differ dramatically from today's coalitions, fragmentation will worsen since in the first round major parties lost ground to smaller ones. Presidents are usually able to balance these forces and build a majority with relative ease, but a tougher economic environment and potentially low approval ratings are likely to make it harder to get legislation through.

Rousseff's coalition, for example, will retain control of 64% of the senate and 59% of the seats in the lower house, down from the current 66%. Numerical majority aside, the election also produced a rebalancing of power *within* the ruling coalition. In the lower house, major parties like the PT and PMDB, the largest and second-largest caucuses, will lose clout to smaller centrist parties. In practice, this means that a second Rousseff administration will have more difficulty dealing with Congress. In her first term, Rousseff's ability to negotiate with Congress was heavily predicated on the cooperation of large centrist parties like the PMDB. Now, however, she will have to deal with a far greater number of smaller, centrist parties with diffuse interests.

As for the opposition, led by the PSDB, no major changes will ensue. They lose a few seats in the senate (from 28% to 23% control) and gain some ground in the lower house (from 29% to 41%). However, one fourth of the new opposition seats in the lower house were won by Marina Silva's PSB. It remains to be seen how the PSB will operate after Silva's defeat, especially since she is likely to attempt to create her own party next year. Moreover, Neves would face heavy opposition from the left, led by the PT and organized labor. This means that even if Neves wins the election, he will have to reach across party lines to achieve a majority. Congressional dynamics do not bode well for coalition management by an opposition-led government.

> Whoever assumes the presidency in January is not likely to be in a position to get through economic reforms in fiscal, tax, or labor policy, at least in the first two years.

While the structural reform outlook is somewhat bleak, there is a silver lining for macroeconomic policymaking. On the management of fiscal accounts, for example, the positive shift would be clear under Neves, but even a second Rousseff government is also likely to make constructive adjustments, though incrementally, to avoid losing Brazil's investment-grade status.

In other words, it is not likely that a Neves administration would be as positive as many expect or a Rousseff administration as negative. The main difference is that while the policies of Neves would be driven more by conviction, those of Rousseff would be a byproduct of necessity.



The future of Latin America? Still up in the air

The outlook for Latin American countries becomes more problematic as throughout the world economic growth stays low.

Solange Monteiro

In the last decade Latin America experienced an unparalleled economic expansion. The relocation of labor to more productive activities and the boom in commodity prices gave extra breadth to its economies. To a greater or lesser extent, Latin American countries have carried out structural reforms, reduced poverty, and seen a steep rise in domestic consumption.

Today, those economies are slowing along with the major economies of the globe. The International Monetary Fund (IMF) is projecting that average Latin American growth would be 2.9% until 2019–1.2 percentage points lower than average growth between 2003 and 2012. Demand for Latin American commodity exports is down as China's growth slows, and external financing is down as the U.S. economy recovers and international interest rates rise.

The implications of these changes were the topic of a seminar on "Latin America and the

New World Economic Outlook," sponsored by the Brazilian Institute of Economics of Getulio Vargas Foundation on September 19th in Rio de Janeiro. Experts from a number of countries analyzed the current situation and future prospects for five economies—Brazil, Mexico, Colombia, Chile, and Argentina—and for Central America, now that international trade is expected to expand at only half the rate seen in the years preceding the 2008 crisis. "The financial crisis was a watershed for the continent. Now there are doubts about the prospects for trade in goods and services, and the extent to which prices of commodities exported by the region are sustainable," said Regis Bonelli, the IBRE researcher who organized the seminar.

STUNTED ECONOMIC GROWTH?

How much will the world economy really grow in the next few years? The issue divides economists. Staff of the U.S. Federal Reserve Bank have been debating, for instance, whether interest rates are falling for structural or for cyclical reasons. "After six years of crisis, we still see very low market interest rates, even below inflation at some points," said José Julio Senna, head of the IBRE Center for Monetary Studies. U.S. economists Lawrence Summers and Paul Krugman have argued that the rich countries have entered into "secular stagnation," a concept coined in the 1930s to describe insufficient demand for goods and services. Senna noted that "One of the signs of stagnation would be that excess liquidity and credit availability and low interest rates in the pre-crisis period, in both the U.S.A. and Europe, did not overheat the economy. That would indicate that advanced economies are suffering from lack of demand."

Senna saw signs of monetary normalization in the United States. Alejandro Werner, director of the IMF Western Hemisphere Department, said that second quarter activity in the U.S. was better than expected, considering a bad start of the year was combined with a tough winter that saw inventories accumulate and exports fall. "With the improvement of production and manufacturing activity, we estimate that the U.S. could grow about 3% in the next few quarters," Werner said, noting that this figure is above the 2% medium-term growth potential the IMF had calculated for the country. Werner also pointed out that more robust domestic demand will allow U.S. companies, which have used the period of low interest rates to accumulate resources, to undertake investment projects at low financial cost.

One of the main sources of the U.S. recovery is real estate. After having stoked the overheating of the economy before 2008 and having suffered in recent years from a lack of demand for houses, real state is now returning to a normal level of activity.

The bellwether indicator of economic recovery is the job market.

But the bellwether indicator of economic recovery is the job market. Werner pointed out that current U.S. unemployment of 6.1% to 6.5% does not include, for example, people who reduced their workload or who decided to leave the job market to return when the economy is better. "About 40% of this group could return to the labor market in the short term, creating a new floor for unemployment and a new ceiling for wage pressures," he said.

In Europe, Luiz de Mello, deputy chief of staff, Office of the Secretary-General of the OECD, observed, recovery is still short of what could be desired. "Six years after the crisis, we still see



Photo: André Telles.

Regis Bonelli

"There are doubts about the prospects for trade in goods and services."



José Julio Senna

"The monetary normalization in the United States will finally come."

significant restrictions on consumption in European countries, which should be the growth engine of recovery," he said. The IMF revised its growth projection for EU countries to 0.8% in October, down from 1.1% last July, primarily because of the performance of Italy, France, and Germany. The continuing crisis in Ukraine may also influence consumer confidence and further reduce consumption. The IMF also reduced Japan's projected growth to 0.9%, down from 1.6%, partly because of an increase in the value-added tax on consumption.

For Latin America, however, the biggest source of concern is still China. The IMF calculations, which take 2003 as the baseline, show that the correlation of growth in China with higher revenues for exporters of commodities has been very high, particularly for Venezuela, Argentina, and Brazil. Though Werner believes the Asian GDP slowdown from 10% to 7.5% has been smooth and orderly, the IMF is concerned with the sources of stimulus in Asian economies. "Loans in China have almost doubled in recent years, from 129% of GDP in 2009 to the current 212%," he said. He noted that the magnitude of indebtedness is a challenge for China at a time when it is moving to replace investment with domestic consumption and also manage potential crises in the informal financial sector (shadow banking) because of the possibly poor quality of loans in the hands of shadow institutions. "China will need to discipline its financial sector without creating panic," Werner said.

Otaviano Canuto, senior adviser on BRICS to the World Bank, pointed out that China is aware that large investments in the economy and huge trade surpluses at the expense of compressing domestic consumption will not find a favorable external environment from now on. "Western countries' consumption growth fueled by financial bubbles disappeared," he said. He believes that if the new government can carry out the reforms approved by the Communist Party—which include making contracts, patent rights, and ownership more secure—the country will enter a new phase that could make it an even more formidable competitor in manufacturing products.

GROWING FROM THE INSIDE OUT

Given this international outlook, experts are unanimous in predicting that in future Latin America will depend less on external demand and increasingly on internal adjustments that each economy must make to boost growth. Canuto cited a study showing that growth in Latin America in the last decade had relied more on export prices and less on stabilization policies and reforms. From now on, however, there will be no such easy gains. Seminar participants agreed that growth in the region will increasingly depend on reforms that have been pending for 20 years but have now become urgent.

In addition to slowdowns in the economies of trading partners, other elements are affecting Latin American growth: many economies are already close to their growth potential, and the end of the demographic bonus will reduce the contribution of labor to growth. Also, less international liquidity will reduce external financing and make it more difficult to correct structural barriers to competitiveness and growth.

Latin American countries will now have to work diligently to raise productivity, better educate workers, upgrade infrastructure, and enhance the business environment. To avoid compromising productive transformation and the stabilization of the economy, seminar participants also pointed out, government transfers and consumption at the expense of savings and a deterioration of the external current account balance, and wage increases above productivity, will have to be addressed.

"It will also be important to review the countercyclical fiscal policies adopted at the beginning of the 2008 crisis, which in many countries have not been reversed," Werner said. Even if countercyclical polices were adopted at a point where the perception of collapsing economies was greater than the later reality, policies continued to be expansionary well after markets had stabilized and their beneficial effects on the economies had greatly diminished. Canuto noted, though, that "Mexico was an exception. It was one of the few countries that understood how to manage a countercyclical policy and the need to press ahead with structural reforms."



Photo: André Telles.

Luiz de Melo

"Six years after the crisis, we still see significant restrictions on consumption in European countries."



Alejandro Werner

"Countercyclical fiscal policies have not been reversed."

São Paulo

Brazil





7.2 School years (2012)

5% Unemployment (July 2014)

21.8 Homicides (per 100,000 inhabitants, 2008-2011)

Population
203
million

2008	5.2
2009	-0.3
2010	7.5
2011	2.7
2012	1.0
2013	2.5
2014(e)	0.2
2015(e)	1.2

GDP
growth(%)

79th
Human Development Index
UNDP

116th
Doing Business
World Bank

56th
Global Competitiveness
World Economic Forum

17.0 Fixed investment (% of GDP)

6.3 Inflation (Consumer price index, August 2004, % annualized)

3.1 External debt (% GDP)



A talk with Michael Reid,
Former editor and current columnist for *The Economist* for Latin America, and author of *Brazil: The Troubled Rise of a Global Power*

How do you see the role of Brazil in South American integration and what about China's penetration in the region?

The major impact of the lack of an effective regional integration project has been the loss of markets. We see fraternization and declarations of solidarity at summits, yet Brazil has not opened up or sought open regionalism—a 1990s concept that Marco Aurelio Garcia [advisor to the President of the Republic] considers antiquated. The fact is that over the last 10 years the policy of integration for the region has resulted primarily in captive markets for contractors and capital goods industries in Venezuela and Argentina. China has come to the region to stay, and Brazil will have to adapt and indeed accept integration, as the countries of the Pacific Alliance did.

In your book, you point out Brazil's historical tradition of dirigisme and government-dependent development. What do you think about Brazil's social policy?

Many of the new social policies, such as the Family Grant program, have positive social impact. They are a necessary response to Brazil's historical social debt, which has its origins in the end of slavery. My biggest concern is with social policies carried over from the old corporate state, such as the current pension system, rather than with the policies of the New Republic. Going forward, each government will have to undertake a pension reform. Brazil is still young but its pension spending as a share of GDP is similar to that of southern Europe. This is unsustainable. I also think Brazil needs a thorough tax reform so that it can spend more on public health and safety, as the street protests in June 2013 demanded. For this, you need a more efficient and modern government, which is effectively progressive in social policies.

(e) IBRE staff estimates.
Sources: Brazilian Institute of Geography and Statistics (IBGE), United Nations Development Programme (UNDP), IBRE, Central Bank of Brazil, World Bank, World Economic Forum.



Brazil: Is the social contract a brake on the economy?

Solange Monteiro

THE LACK OF DOMESTIC stimulus to growth and productivity, cited by Alejandro Werner, director of the Western Hemisphere Department of the International Monetary Fund, as a common challenge to the countries of the region, seems particularly pertinent to Brazil's current stagnation. "Domestic policies weigh the Brazilian economy down more than in most countries in the region," IBRE researcher Samuel Pessôa commented. According to the IMF *World Economic Outlook* of May 2014, between 2003–10 and 2011–14 Brazil's growth declined by 2.11 percentage points, while growth in Latin America as a whole fell by 0.66 percentage point and in the world by 0.54 percentage point. "We Brazilians made choices that produce low domestic savings and fixed investment; consequently the economy grows less," he said.

Pessôa believes social policy choices consolidated as the 1988 Constitution emphasized the democratic features of the country and favored redistribution of income over growth. "We live in a democracy of inequality, where the median voter earns less than the average, which creates demand for income redistribution and tax increases. In this social contract, which favors equality, growth becomes secondary," Pessôa said. The choice was made apparent over the

BRAZIL: The weight of the social contract

Increase in non-financial public expenditure of the federal government, excluding transfers to states and municipalities (percentage points of GDP, 1999-2013)

-6.6	Wage bill
42.8	Social Security benefits
13.9	Subsidies
-10.3	Administrative costs
10.7	Health and education spending
37.9	Other social spending
1.6	Fixed investments

Source: IBRE/FGV.



Photo: Filipe Frazão/Shutterstock.com.



Photo: André Telles.

Samuel Pessôa

"We Brazilians made choices that produce low domestic savings and fixed investment; consequently the economy grows less."

past 15 years as government spending went up by 5 percentage points, mostly on pensions, health, education, and social spending, such as the Family Grant Program, wage bonuses, and unemployment insurance. "These expenditures were elected by society for which the Congress established eligibility criteria and values," Pessôa said. "This is not wasteful or inefficient. It is the social contract."

The same social contract, however, keeps Brazilian savings growing less than GDP, unlike what occurs in other countries. Pessôa explained that "Whenever there is a favorable situation for the economy to expand, Congress votes to appropriate a significant share of the increase in incomes for government consumption. This makes savings grow less than the expansion of the economy."

According to Pessôa, this trend has intensified over the past four years as the government moved to participate more in the economy: "The national-developmentalist policy adopted by the government recently was responsible for a reduction in potential growth from 3% down to 1.6%. And 80% of this slowdown is due to declining productivity." Lower productivity reflects price controls, greater tolerance of inflation, less transparent fiscal policy, the expanding role of public banks in financing investment, and indiscriminate adoption of policies to buy goods and services locally that have increased the cost of fixed investment. "Today's social contract has resulted from the current political balance, and I think that it will change, because in the long run the emerging new middle class will be more conservative. The new middle class will find that they are getting little from the government in terms of public services and will demand that taxes be lowered," Pessôa concluded. "If economic policy remains the same, Brazil will not be able to resume 3% growth."

Mexico





8.5 School years (2012)
5.2 Unemployment (%, July 2014)
23.7 Homicides (per 100,000 inhabitants, 2008-2011)

Population
122
million

71th
Human Development Index
UNDP

53th
Doing Business
World Bank

55th
Global Competitiveness
World Economic Forum

2008	1.4
2009	-4.7
2010	5.2
2011	3.8
2012	3.9
2013	1.1
2014(e)	2.3
2015(e)	3.5

GDP
growth(%)

20.7 Fixed investment (% of GDP)

4.1 Inflation (Consumer price index, August 2004, % annualized)

19.3 External debt (% GDP)



"North America is about 30% of our export market and Mexico, where we have been manufacturing electric motors since 2000, is currently our largest industrial operation outside of Brazil with four factories. In 2006, in partnership with Voltran, we expanded our production to manufacture transformers.

"Recently, the company announced investments of US$210 million over the next five years in Mexico, following the strategy of vertical integration of production processes. The project includes construction of an iron foundry that will meet the entire need for machined cast components for casings of industrial electric motors to be produced in Mexico and exported to North American markets."

Julio Ramires
Director, WEG Mexico



"Mexico is a key part of Braskem's internationalization project because of the opportunities it represents: Mexico is one of the nations with the largest number of free trade agreements in the world (over 40 countries); it has a large domestic market, good infrastructure, and ongoing expansion, in addition to being the second largest economy and one of the most stable in Latin America.

"Mexico has a privileged geographical position—a strategic point for the projection of Braskem's operations in the northern hemisphere. It is also important for its reserves of hydrocarbon, with great potential for growth after the energy sector reform. This favorable scenario will attract important investments in exploration and exploitation of oil and petrochemical projects."

Cleantho Leite Filho
Director of Business Development, Braskem Idesa

(e) World Bank estimates.
Sources: United Nations Economic Commission for Latin America and the Caribbean (ECLAC), United Nations Development Programme (UNDP), Central Bank of Mexico, World Bank, World Economic Forum. Information without date indication refers to 2012.



Mexico: Facing a difficult take-off

Solange Monteiro

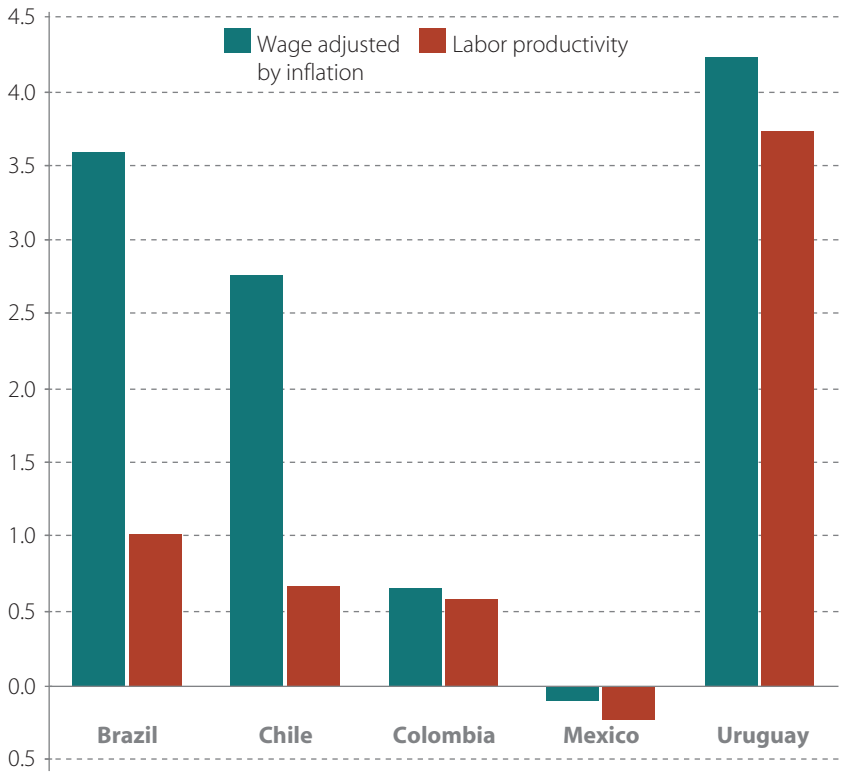
UNLIKE ITS NEIGHBORS IN THE REGION, Mexico did not benefit as much from the commodity boom but it is the country that has advanced reforms most, in recent years, in the financial sector, fiscal matters, telecommunications, and energy. The government expects the reforms will raise potential growth by 1 percentage point, to 4.7%, in 2015 and growth will reach 5.3% in 2018. So far, however, the Mexican growth trajectory does not seem to have taken off, with the World Bank this year projecting growth of 1.9%. "Mexico is a story of frustration for analysts, who are debating when the economy will finally take off," said Felipe Tâmega, chief economist at Itaú Asset Management.

The delay in growth, Tâmega said, can be attributed partly to short-term uncertainties brought about by the reforms themselves: "In general, companies that are already operating there wait to make investments, and new companies want to have the new rules defined so they can plan their activities." For now, he said, the growth window is still focused on expectations about the recovery of the American economy. He noted that "Services links between Mexico and the United States have strengthened more than industry links. If this is confirmed, we can be more optimistic about the positive effects of the U.S. recovery on Mexico's economy."

According to Tâmega, one of the factors of concern in the short term is the current discussion of the minimum wage. "Today Mexico has an advantaged position in terms of unit labor costs," he said, "being competitive in comparison even with China. If the minimum wage increase of 150% that is being discussed takes place, it

Mexico: Wages and produtivity growth have been below the region average.

Evolution of real wages and productivity, 2008-2013



Source: Haver Analytics and International Monetary Fund.

will have a strong negative impact." Gerardo Esquivel, professor at the Center for Economic Studies of the College of Mexico, disagrees. He believes that raising the minimum wage, if done gradually, would have the opposite effect: It would contribute to the recovery of domestic consumption. "One must remember that the purchasing power of the minimum wage in Mexico has fallen nearly 75% in the last 30 years. The minimum wage corresponds to 20% of average earnings, while the Latin American average is 40%," he pointed out.

"I do not say that the issues addressed in the reforms are not important, but I think they will not have the expected effect," Esquivel said. "Our problem rests mainly on four factors: dynamic export-oriented growth that ignores a weak domestic market, stagnant wages that undermine the ability to purchase and leave half the population in poverty, a shortage of affordable credit to the productive sector, and the low share of investment in total government spending." Besides recommending revised public spending, he also warned that decisions about oil concessions would be critical to Mexico's future fiscal situation. "We will be splitting the revenue from this sector with private companies, and it will be necessary to observe how the terms of such sharing will be negotiated," he said.

Even with substantial structural reforms, Tâmega and Esquivel agree that there will be little change in Mexican growth in the next few years. "It will not be a horror story because we will keep the economy stable," Esquivel said. "But stability will continue on the same path of mediocre growth below 3%."



Agreements between partners

"Relations between Brazil and Mexico are quite solid and are currently supported by the economic stability both countries have achieved. Although trade relations are currently below potential, over the past decade Mexico's exports to Brazil increased 767%, while trade in the opposite direction grew 35%.

"Currently, Brazil is Mexico's largest trading partner in Latin America, with approximate total trade of US$10 billion—close to Mexican trade with all the member countries of the Pacific Alliance together, which was about US$11 billion in 2013. The Pacific Alliance countries have already eliminated almost all of their tariffs, but negotiations between Brazil and Mexico still have some way to go. Currently, we have only Regional Agreement Preferential Tariff No. 4 (APR-4) of the Latin American Integration Association, which grants a mutual 20% preferential tariff on various products, and Economic Complementation Agreement No. 53 (ACE-53), which sets fixed preferences of 20% to 80% for about 800 tariff lines. In addition, there is ACE-55 for the automotive industry, signed in 2002 between Mexico and the members of Mercosur.

"Regarding foreign direct investment, the latest Census of Foreign Capital of the Central Bank of Brazil found that in 2012 Mexico had over US$18 billion in assets in Brazil. Some Mexican estimates indicate that the investment is in fact US$ 30 billion, consolidating Brazil as Mexico's second destination for investment after the United States. On the other hand, Brazil's investment in Mexico is still small. That means that the Brazilian private sector has many investment opportunities yet to be explored in Mexico. Currently, for example, the largest private investment project in Mexico is the development of Polo Ethylene 2I, an association between the Mexican Idesa Group and Brazil's Braskem. The project foresees investments of US$4.5 billion to build the largest petrochemical complex in Latin America, which will produce 1 million tons of polyethylene and ethylene by 2015.

"Brazil has also been involved in the largest operation of foreign investment registered in 2013 in Mexico—the purchase of Grupo Modelo by Belgian-Brazilian Anheuser-Busch InBev corporation. The US$13.2 billion operation was essential to Mexico's record inflow of US$35.2 billion in foreign direct investment last year.

"Nor does Brazil look to Mexico just to do business. Brazilians have become the leading Latin American visitors to Mexico, especially after elimination of visa requirements for tourism. Last year, 267,000 Brazilians visited Mexico, 36% more than in 2011, and this year 144,000 Brazilians had visited Mexico by June 2014—9% more than in the same period of 2013."

Marcos Raposo Lopes
Brazil's Ambassador to Mexico

Colombia


Bogotá



7.1 School years (2012)
9.3 Unemployment (%, July 2014)
33.2 Homicides (per 100,000 inhabitants, 2008-2011)

Population
48
million

98th
Human Development Index
UNDP

43th
Doing Business
World Bank

69th
Global Competitiveness
World Economic Forum

2008	3.5
2009	1.7
2010	4.0
2011	6.6
2012	4.1
2013	4.3
2014(e)	4.6
2015(e)	4.5

GDP
growth(%)

23.6 Fixed investment (% of GDP)

3.0 Inflation (Consumer price index, August 2004, % annualized)

24.4 External debt (% GDP)



"The relationship between Brazil and Colombia is in a particularly dynamic phase. Exponential growth of bilateral trade in the past decade resulted in flows of more than US$4 billion in 2013. Brazilian companies have played an important role in the expansion and modernization of Colombian infrastructure, with Brazilian building companies at the head of construction of roads, power facilities, and river navigation, among other areas. Brazil has cooperated with Colombia in such strategic areas as the development of family agriculture, scholarships for college students, and the training of platoons specialized in removing land mines. Repeatedly we have demonstrated our support for the peace process and will continue to work with Colombia to develop the country post-conflict. "

Maria Elisa Berenguer
Brazilian Ambassador to Colombia



"Natura has been operating in Colombia for seven years. The country is now one of our key markets in Latin America after Argentina and Mexico. Steady growth of the local economy, averaging 4.7% for the past four years, strengthens the prospects for our company there. Currently we have 50,000 consultants in Colombia and 15% of the products we sell in the country are produced locally. We continue investing in expansion of our network of consultants and in activities to enhance our brand preference and profitability. Natura's international operations in Latin America and France now represent 18% of the company's overall net income, which has grown on average 40% a year since 2009."

Erasmo Toledo
Vice President of International Operations, Natura

(e) World bank estimates.
Sources: United Nations Economic Commission for Latin America and the Caribbean (ECLAC), United Nations Development Programme (UNDP), Central Bank of Colombia, United Nations Conference on Trade and Development (UNCTAD), World bank, World Economic Forum.



Colombia: The oil illusion

Solange Monteiro

COLOMBIA HAS BEEN benefitting from high prices for its main export commodities—oil, coal, and coffee—and from favorable financial conditions. But the major concern in the medium term is public finances because the country is dependent on oil revenue, which is expected to decline in the next few years. "Colombia cannot run the risk of continuing this dependency," said Roberto Steiner, director of the Foundation for Higher Education and Development, stressing that the government is already working with an expectation of declining oil revenues. "In the medium term, oil revenues are expected to decrease from 2.5% to 1.7% of GDP," Steiner calculated.

The country has managed to keep inflation on target for more than five years and has a benchmark interest rate of 4.5%, consistent with growth of 4–5%. It has also been successful in gradually reducing high unemployment, thanks in part to a reform in 2012 that reduced payroll taxes by 13.5%, making hiring less costly.

Steiner pointed out that Colombia stands out for attracting foreign direct investment of 5% of GDP, adding "What helped to attract foreign investment was the reduction of the tax on capital inflows in 2012."

On the other hand, the surge of capital coming in caused the peso to appreciate by 7.5% between March and August this year. The question now is the magnitude of the correction when the capital flows decline, and how a possibly large correction will affect inflation. "We can be optimistic, since we managed to curb inflation in other critical situations, as in the months after the fall of Lehman Brothers in 2008, when the peso devalued by 40%," Steiner said. "A less appreciated peso could open up opportunities for industry and the agribusiness sector, which currently suffer from the appreciation."



Roberto Steiner

"Colombia cannot run the risk of continuing its oil dependency."

Steiner believes the two main areas of concern for Colombia are the growing external current account deficit—a clear sign of dependence on traditional exports and an imbalance between what the country produces and what it consumes—and the fiscal stance. "We depend on the quality of public policy to meet our goals," he said. In the medium term, Steiner estimates that demands for spending on pensions, health, and education will require about 2 percentage points of GDP in additional public spending. "The risk is that the solution to financing the additional spending will be a major tax increase, which would threaten the competitiveness of Colombian companies," he warned. "Today we have temporary taxes that have become permanent, an excessive number of tax exemptions, and inefficient tax collection. Instead of increasing taxes, we should focus on improving the tax system."

Santiago

Chile





9.8 School years (2012)

6.5 Unemployment (%, July 2014)

3.7 Homicides (per 100,000 inhabitants, 2008-2011)

Population
18
million

41th
Human Development Index
UNDP

34th
Doing Business
World Bank

34th
Global Competitiveness
World Economic Forum

2008	3.7
200	-1.0
2010	5.8
2011	5.9
2012	5.6
2013	4.2
2014(e)	3.3
2015(e)	4.5

GDP
growth(%)

24.1 Fixed investment (% of GDP)

4.5 Inflation (Consumer price index, August 2004, % annualized)

43.9 External debt (% GDP)



"The density of ties between Brazil and Chile might be most visible in trade and investment. The country is our third largest trading partner in Latin America, with bilateral trade of US$8.8 billion in 2013.

"In January this year, the Mercosur-Chile agreement reached 100% tariff reduction. Today, Brazil and Chile are strengthening relations between Mercosur and the Pacific Alliance, and the trade is already a reality. In 2012, trade between Mercosur and the Pacific Alliance reached US$52 billion, more than double the trade between Pacific Alliance countries. And, separately, Brazil imports more Chilean products than all other members of the Pacific Alliance.

"Brazil is also the top destination in the world for Chilean company investments, with over US$25 billion invested in a variety of areas, from pulp and paper to retail. The agenda for cooperation between Brazil and Chile is very broad and there is close cooperation on Antarctic issues, defense, science and technology, human rights, and infrastructure, among others. There are also areas of great potential, such as cooperation in infrastructure."

Georges Lamazière
Brazilian Ambassador to Chile



"I am optimistic about Chile's economic growth in coming years. The country is well-positioned to deal with the challenges of the present while looking to the future. Since the 1990s Chile had not changed its economy. Now it is in full restructuring, with an agenda of tax, labor, health, and education reforms.

"In this scenario, BTG Pactual sees several opportunities for strategic investments in areas such as energy, insurance, and credit. There are still business opportunities in mergers and acquisitions in the region. The solidity of the Chilean economy over the past 20 years provides the security needed for large investments. It is a unique experience to follow closely the growth of a country undergoing a total transformation."

André Porto
Chief Operating Officer of BTG Pactual, Chile

(e) World bank estimates. Sources: United Nations Economic Commission for Latin America and the Caribbean (ECLAC), United Nations Development Programme (UNDP), Central Bank of Chile, United Nations Conference on Trade and Development (UNCTAD), World bank, World Economic Forum.



Chile: Unexpected step back

Solange Monteiro

THIS YEAR, CHILE was badly surprised by an unexpected drop in economic activity. Felipe Tâmega, chief economist for Itaú Asset Management, pointed out that the end of an investment cycle in the production of copper, the main export, coincided with both slowing Chinese demand for copper and reduced Chilean domestic consumption, which for years had been rising above its potential. "Domestic demand took longer to show signs of a slowdown mainly because it was supported by a buoyant labor market and an ample supply of credit," Tâmega said. The result? Lower GDP growth.

Meanwhile, the fall in copper prices and the consequent depreciation of the peso generated both a contraction in the economy and inflationary pressure. The maturation of the investment cycle, which at first appeared to be simply an adjustment of demand, proved to be the beginning of a broader slowdown. According to the Central Bank of Chile, fixed gross investment growth fell from 9% in the first half of 2013 to –8.1% in the second quarter of 2014.

Another factor working against the economy is the aging of copper mines, which raises production costs. "One way to look at it is to realize that the large investments in recent years did not increase production in the same proportion," said Guillermo Larraín, vice president of BancoEstado in Santiago. "Meanwhile," Tâmega added, "Peru is now exploring new copper mines to intensify competition."

The business environment and investment intentions in general were also impaired more than expected in 2014 by expectations related to discussions about tax reform, which extended over much of the year; Chilean President Michelle Bachelet promulgated the final version in late September. The new tax law increases the corporation tax rate from 20% to 25–27%. The government expects to raise US$8.3 billion more in tax revenue and intends to use the additional revenues to finance changes in education, health, and social security. Another reform that is shaking market expectations relates to education, with results that can only be seen over the long term. "The reforms we see today in Colombia, Mexico, and Peru are important to a stage of development that we have already reached," Larraín said. "The education reform is part of a new generation of more complex reforms. It is the only way to solve the problems of income inequality and low productivity."



Photo: André Telles.

Felipe Tâmega

"Chile's domestic demand took longer to show signs of a slowdown mainly because it was supported by a buoyant labor market and an ample supply of credit."

Tâmega believes Chile's main challenge is to prepare for a more intense phase in the adjustment of Chinese demand. "China's slowdown and the structural change to less construction-led growth implies that Asia's growth will have less impact on Chile's growth," he said, indicating that this will require an adjustment to Chile's potential growth. The growth decline, Larraín explained, is difficult to estimate in the short term. "In a situation like this, some sectors contract, but other sectors can expand," he said, indicating that, with currency depreciation and inflation under control, the outlook improves for other export sectors, such as agribusiness, forestry, salmon, and wine. The government is seeking to encourage productive groups, such as those providing services to the mining industry, that may eventually export services to neighboring Peru and Colombia, but "these initiatives require time to mature," Larraín said. Meanwhile, the expectation is that in the short term the reforms will have a positive fiscal impact and the slowdown in the economy will not persist.

Argentina





9.8 School years (2012)
7.4 Unemployment (%, July 2014)
5.5 Homicides (per 100,000 inhabitants, 2008-2011)

Population
41
million

49th
Human Development Index
UNDP

126th
Doing Business
World Bank

104th
Global Competitiveness
World Economic Forum

GDP growth(%)

2008	6.8
2009	0.9
2010	9.1
2011	8.6
2012	0.9
2013	3.0
2014(e)	0
2015(e)	1.5

21.8 Fixed investment (% of GDP)

18.2 Inflation (Consumer price index, August 2004, % annualized)

29.6 External debt (% GDP)



"Because of its importance, any joint strategy between Brazil and Argentina over the future of their bilateral relations should always be mindful of the accumulated assets and the many opportunities still open for both countries. As a reminder of this legacy, it is worth mentioning that between 1991 and 2013 the flow of Brazil and Argentina trade increased twelvefold. The dynamism of our relations requires constant effort both in the short and the long term. Despite remarkable advances, Brazil and Argentina still have huge potential to explore, especially with regard to integration of their production structures.

"Transport and energy integration offers ample investment opportunities around projects of common interest, as shown in studies for connecting the rail networks of the two countries conducted ... . In the energy area, beyond the different projects for shared utilization of hydropower resources in the La Plata Basin, there are talks about reactivating the thermal power plant at Uruguayana in the south of Brazil using Argentina's gas. Such initiatives allow expansion of investments by both countries, which already are quite significant: Brazilian companies have invested US$17 billion in Argentina and Argentine companies have invested US$8 billion in Brazil.

Everton Vargas
Brazil's Ambassador to Argentina



"The prospect of Brazilian investment in Argentina will be buoyed in 2015 by four events: (1) the negotiations with holdout investors in Argentine debt; (2) the general elections, which will elect one-third of the Senate, half of the Chamber of Deputies, and a new president; (3) China's financial contributions for infrastructure investment agreements in Argentina; and (4) the presidential elections in October 2014 in Brazil and Uruguay, whose new governments may redefine their bilateral relations and, further, review the Mercosur agenda. As for Brazilian business interests, we can expect a waiting period and eventual deterioration of commercial practices if Argentine authorities persists in the habitual use of populist and protectionist expedients. Indeed, 2015 will be a lost year; economic activity in Argentina should renew when the new government takes over in January2016."

Alberto Pfeifer
Secretary, Committee of Institutional and International Relations, and council member, Argentine-Brazil Chamber of Commerce

(e) World bank estimates. Sources: United Nations Economic Commission for Latin America and the Caribbean (ECLAC), United Nations Development Programme (UNDP), Central Bank of Argentina, National Institute of Statistics (INDEC) United Nations Conference on Trade and Development (UNCTAD), World bank, World Economic Forum.



Argentina: Growth blackout

Solange Monteiro

ARGENTINA WAS IN THE NEWS throughout the year with reports on higher inflation, economic stagnation, and various bouts of arm-wrestling related to the New York court decision that it must pay holdout bond investors. Given that situation, "whoever looks at the short term will not have much to see beyond an economic crisis and a period of great instability," said José Maria Fanelli, an economist at the Center for the Study of State and Society.

Fanelli described a country whose dynamics until 2008 resembled that of other Latin American countries that benefited from high commodity prices, saw their currency appreciate, and raised public spending. "Argentina does not differ much from other countries," Fanelli said "What differs is our mess." In some aspects, the country was more conservative than most of its neighbors. Fanelli explained that "We were dedicated to paying down foreign and domestic debt. After the debt renegotiation, net public debt was only 18% of GDP, and Argentines have significant savings deposited abroad. In the future, we should not have pressure on the external current account in terms of income payments."

However, after the 2008 crisis, Argentina's fiscal deficit began to widen, financed by printing money, which pushed up inflation. Exports dropped significantly as Brazilian imports and Chinese demand for soybeans fell even as public spending was rising. But "These numbers alone do not produce a crisis," Fanelli said, pointing out that the true tipping point was the substantial increase in government subsidies to consumers of transport services and energy. From 2005 to 2011, these subsidies went from 0.65% to 3.45% of GDP. Fanelli warned, "We have destroyed the energy sector, turning its surplus of US$5 billion in 2004 into a deficit of US$7 billion in 2010."



José Maria Fanelli

"Once the energy issue is resolved, Argentina will have a good outlook, including investment opportunities in the energy sector and low public debt."

Fanelli believes the distortion caused by energy policy is the number one reason for low growth because it has an impact on both the external and the fiscal accounts. Energy subsidies now represent about 4% of GDP—about the same as the budget deficit the country is struggling to finance. "The fiscal issue would be resolved if the Argentines paid their own electricity bills," Fanelli said. How the energy bill will be paid will determine whether the economy will recover or fall into recession. Most of the answers are likely to be held off until after the presidential elections in 2015. "Once the energy issue is resolved," Fanelli concluded, "Argentina will have a good outlook, including investment opportunities in the energy sector with the discovery of shale gas in the Vaca Muerta, and low public debt."



Central America

Only negatives from commodities

Solange Monteiro

UNLIKE WHAT HAPPENED with most South American countries, high commodity prices have not benefitted Central American economies but instead have caused problems. With no agricultural or mineral wealth, they experienced a significant appreciation of their currencies, said Alberto Trejos, former Minister of Foreign Trade for Costa Rica. "The situation has become

Central America's average growth

2002 – 2015, %



Source: INCAE.

more delicate mainly in the northern triangle (Honduras, El Salvador, and Guatemala), because their export products compete with China's products, and as a result their export prices declined," he said.

Despite their different economic and social profiles, Central American countries in general are characterized by openness and generally prudent economic policies. Today, attention is mainly focused on Costa Rica and Panama, the most prosperous countries in the region. Trejos said that despite reforms these countries have put in place, today they face significant domestic challenges. A fiscal deficit, currency appreciation, and high labor costs have reduced Costa Rica's competitiveness. "There are policy issues that affected expectations significantly, putting in doubt the modernization of the economy," Trejos said. Panama also needs salary adjustments and fiscal reform. The country, which grew in double digits in 2011 and 2012, now has difficulties in expanding its most competitive sector, infrastructure, the marginal returns of which have diminished.

The direction of both economies will influence the future of the entire isthmus. Costa Rica has focused its exports on high-tech goods and services and Panama on logistics and financial services—exports that have high value-added. The two countries are also the locomotive driving a successful Central American common market. "Companies see Central America as a market rather than individual countries, despite their differences," Trejos pointed out.

Another challenge for Central America is contradictions in the relationship the region has been building with Colombia. On the one hand, the dynamism of the Colombian economy has brought a significant increase of direct investment from Colombia into the region. "As a source of capital, Colombia has been a more complementary partner than Mexico," Trejos said. In 2012 and 2013, except for Belize and Nicaragua, Central American countries attracted US$5.4 billion in Colombian direct investment in the financial, hospitality, and food sectors. On the other hand, as a result of the success of the U.S.-supported Plan Colombia aimed at combating Colombian drug cartels and left-wing insurgent groups, there has been a reorganization of drug trafficking, which has increased violence in Central America. Trejos emphasized that until the security problems are solved, countries in the region will not prosper.

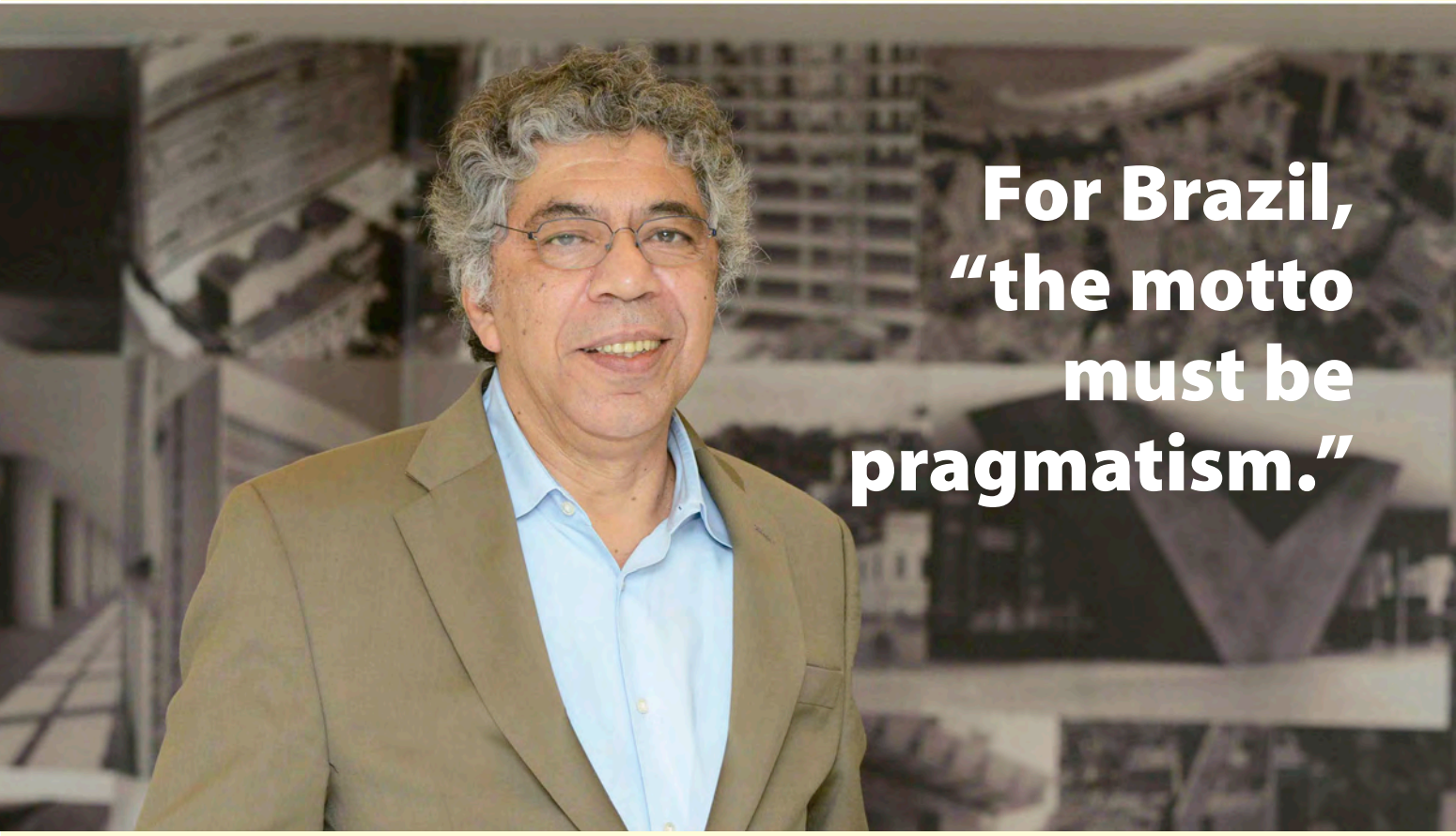


Photo: André Telles

Alberto Trejos

"As a source of capital, Colombia has been a more complementary partner than Mexico."

Photo: André Telles



For Brazil, "the motto must be pragmatism."

Otaviano Canuto

Senior Adviser on BRICS to the World Bank

Solange Monteiro

Otaviano Canuto has observed the boom in Latin American exports of commodities from a variety of positions at the World Bank and the Inter-American Development Bank. In the seminar on "Latin America and the New World Economic Outlook," organized by the Brazilian Institute of Economics in September, Canuto said the challenge for Latin American countries is to carry out reforms even as their economies are slowing down. For Brazil, he said, "the motto must be pragmatism," in both external economic relations and domestic policies. Canuto also argued for reducing Brazil's gross debt in order to increase private investment and reviewing public spending, adding, "From now on, the social or productive return on public spending can make a huge difference for growth and prosperity."

***The Brazilian Economy*—You mentioned that the Latin America boom was affected by three major factors: increased production resulting from reallocation of labor to more productive activities, a heavy increase in demand for commodities, and abundant international liquidity. What countries have benefited most from the boom and what factors will affect their future?**

Otaviano Canuto—If we look at how countries took advantage of the recent boom in commodity prices to improve their fiscal indicators and investment, most performed better than they did in previous cycles. If we evaluate the quality of economic

policy in most countries in the region—Brazil, Colombia, Peru, Paraguay, and Uruguay—they managed the commodity boom well to improve social indicators, accumulate international reserves, and strengthen their external position.

On the other hand, there was a certain complacency about the need for reform, particularly in Brazil. The thrust for institutional reforms that had characterized many countries in the region in the 1990s and especially the early 2000s became secondary because of the relief the commodity boom afforded them.

Countries that resume reforms will now have to adapt to a new international outlook … every country should put together its own reform program to address its main difficulties in raising productivity and competitiveness …. Mexico is a good example; it has reform proposals for infrastructure, the oil sector, the tax code, and education.

In recent years, Latin American countries like Peru and Colombia began to open up their economies, joining Chile and Mexico in trade agreements with the Asia-Pacific region. How will opening up their economies affect their manufacturing industry and integration into regional supply chains?

The manufacturing challenge is common to the region, with the obvious exception of Mexico, because of its integration into North American regional supply chains. In the case of Mexico, however, this integration has not guaranteed higher growth because ultimately the manufacturing sector is not large enough to pull the rest of the economy. In the other countries of the Pacific Alliance as well as Brazil, the manufacturing challenge should not be addressed by protecting domestic industry, as was done in the past. Their prospects of becoming part of regional supply chains will depend in large measure on policies that reduce costs and increase the productivity of local workers. Achieving a significant position in some of the global supply chains requires resources and other things that are out of reach for Latin American countries. Even so, the region would benefit if countries would join forces to explore the comparative advantages of each country, because denser production chains would open opportunities for all.

The region would benefit from joining forces to explore the comparative advantages of each country because denser production chains would open opportunities for all.

What is the role of Brazil and Mercosur in the regional context?

Certainly we must leave behind the idea of Mercosur as a self-sufficient system that should operate as a sort of autarchy. Mercosur at least will have to secure smoother integrated production within the bloc without interfering with the operation of competitive markets. Mercosur has to open up, do what it takes to be part of the [world trade] game. The introduction of protectionist trade policies within the bloc certainly does not help. I think we have to revise Mercosur and if appropriate adopt a more flexible approach to the business country members do with the rest of the world.

For Brazil, China has been an important market for commodities but at the same time a competitor in South America's manufactured goods market. What are the future prospects for Brazil-China relations?

China's impact extends to both the penetration of Chinese products in the region and the manifest interest in investing in the region … . The Chinese are interested in investing in industries like the automotive industry, urban mobility, and rail, as well as in exploring shale gas opportunities in Argentina. Clearly, China's importance will extend far beyond its share in the region's manufactured goods market, which is already significant.

For Brazil, this is a clear demonstration of how Mercosur's institutional framework has become obsolete … . If there was any intention to protect the Mercosur market as a privileged area for Brazilian companies, the reality is that is not practically feasible. However, Brazil can enhance value-added in activities associated with natural resources, research, and professional services related to natural resources. This is a natural area where Brazil can, like other resource-rich countries in the region, build up significant participation in global supply chains. Trying to be competitive in all segments will not prevent Chinese penetration into other countries in the region.

We must leave behind the idea of Mercosur as a self-sufficient system that should operate as a sort of autarchy.

Brazil has not advanced in trade openness. The trade agreements it has signed are of little relevance, and Brazil's South-South foreign policy has not brought about significant economic gains. What is your view on Brazil's trade policy?

The results of the policy orientation have been meager. Basically, it only served to defend a framework of past trade policy to maintain the status quo … . At one point the country made a commitment to a global multilateral negotiating agenda, but that agenda stagnated. … The plain fact is that we are left with neither a better multilateral trade framework nor bilateral free trade agreements that could have been a meaningful improvement.

The motto must be pragmatism. Brazil is a country of global integration … . Diversifying our front lines would be like insuring against risks. Focusing on the countries in the South cannot be at the expense of the ones in the North. Pragmatism should lead Brazil to explore all possibilities on all fronts.

The main challenges facing Brazil today are domestic, such as low savings and productivity. Some argue that these are both directly related to the Brazilian social contract rooted in the 1988 Constitution that encourages public transfers and consumption at the expense of savings and investment. Do you agree?

Today there coexist the manifest desire of the Constitution for more social spending and the preservation of other privileges that determine public spending. In a way, leniency in maintaining unjustified privileges was possible by increasing the tax burden during the commodity boom. The way to protect social spending is to review closely the quality

of expenditures and who the beneficiaries are. … It is possible to pursue a policy to increase productivity without conflict with the population's political desires [for more social spending and better income distribution] as expressed in the Constitution.

What will be the main challenge for the next government in reviving growth and fighting inflation?

It is worth separating short-term and long-term policies. In the short term, … one obvious correction is adjusting controlled prices, including some type of mechanism to avoid price misalignment. Another correction is to prepare the country for a likely increase in the U.S. interest rate and a period of volatility in withdrawals of assets from Brazil and other emerging countries, which will probably put pressure on the exchange rate—especially because today Brazil's external current account is no longer entirely financed by foreign direct investment. These two corrections—the adjustment of administered prices and the likely depreciation of the exchange rate—will entail additional inflation. As inflation has for some time already been running close to the central bank's upper target, this will bring up an immediate inflation challenge. To curb inflation, it will be vital that monetary policy is supported by consistent fiscal policy.

Fiscal policy in the short term needs to ensure that public debt and the budget surplus return to a sustainable trajectory. In addition to adjusting administered prices and some exchange rate depreciation, public spending in the last two years will need to be acknowledged more explicitly. At some point, it will be necessary to contain expenses that were postponed. Some liabilities, such as the energy bill, are obvious, and next year they will more than ever be the center of fiscal policy. The medium and long-term policy is what I have already described. We cannot be naïve and imagine that it will be possible to see results in the short term. However, a correct policy signaling the right direction can help to reduce risk premiums.

For Brazil the only way to see lower interest rates and higher private investment will be to reduce the gross public debt-to-GDP ratio.

What is needed to raise investment?

A point I like to emphasize is that for Brazil the only way to see lower interest rates and higher private investment in the future will be to reduce the gross public debt-to-GDP ratio. In Brazil, the bulk of financial assets is in public debt. Since you cannot try to reduce the interest burden by force, the only solid way to do it is to have sufficient fiscal primary surpluses to reduce gross public debt. If we reduce gross debt, whoever wants to make money in Brazil will have to either buy private equity or participate in public-private infrastructure operations. The only way to stop the country being a rentier of the public sector will be to reduce the size of public debt. Any plan to increase private investment and place the Brazilian economy on a sustainable growth path with increased productivity and economic stability must take this route.

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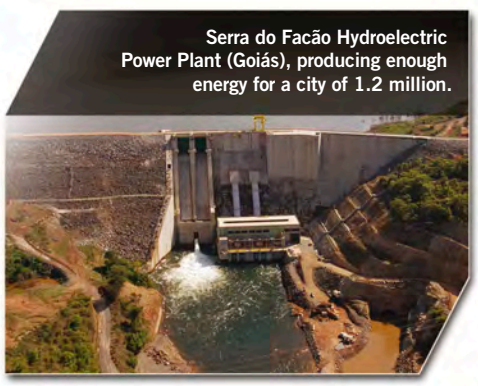
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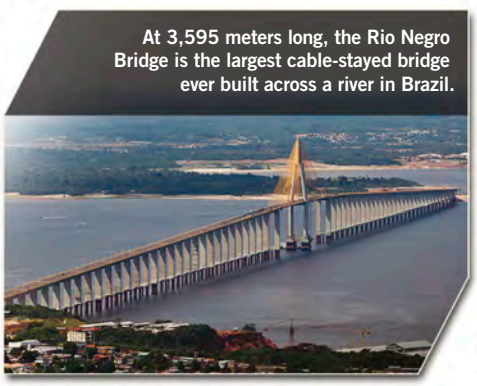
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How can the infrastructure program be speeded up?

Representatives of the heavy construction industry met to discuss how to accelerate the Brazilian infrastructure program.

Solange Monteiro

SINCE THE LAUNCH OF THE Growth Acceleration Program (PAC) to expand the public transport system in the cities that hosted the World Cup in Brazil, large infrastructure projects have come to occupy the attention of Brazilians, especially those in the private sector, more than ever. The results of these efforts, however, leave much to be desired. What brakes are preventing Brazil from accelerating investment? That was the question discussed by economists and industry representatives who gathered at the "Seminar of Infrastructure and Heavy Construction in Brazil," sponsored by the Brazilian Institute of Economics of Getulio Vargas Foundation (IBRE/FGV) on September 30 in Rio de Janeiro.

IBRE researcher Armando Castelar capsulized the problem: "The view is that the public sector is the great lever, but also the great hurdle." He believes that the lack of a comprehensive strategy has caused programs and initiatives to fail at various points, starting with institutional planning and decisions about public works.

The result is an economy that is steadily losing competitiveness. "If for decades we have identified our role as an exporter of grain and ore, why have we not taken care of the transport infrastructure?" asked Ricardo Pinto Pinheiro, president of the Brazilian Association of Highway Concessionaires (ABCR). "In the United States, which has continental dimensions like Brazil, there are 4 million km of paved highways. Here, we have just over 200,000 km."

João Manoel Pinho de Mello, professor at the Institute of Education and Research, weighed in with telling detail: "While a load shipped from Mato Grosso state in Brazil costs US$190 per metric ton to get to China, from Cordoba in Argentina it costs US$102, and from Illinois in the US it costs US$71," he said. He believes that infrastructure investment falls far short of the actual needs, noting that "From 2004 to 2011, Brazil invested only 0.03% of GDP in railways and 0.16% in highways, while in the same period a typical OECD country spent 0.29% on railways and 0.89% on highways."

Carlos Campos, researcher at the Institute of Applied Economic Research (IPEA), showed that infrastructure investment rose in recent years mainly because of more private sector participation: "The private sector accounted for 46.5% of total investments in infrastructure between 2002 and 2013, and the outlook is that private sector investment will continue to rise in 2014–16," he said. One study by Campos showed that government actions were insufficient to improve the capacity of the public sector to carry out large projects. He found that from 2003 to 2012 execution of authorized spending on road projects (R$116.8 billion) was only 53% and on ports (R$19 billion) just 47%."Among factors affecting execution are low-quality projects, difficulties in obtaining environmental permits, and delays in expropriations," he said. Álvaro Monnerat, director of operational excellence for Carioca Engenharia, highlighted the impact of these inefficiencies on construction operations. "It is estimated that in the last decade the sector registered a level of waste in these operations of about 42% and a decline in productivity of 23%," he said.

"It is estimated that in the last decade the sector registered a level of waste in [construction] operations of about 42% and a decline in productivity of 23%."

Álvaro Monnerat

PAC Secretary Mauricio Muniz acknowledged the impact of such bottlenecks as securing environmental permits and expropriation procedures, but insisted that "These issues have not been overlooked. They are part of a continuous process of improvements and enhancements,

Federal government investment program

(US$ billion)

Total	**99**
Roads	**17**
Railways	**37**
Ports	**23**
Airports	**8**
High-speed train	**14**

Source: National Development Bank (BNDES).
Note: Original values in national currency converted into US dollar at 2.44 Brazilian Real per US dollar.

which includes discussions with the actors involved." He claimed that the seven years of PAC have changed the level of investment and regulation of the investment environment in Brazil. "We must recognize the bottlenecks but also appreciate the advances. The PAC is an improvement in planning, and each sector today has clarity and transparency about its priority projects," he said.

"We need to make people understand how much our life improves when there is investment, and the economic and social impact when resources are invested efficiently."

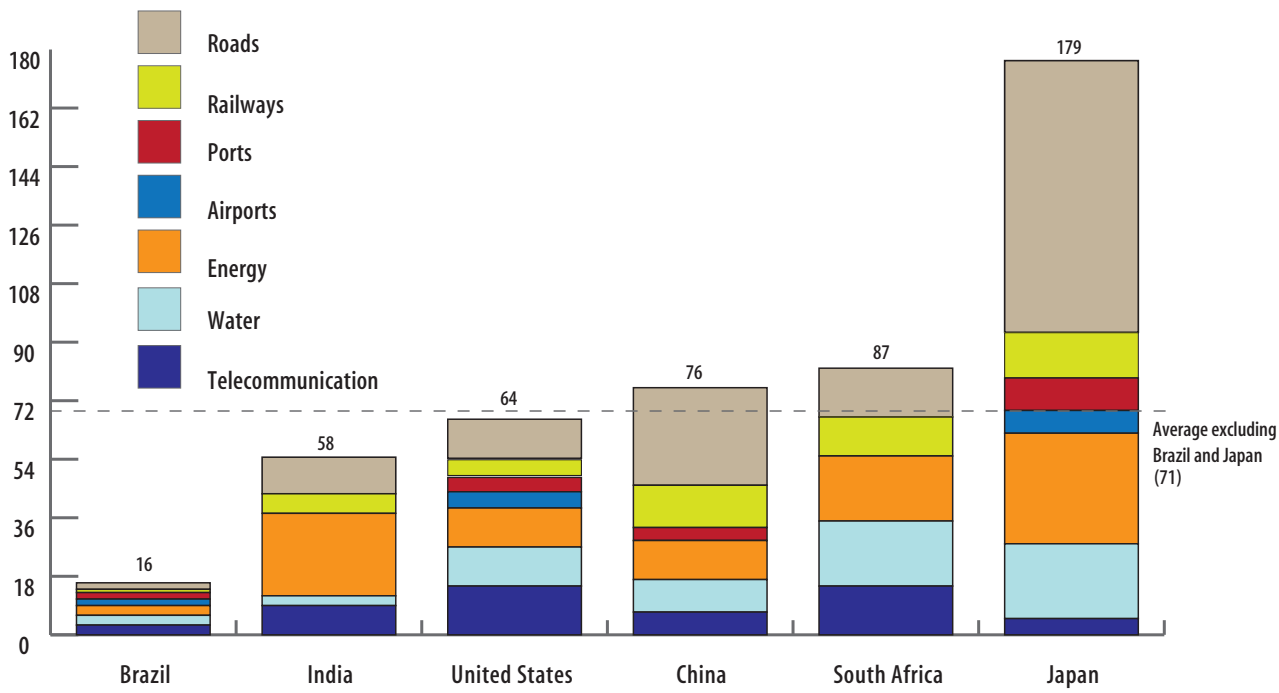
José Carlos Martins

Muniz admitted there had been cases where the government had approved works not yet designed. "Urban mobility, for example, totals R$143 billion in works and has been criticized for long delays. There were situations where … we found that states and municipalities did not have projects but we decided to support them even though at the time they had only ideas," he says. Was it a bad decision? No, says Muniz: "If we had not approved those public works, we would not have advanced in creating a culture that encourages such projects."

Funding models

Seminar participants also discussed financing alternatives for projects. Nelson Siffert, superintendent of infrastructure for the National Development Bank (BNDES), highlighted the importance of the infrastructure sector in BNDES disbursements. Currently, infrastructure accounts for 37% of its loans, which this year are expected

Infrastructure assets (% of GDP)



Source: McKinsey Global Institute, 2013.

to total R$190 billion. "The share of infrastructure in total disbursements is expected to grow in the future, given its impact on the economy," he said.

Siffert defended the BNDES project finance model as ensuring the sustainability of infrastructure projects, particularly in concessions, as well as the creation of special-purpose entities, which are widespread in the electricity sector and in highway and airport programs, saying "They are important tools for capital-intensive projects." He also highlighted efforts that have been made to boost the participation of capital markets in infrastructure debenture issues. Siffert also emphasized the importance of creating an environment to stimulate competition for infrastructure concessions. "The competition takes place in the bidding process, and that moment deserves more attention," he said.

Aluízio Guimarães Cupertino, president of the Council of the Heavy Construction Industry Association of São Paulo, stressed the importance of designing contracts "to ensure the best performance both in the execution of the public work and its management."

Regarding regulation, Nara Kohlsdorf, manager of norms and awards for the National Land Transport Agency (ANTT), argued for streamlining administration. "We need not only to reduce the amount of paper but also to have reasonable rules, check whether certain requirements are necessary, and see whether there might be market-based solutions," she said.

"While a load shipped from Mato Grosso state in Brazil costs US$190 per metric ton to get to China, from Cordoba in Argentina it costs US$102, and from Illinois in the US costs US$71."

João Manoel Pinho de Mello

Speakers at the seminar were willing to collaborate to improve the prospects for more streamlined infrastructure projects. Rodolpho Tourinho Neto, chief executive of the National Union of Construction Industry, described an initiative in which his union is working with the Brazilian Association of Infrastructure and Base Industries, the Brazilian Association of Financial and Capital Markets, and the Brazilian Federation of Banks to draw up recommendations for the sector. "It is important to focus on solutions, not just diagnoses," he said. "In the case of expropriations, for example, we work with a 1940s law, and we need to change it. As for environmental licensing, we suggest that only one agency should be responsible for the process, or there should be time limits for each agency to rule."

José Carlos Martins, president of the Brazilian Chamber of the Construction Industry, spoke to the importance of bringing together the efforts of all to improve initiatives and national competitiveness. "We live in a culture of immediacy, but our sector works over the long term. As leaders, it is up to us to convey this message to society," he said. "The elections elicit reflection and discussion, and we need to make people understand how much our life improves when there is investment, and the economic and social impact when resources are invested efficiently."

Gloomy prospects for the economy

IBRE staff discusses prospects for the Brazilian economy in a time of transition.

Solange Monteiro

Several economic indicators worsened in the third quarter, as did the confidence of entrepreneurs and consumers in the economy. That will no doubt heighten the challenges for the president who is sworn in early next year. In the Economic Analysis Seminar organized by the Brazilian Institute of Economics (IBRE) in mid-September, IBRE researchers expressed considerable concern about the current situation of the economy. "There was some expectation of economic recovery after the World Cup, but pessimistic expectations proved to be stronger, "said Samuel Pessôa. "The difference is that now there is no global crisis to justify our internal crisis," commented Armando Castelar

Other indicators reinforce the pessimism. "In the second quarter the service sector, for example, contracted by 0.5%. This has only happened twice in the last eleven years," Regis Bonelli said. Domestic savings have been declining since 2011 and are now down to 13% of GDP from 19% of GDP in 2011. The savings drop and a fall in investment by 5.3% in the same period confirms the severity of the country's financing needs. Silvia Matos explained that "Our projection is that fixed investment will fall by 7.9% in 2014. Surveys show that the manufacturing sector intends to invest little in the next 12 months, and the scenario for the construction sector is critical"; she said IBRE is projecting that fixed investment in Brazil will end the year at 17% of GDP compared to 20% of GDP in 2011.

Aloisio Campelo affirmed that certain sectors of the economy had seen some improvement in activity in the third quarter. But, he warned, "This seems more related to the normalization of working days, after the period of the World Cup holiday." Consumers were concerned with uncertainty about employment considering how few jobs were created. Castelar pointed out that reduced credit implied a decline in activity in such labor-intensive sectors as construction, commerce, and financial intermediation, which should affect employment heavily.

> **"Now there is no global crisis to justify our internal crisis."**
>
> ***Armando Castelar***

Castelar also identified a fall in confidence in both public and private banks: "In the last 12 months, private bank credit adjusted for inflation declined, as was seen at the height of the crisis in 2009." He believes that in order to ensure GDP growth in 2015, whoever is elected president will have to win back the credibility of both consumers and markets. "Today we are growing as little as in 2009, but with much higher inflation and external current account deficit. This implies a non-trivial cyclical adjustment."



As for monetary policy, José Julio Senna signaled concern about market expectations that the presidential candidates will not raise interest rates. "I think the market is buying the presidential candidates' speeches," Senna said, indicating that usually a new administration would do the opposite. "There is no way out given that Brazil has a flexible exchange rate. That was the case with Arminio Fraga in 1999, when he raised interest rates from 39% to 45%; Antonio Palocci and Henrique Meirelles in 2002 raised interest rates twice; and Alexandre Tombini increased interest rates from 10.75% to 12.5%," he said.

"Our projection is that fixed investment will fall by 7.9% in 2014. … The manufacturing sector intends to invest little in the next 12 months, and the scenario in the construction sector is critical."

Silvia Matos

Nelson Barbosa argued for caution on interventions to contain depreciation of the real. In his view, Central Bank interventions in the exchange market have been higher than would be desirable and somewhat precipitate. Based on the nominal exchange rate since the beginning of the Real Plan in

1994, Barbosa estimates that the long-term average exchange rate at 2.50 reais per U.S. dollar, adding, "This means that the Central Bank sold 25% of Brazil's international reserves in the form of swap operations, but the exchange rate did nothing more than return to its long-term average."

On the fiscal side, economists pointed to the problem of maintaining government consumption when there is no room in the budget. From January to July, the primary surplus was R$24.7 billion, the lowest since the Fiscal Responsibility Law was enacted in 2000. "On the one hand, the voter wants more consumption and more public spending. On the other, it is hard to think how rising spending can continue," Barbosa said. "We cannot deny that there has been some control of administrative and personnel expenses. However, we have a complicated political economy and the fact is that over the past three years the fiscal primary surplus has deteriorated," Pessôa noted.

"Central Bank interventions in the exchange market have been higher than would be desirable and somewhat precipitate."

Nelson Barbosa

IBRE estimates that the 2014 primary surplus will be 0.2% of GDP—far below the government target of 1.9%. What is the actual margin for fiscal adjustment is an issue that generates controversy and will certainly depend on the preferences of the president elected. Between reducing subsidies, eliminating tax exemptions, and greater fiscal effort, IBRE researchers estimate that a primary surplus of 1.1% in 2015 is possible. "If we do everything right we will work with lower interest rates and this will give us a chance to improve domestic savings and seek an adjustment of the economy that leads us to another period of growth," Pessôa concluded.



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If the next government can overcome the policy challenges and increase confidence, a new cycle of more sustainable growth and investment is a possibility.

THE GLOBAL ECONOMIC outlook is for gradual recovery of the developed economies, but with heterogeneity among countries. In the United States, the prospects are very favorable. In contrast, although the Eurozone has come out of the recession, there are still no clear signs of solid growth there. The Chinese economy is still gradually slowing down, but inflation is under control and the government has room to adopt expansionary polices to prevent a further significant slowdown in economic activity.

Although the growth outlook is better for developed countries, the risks for emerging economies remain. A rising U.S. interest rate may attract an outflow of funds from emerging countries. Undoubtedly, this risk is greater for countries with weak economic fundamentals; unfortunately, Brazil is one of those countries.

With the release of second quarter GDP, we revised our GDP growth forecast down to 0.2% for this year; in June we had projected 1.6%. Over the past few months the outlook for economic activity has progressively worsened, leading to successive revisions of the forecast.

What can we expect for 2015?

Economic imbalances have widened in recent years. The growth expected for the Rousseff administration term is 1.6% on average, much lower than the 4% under Lula. Over the last four years the trade-off between inflation and growth has also worsened: the projection is that inflation for this administration term will be 1.1 percentage points above the average for the Lula administration after 2003. And, even with low growth and weak investment, the external current account deficit has risen significantly. This deterioration is troubling.

A major question is how willing the rest of the world will be to continue financing Brazil's external current account deficit. Brazil may experience further volatility if external financing conditions worsen, stimulating another increase in the domestic interest rate and steeper exchange rate depreciation to reduce the external deficit. That would penalize investment and growth.

No doubt, 2015 will be a very challenging year. Our baseline scenario contemplates restoration of monetary and fiscal policy credibility, which would make possible a more effective policy to curb inflation with lower adjustment costs in the medium term. We expect fiscal policy to be much more sound, with a primary surplus of 1.1% in 2015, up from 0.2% in 2014. Such a change in fiscal policy could heighten both confidence and debt sustainability in the medium term.

In addition to dealing with the problems associated with macroeconomic policy, a new cycle of reforms is necessary to raise productivity. Making utility and infrastructure concessions more flexible and improving the business environment would benefit the supply side by increasing investment and productivity.

Brazil: IBRE baseline scenario for 2014-2015.

	2010	2011	2012	2013	2014 Proj. September	2015 Proj. September
Real GDP growth (% change)	7.5	2.7	1.0	2.5	0.2	1.2
Inflation (% change)	5.9	6.5	5.6	5.9	6.3	6.1
Central Bank policy rate (end-period, %)	10.75	11.00	7.25	10.00	11.00	12.00
Exchange rate (average, Reais per U.S. dollar)	1.8	1.7	1.9	2.2	2.3	2.5
Primary balance surplus (adjusted, % of GDP)[1]	1.5	2.4	1.6	0.7	0.2	1.1
External current account balance (% of GDP)	-2.3	-2.1	-2.2	-3.7	-3.6	-3.2
Trade balance (US$ billions)	20	30	18	3	2	7
Export (US$ billions)	202	256	243	242	235	242
International reserves (US$ billion)	289	352	378	374	370	370

Source: Brazilian Institute of Geography and Statistics, Central Bank of Brazil, IBRE staff projections.

[1] Recurring government primary balance surplusdefined as budget balance excluding interest payments on public debt, extraordinary revenues from dividends and concessions, and some investments of the Growth Acceleration Program..


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