Monetary policy
More uncertainty about inflation

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A shaky trade balance surplus

Interview
Eugênio Vilaça Mendes
Public health consultant



THE BRAZILIAN ECONOMY

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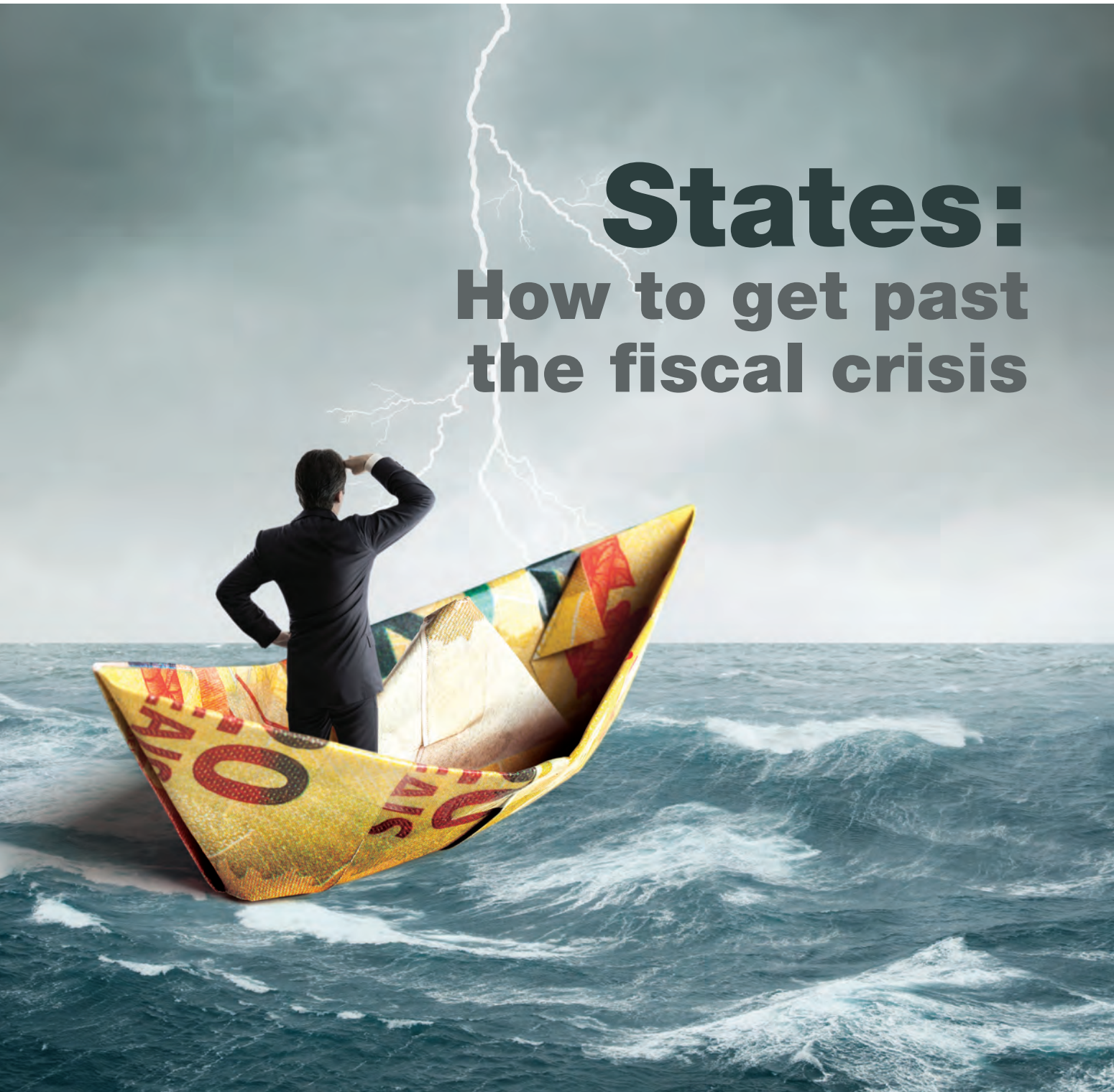

States: How to get past the fiscal crisis

FGV IBRE

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THE BRAZILIAN ECONOMY

Economy, politics, and policy issues

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8 States: How to get past the fiscal crisis



As states are confronted with rigid spending requirements and falling tax revenues, public services are deteriorating. The federal government allowed states to borrow from BNDES because it was not making mandatory financial transfers to them, so that a number of states are now in danger of outstripping Fiscal Responsibility Law limits. A difficult and painful fiscal adjustment has become necessary —and only institutional reforms will put state finances back on a sustainable path. Chico Santos reports.

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The financial crisis has now reached Brazil's municipalities. In the first 10 months of 2015 current revenues of state capitals were on average 1.3% lower than in the same period of 2014. What kept the average from being worse was that São Paulo had managed to increase revenues by 1.8%. The National Association of Mayors is now calling for federal, state, and municipal governments to create a forum to discuss common problems.

Monetary Policy

18 More uncertainty about inflation



With little clear about the direction of monetary policy and fiscal adjustment, curbing inflation expectations and meeting the inflation target has become even more questionable. The central bank Monetary Policy Committee decision to keep the central bank policy rate the same has generated speculation that the administration, concerned to revive the economy, influenced it. Solange Monteiro consults the experts about what the government needs to take into account.

Trade

22 A shaky trade balance surplus

Last year the trade balance rebounded from a deficit of US$4 billion in 2014 to a surplus of US$19.7 billion—but the reason it did is that the economy was deteriorating. In 2015 the fall in the prices of exports more than offset the 15% increase in their volume, so that growth in export value was cut by 20%. The exchange rate devaluation helped to mitigate the effects of falling prices, but it also raised the costs for sectors that have to import inputs. Solange Monteiro analyzes the problems.

Interview

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Public health consultant Eugênio Vilaça Mendes, former deputy secretary of health for Minas Gerais state and former consultant to the Pan American Health Organization, explains to Solange Monteiro why its management needs to be enhanced to make the health system sustainable and prepare it for the technological, demographic, and disease profile changes in store for the country.



Editors' Note

AS THE SERIOUS CRISIS facing Brazil spreads —GDP is projected to fall by 3% in 2016, after closing 2015 down 3.7%, according to IBRE staff estimates—another element of concern and anguish has arisen in the already troubled daily life of millions of Brazilians. That is their health. Late last year, the health crisis in Rio de Janeiro state, in addition to the apparently invincible mosquito, *Aedes aegypti*, laid bare the darker side of the huge fiscal crisis distressing the Brazilian federation. With too little revenue even to pay their employees, Brazilian states are almost totally without resources to maintain basic public services.

For 2015 VAT tax (ICMS) collections, the main source of state revenue, were down nearly 4% through October in the wake of the sharp downturn in the Brazilian economy. Worse, over the years a number of structural problems, mainly caused by the 1988 Constitution, have aggravated the fiscal problems of the states. While laudable in its objectives, the new Constitution adopted a model that created numerous entitlements for all. The federal government now has the obligation to meet these expectations without having the necessary funding base in its budget to sustain, for example, its assigned constitutional responsibilities for health. Now, with the worrisome possibility that GDP could drop by nearly 7% in less than two years, as the media make clear daily the situation is ever more dramatic.

With ICMS income sinking fast, current revenues of the states have plummeted: 2015 was the first year since 2010 that revenues were lower than the states had budgeted for. Estimates are that last year current revenues were 5.9% lower than initially expected. In contrast, in 2010 current revenues exceeded budget estimates by 8%.

Although on a much smaller scale, the downturn in the economy has also affected the private health insurance market. Through September it had fallen by 0.3% compared to the same period in 2014. Amid forecasts of rising unemployment and deteriorating household incomes, insurance operators expect a gradual worsening for the sector as costs rise and the population gradually ages.



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ECONOMY

External balance improves

Though the current account deficit reached US$2.5 billion in December, for the year it narrowed to US$58.9 billion, 3.3% of GDP, down from US$104.2 billion, 4.3% of GDP in 2014. Deep recession slashed demand for imports and a weaker currency helped local exporters sell more. Foreign direct investment also fell in the year, by 29% to US$75 billion. (January 26)

Inflation at 12-year high

Brazil's inflation rate rose to a 12-year high of 10.71% year-on-year, the highest since November 2003 and well beyond the central bank's target ceiling of 6.5%, said national statistics institute IBGE. The January inflation rate was 1.27%, the highest recorded for the month of January since 2003 and accelerating from 0.96% in December. The rise was driven by food (2.28%) and transportation (1.77%) prices as urban bus fares and gasoline taxes went up. (February 2)

Industrial production plunges 8.3%

In December industrial output in Brazil fell for the seventh straight month, capping the worst year for manufacturers in more than a decade as they struggled with inflation, high interest rates, and political uncertainty. Output at factories and mines sank by 8.3% in 2015, statistics agency IBGE said, the worst performance since the data series started in 2003. After seasonal adjustments December production was 0.7% below November. Manufacturing and mining production was nearly 20% below its 2013 peak. (February 3)

ECONOMIC POLICY



Photo: Fabio Rodrigues Pozzebom, Agencia Brasil.

Central Bank Governor Tombini struggles to cap inflation.

Central bank interest rate unchanged

In a divided vote in January the central bank Monetary Policy Committee left its policy interest rate untouched at 14.25% despite rising inflation, opting against an increase that might have further slowed the world's seventh-biggest economy. Surprising some observers, the bank cited "increased domestic and particularly external uncertainties" for the decision. Central Bank Governor Alexandre Tombini and five other members of the committee had voted to hold the rate steady, against two votes to raise it. Bank officials are under pressure to ease the hardship of ordinary Brazilians squeezed by rising prices with double-digit inflation and increasing unemployment. The rate has now been steady since July 2015, when the bank made the last of seven consecutive hikes to try to put a lid on inflation. (January 21)

Fiscal deficit hits a record 10.34% of GDP

In 2015 the consolidated public sector nominal deficit hit R$613 billion (US$150 billion), equivalent to 10.34% of GDP, the central bank reported. Excluding interest payments, the primary budget deficit was R$111 billion (US$27 billion), the biggest since 2001. In a bid to get its fiscal house in order, Brazil's government launched an austerity plan in early 2015. Not yet fully approved by Congress, it included tax hikes and spending cuts. With deepening recession and stalled austerity measures, the deficit has grown. (January 30)

INTERNATIONAL

Perception of Brazilian corruption worsens

Brazil, plagued by a scandal surrounding state oil giant Petrobras, has registered the biggest plunge on this year's Transparency International corruption index. In its Corruption Perceptions Index 2015 report, the organization said that Brazil had dropped seven notches from 2014. It is now in 76th position out of 168 countries because of the kickback allegations engulfing Petrobras. (January 27)

POLITICS

Rousseff's impeachment problems fading

Her opponents in the Brazilian Democratic Movement Party (PMDB) are losing hope that they can impeach President Dilma Rousseff and replace her with Vice-President Michel Temer, a PMDB member. A recent Supreme Court ruling expanded the authority of the Senate, where she has solid backing, and reduced the clout of Lower House speaker Eduardo Cunha, who triggered the impeachment process. The president's critics accuse her of manipulating government accounts to boost public spending during her 2014 re-election campaign, but in recent weeks, political consensus has been emerging in the political establishment that the evidence against her is not solid enough to justify impeachment. (January 20)

Former President Lula under investigation

Brazil's federal police are now investigating whether former President Luiz Inácio Lula da Silva may have used bribes to influence the passage of legislation benefiting the auto sector, according to court documents. The investigation is part of the Operation Zealots probe that originally looked into the bribing of lower-level tax collectors. It is separate from the much-publicized investigation into price-fixing and political kickbacks at state-run oil company Petrobras. (February 5)

PUBLIC HEALTH

Is Brazil losing its main public health battle?

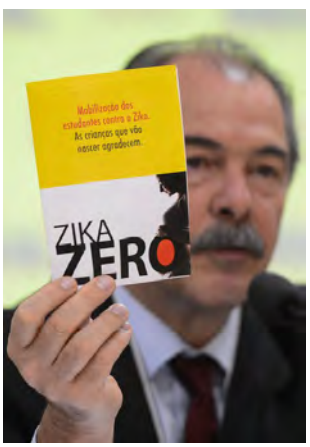
In a controversial statement, Health Minister Marcelo Castro said that Brazil is getting nowhere in its fight against *Aedes aegypti*, the mosquito that spreads dengue fever, chikungunya, and zika. "We have had the mosquito here in Brazil for about three decades and we are losing the battle badly," he said, pointing out that in 2015 the country registered a record number of dengue fever cases, more than 1.6 million. Others in the federal government objected to the statement because the administration has been trying to intensify its actions to fight the mosquito. (January 25)

Soon after Castro's comments, in a recorded TV message to the nation President Dilma Rousseff declared war on the mosquitoes responsible for spreading the virus. She announced a national mobilization day, during which thousands of soldiers and sanitation employees would work to eradicate the insects in homes and offices. Zika has been linked to babies being born with underdeveloped brains. As it has been spreading throughout the Americas, the World Health Organization has declared the disease to be a global public health emergency. In her address, Ms. Rousseff said that substantial federal resources were being released to fight *Aedes aegypti* mosquitoes, because it was a fight that "cannot be lost … I insist, since science has not yet developed a vaccine against the Zika virus, that the only efficient method we have to prevent this illness is the vigorous battle against the mosquito." (February 4)

Photos: Antonio Cruz, José Cruz, and Elza Fiuza







Brazil mobilizes to fight the mosquito-transmitted zika virus: Sanitation workers intensify inspections, and Minister of Education Aloizio Mercadante distributes a flyer on zika virus for students.

DICOM

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States:
How to get past the fiscal crisis

As states are confronted with rigid spending mandates and falling tax revenues, public services are deteriorating. The states must now make a difficult and painful fiscal adjustment—and only institutional reforms will put their finances back on a sustainable path.

Chico Santos

THE END OF 2015 and early 2016 saw much bad news for Brazilians. The most perverse fiscal news was the transmission of *aedes aegypti* disease by seemingly invincible mosquitoes, especially in Rio de Janeiro state. But even without the epidemic Rio Grande do Sul, Rio de Janeiro, Minas Gerais, Sergipe, and Tocantins states were already finding it difficult simply to pay public employees. The 2016 budgets of Rio de Janeiro and Minas Gerais states



show large deficits—in Minas Gerais almost R$9 billion and in Rio de Janeiro, R$14 billion against budgeted spending of R$79 billion.

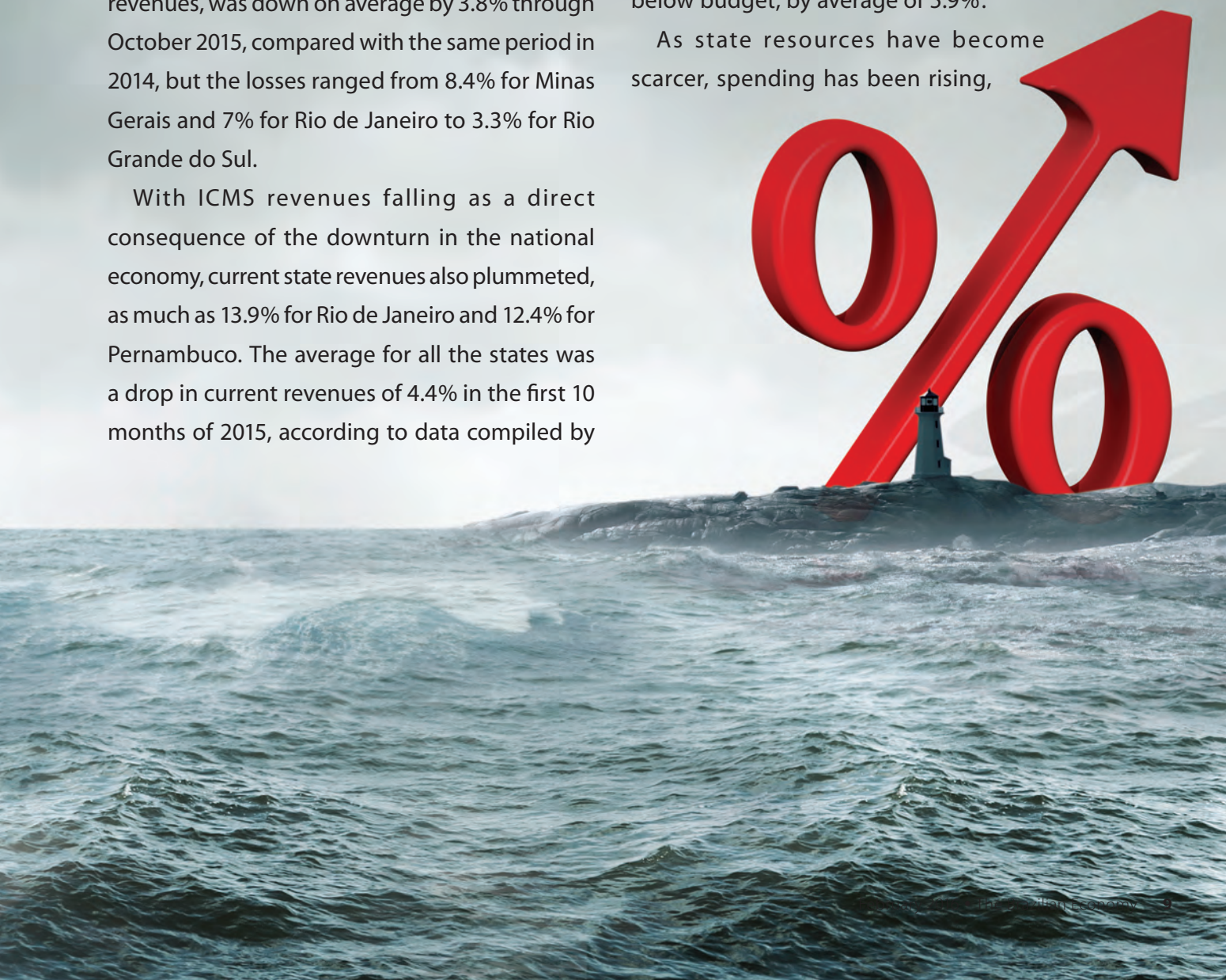
These numbers illustrate the very complicated situation of states and municipalities caused in part by the massive fiscal crisis affecting the federal government, and in part by structural problems created by the Constitution of 1988, says Fernando Rezende, professor at the Brazilian School of Public and Business Administration (Ebape) of the Getulio Vargas Foundation.

On the revenue side, financing from the tax on sales and services (ICMS), the main source of state revenues, was down on average by 3.8% through October 2015, compared with the same period in 2014, but the losses ranged from 8.4% for Minas Gerais and 7% for Rio de Janeiro to 3.3% for Rio Grande do Sul.

With ICMS revenues falling as a direct consequence of the downturn in the national economy, current state revenues also plummeted, as much as 13.9% for Rio de Janeiro and 12.4% for Pernambuco. The average for all the states was a drop in current revenues of 4.4% in the first 10 months of 2015, according to data compiled by Aequus Consulting. In fact, 2015 was the first year since 2010 that actual state current revenues were below budget, by average of 5.9%.

The federal government allowed the states to borrow from the National Development Bank (BNDES) and multilateral financial institutions because it was not making its mandatory transfers of resources to them.

As state resources have become scarcer, spending has been rising,



"States have been suffering from a structural crisis as they have lost more and more space in the federation."

José Roberto Afonso

especially to pay personnel expenses. Renato Villela, São Paulo State financial secretary, believes that a large number of Brazilian states may have started 2016 above the prudential limit set by the Fiscal Responsibility Law (LRF) for personnel expenses, which is 48.6% of net current revenue.

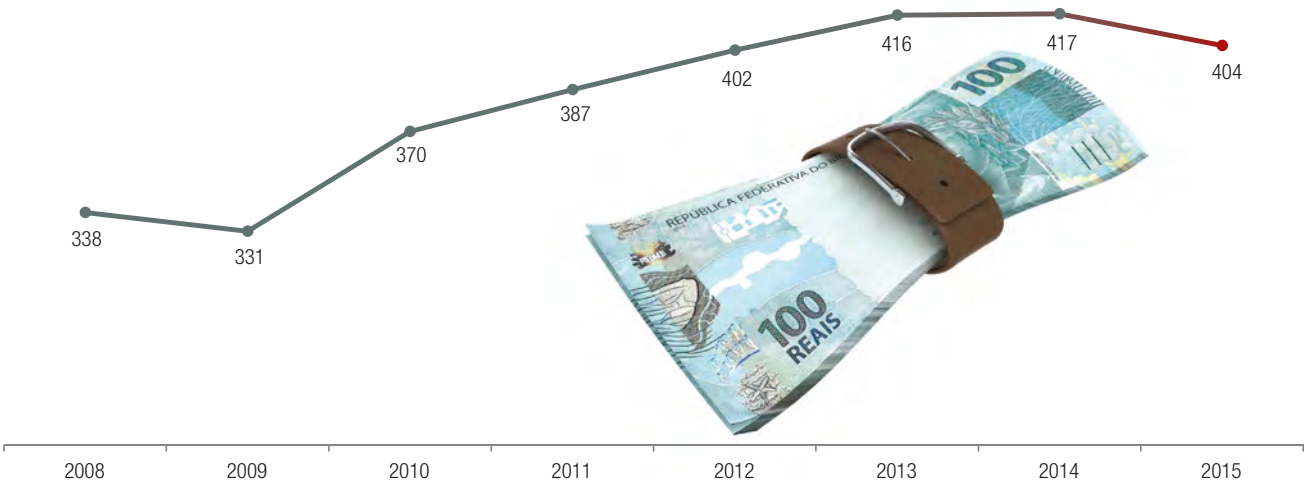
According to Aequus Consulting, while in August 2011 26 of the 27 states had personnel expenses below the LRF limit, in August 2015 seven states were between the prudential limit and the maximum of 54%, and two, Rio Grande do Norte and Rondônia, were spending above the LRF maximum. States are breaching the limits because of declines in revenue.

States have 16 months to comply with the LRF limits, Villela explains. Aequus estimates that states' personnel expenses were 5% higher in 2015. While Villela recognizes that it is essential for states to cut personnel costs, he says that will not be easy given the public employee hiring rules. "There is an inconsistency between what the Fiscal Responsibility Law calls for … and what states can possibly do," Villela says. For instance, only after personnel costs exceed 49% of net current revenues can the state executive lay off staff, and even then the rules are very strict.

Villela calls the situation "very worrying" in the short term, although it is less worrying for São Paulo state because it has long managed its finances prudently. To address the crisis, he thinks, states and municipalities need much more

State collections of ICMS, major tax revenue source has declined reflecting the downturn in the economy as well as erosion of the tax base.

R$ millions, adjusted for inflation



Source: Compara Brasil.

powerful fiscal management tools than those currently available.

To control spending, Villela recommends measures to reduce the rigidity in spending, reduce personnel, adjust public employee pensions and wages, and ease constitutional entitlements. On the revenue side, Villela supports initiatives to broaden the tax base, eliminate tax benefits, and end the "tax war" states are waging to attract investment.

Debt off the rails

Since 2010, the federal government has gradually relaxed state debt limits to allow urgent investments. Villela believes debt limits worked well as long as the federal government "maintained a fiscal stance according to established rules"—in other words, set a good example.

According to Villela, the federal government allowed the states to borrow from the National Development Bank (BNDES) and multilateral financial institutions because it was not making its mandatory transfers of resources to them: "The federal government abandoned the coordination of a fiscal responsibility policy for the states." According to an IBRE survey, between 2008 and 2014 Brazilian states borrowed R$15 billion, which pushed up their consolidated debt from R$404 billion in 2010 to R$577 billion in August 2015.

This explosive increase in the stock of debt led the states and municipalities to plead for, and get from, the National Congress changes in the terms of state debts to the federal

States have substantially increased their debts to offset part of declining revenues

R$ billions

	2014	August 2015
Acre	3.2	3.1
Alagoas	9.2	NA
Amazonas	3.4	3.5
Amapá	1.7	1.3
Bahia	10.3	13.4
Ceará	6.1	7.6
Distrito Federal	3.6	3.6
Espírito Santo	3.2	3.3
Goiás	14.9	15.6
Maranhão	4.7	4.9
Minas Gerais	85.3	92.4
Mato Grosso do Sul	7.9	NA
Mato Grosso	4.6	4.8
Pará	1.5	1.8
Paraíba	2.7	3.3
Pernambuco	10.7	11.3
Piauí	3.8	2.9
Paraná	16.5	15.4
Rio de Janeiro	82.1	93.5
Rio Grande do Norte	NA	0.6
Rondônia	3.4	3.2
Roraima	0.5	0.2
Rio Grande do Sul	59.9	64.4
Santa Catarina	8.1	8.8
Sergipe	3.4	3.4
São Paulo	200.5	212.8
Tocantins	1.9	2.2

Total state' debt

R$ billions



Source: IBRE.

A large number of Brazilian states may have begun 2016 above the prudential limit set by the Fiscal Responsibility Law for personnel expenses, which is 48.6% of net current revenue.

government. Today interest on what states owe to the federal government is equal to inflation measured by the National Index of Consumer Prices plus 4% or the central bank's policy interest rate, whichever is less; previously it was inflation measured by the General Price Index plus 6 to 9%. However, there was no change in the mandate to use 13% of net state current revenue to pay off debt to the federal government.

Júlio Bueno, who is secretary of finance of the State of Rio de Janeiro, believes that in the current situation it is more important to change the net current revenue commitment to pay off debt than to reduce the interest paid. "The interest change reduces the debt burden in the long term, but what states need right now is to reduce the debt payment flow," he says.

Secretary Bueno must deal with perhaps the most difficult state fiscal situation in Brazil. He attributes his troubles to a combination of economy's downturn and the fall in oil industry activity caused by both the state-oil company Petrobras crisis and the plunge in international oil prices from about US$100 per barrel in mid-2014 to less than US$35 in the first weeks of 2016.

As the largest oil producer in Brazil and headquarters of almost all the companies operating in the sector for Rio de Janeiro state, the oil industry is the main economic activity. The oil crisis hits its state and municipal budgets in two ways: Tax revenues go down because there is less economic activity and movement of goods and services, and collection of royalties and special contributions from oil production also drop.



The capital of Bahia earned only last year **94.5%** of 2015 budgeted revenue through October 2015

Although oil and gas production is still growing in Brazil, payment of royalties is based on international prices and consequently falls when they do. Bueno's department calculates that revenues from royalties and special contributions dropped

from R$8.7 billion in 2014 to R$5.5 billion in 2015, and ICMS tax collections were down to R$32 billion—R$6 billion less than was budgeted.

The estimated R$13 billion shortfall in budgeted revenue was covered, Bueno says, mostly with extraordinary revenues, which were not enough to cover the whole public wage bill at the end of the year; the state is paying it in installments and postponing other expenses. In 2016 the estimated deficit of R$14 billion will also have to be covered by extraordinary revenues, and spending cuts, he noted. In January, salaries were postponed for one week. ICMS went up for some products and services, and the state government is working on a securitization program for its outstanding debt as a way to anticipate revenue.

Nationally, Bueno sees a need for the federal government, states, and municipalities to coordinate to find a solution of common interest, observing, "Both the federal government and the states and municipalities are partners in this crisis."

The first item on the common agenda, Bueno says, is public employee pensions: since the legislation is federal, federal government intervention is indispensable, but without the support of states and municipalities the federal government cannot approve changes to the public employee pension fund without working out a sustainable balance. The pension imbalance is one of the factors tormenting Rio de Janeiro state as it tries to close its 2016 budget gap.

Among measures urgently needed to balance public finances in Brazil, Bueno calls for reinstatement of the controversial Provisional Contribution on Financial Transactions (CPMF),

"There is an inconsistency between what the Fiscal Responsibility Law calls for … and what states can possibly do."

Renato Villela

while recognizing that not all states would agree. But he does believe that all states would agree on relaxing revenue earmarking.

Bueno would also like to see a revision in the current exploration model for deep-sea oil, an issue that most affects his own state. At this point, for Bueno it is most important to rethink such crucial aspects of the law as the obligation that Petrobras operate all the blocks, with a 30% stake, and the local content rules.

Bueno says that if these oil exploration points are modified and there are new auctions for deep-sea oil blocks, it is likely that businesses will be ready to invest US$150 billion in the sector—though much will also depend on some recovery in excessively depressed oil prices.

An essentially structural problem

Professor Rezende is convinced that the current crisis is essentially a structural problem: "We are living with the illusion that the crisis is temporary and all problems will be solved if the economy resumes growth. This interpretation is refuted by the facts."

He also believes that Brazil's fiscal problems are having a more intense effect on the states. The problem, he says, originated with the

"The interest change reduces the debt burden in the long term, but what states need right now is to reduce the debt payment flow."

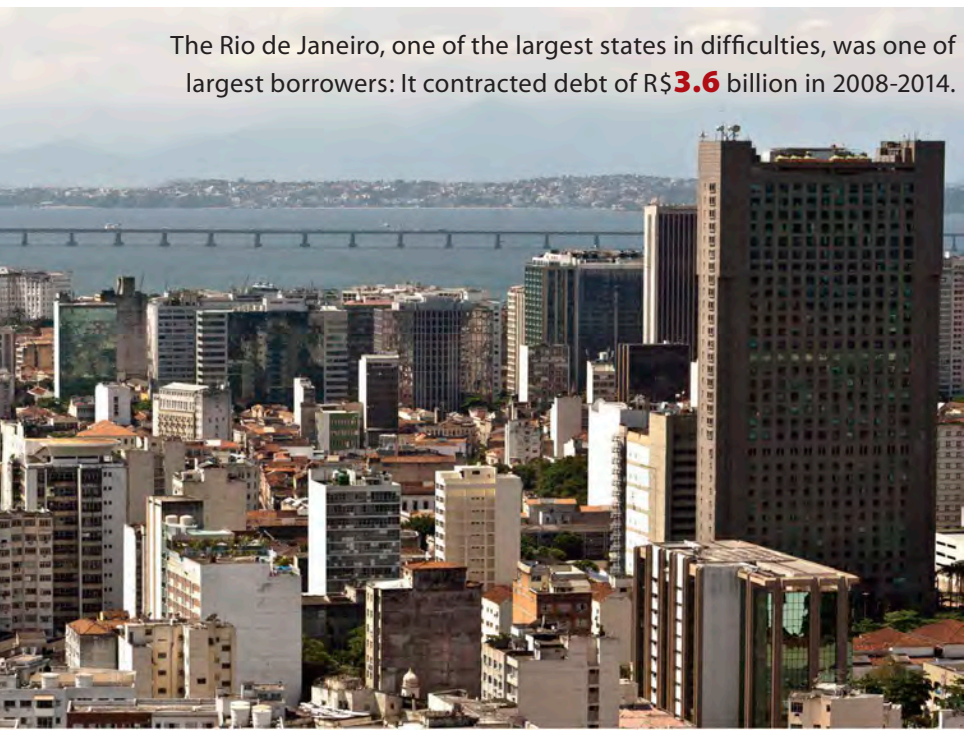
Júlio Bueno

drafting of the 1988 Constitution when large states opted for the ICMS, a VAT-type tax, which over time has become outdated while smaller states live mainly on the mandated transfers from the federal government: "Today the tax base of large states is suffering severe erosion."

Right now, the most important area making the ICMS outdated is telecommunications, where companies are losing business daily with new free Internet-based applications such as WhatsApp. Similarly, fossil fuels will eventually lose ground as environmentalist pressure for clean energy sources grows.

A second important source of ICMS erosion, Rezende says, is the precipitous decline of the share of manufacturing in Brazilian GDP, which was only 11% in 2015, down from 27% in 1985, according to the Federation of São Paulo State Industries.

Rezende points out that the Constituent Assembly that drafted the 1988 Constitution thought about the distribution of revenues but not a proportionate redistribution of spending responsibilities. "Traditionally, public safety remained the responsibility of state governments and medical assistance continued under municipal governments," he said. But as the 1988 Constitution expanded guarantees such as the labor entitlements of public employees and social security, fewer resources were allocated to such essential services as public safety and medical care. Rezende explains that "Today, state government control of their budgets is very low, almost zero. Everything is already decided by constitutional provisions or by federal regulation … . Not surprisingly, we are witnessing a significant deterioration of public security, urban public services, and public health."



The Rio de Janeiro, one of the largest states in difficulties, was one of largest borrowers: It contracted debt of R$**3.6** billion in 2008-2014.

While in principle the constitution guarantees resources for public health, Rezende notes, it shares revenues with Social Security, and as Social Security entitlements expanded, resources

for public health declined. While Social Security is an individual entitlement guaranteed by the constitution, he explains, public health is a collective right without legal individualization.

The return of the CPMF, Rezende says, will bring some immediate relief, but in the medium and long term "it will cause a further deterioration of our tax system and a loss of competitiveness of the economy."

Rezende sees no solution to state fiscal problems: "We will not be able to address the fiscal problem of states if we do not discuss reform of the federation. I am not talking about tax reform. I am talking about the constitutional allocation of revenues between the members of the federation, the states and federal government." He considers it even more urgent that the states have a centralized forum to debate their interests. Currently each tries to solve its financing needs by begging resources from federal government.

IBRE researcher José Roberto Afonso also believes that without structural reform the fiscal problems of states cannot be solved, noting that "States have been suffering from a structural crisis as they have lost more and more space in the federation." He thinks that states have to do "everything possible to make fiscal adjustment," but particularly cutting spending. "There is no magic and some states have already taken important initiatives that are sometimes unpopular," he says. Raising the ICMS, he says, would help momentarily but in the medium term the ICMS tax base is declining. The institutional reforms Afonso calls for start with the tax and budget systems, fiscal responsibility, social security and public administration. He agrees with Rezende that states need to create "a formal joint committee" so they can negotiate with the federal government collectively rather than individually.

"Either investment will be greatly reduced or simply cut."

Raul Velloso

Raul Velloso, a leading expert on public finances, regrets that the current crisis has had such a direct impact on investment at a time when the country most needs to address its chronic infrastructure deficiencies. "Either investment will be greatly reduced or simply cut," Velloso said, noting that "government energies are being primarily spent on plugging holes." He believes that given the magnitude of the state fiscal crisis, in 2016 Brazil will see "truculent [state] management with delays in paying public employees' salaries and resources for education and health threatened."

With expenditures mandated but revenues falling, Velloso sees few alternatives for states other than painful cuts. Since 2012 federal government encouragement of state and municipal borrowing also accommodated their lax personnel management. The borrowing was allegedly for investments only, but "That did not stop states and municipalities transferring money from investments to current spending," he noted. Last year former Minister of Finance Joaquim Levy, correctly Velloso thinks, closed the taps for new borrowing, so states will have to move beyond the fiscal crisis without further borrowing. He fears that policy makers may opt for a nefarious inflation tax as a solution, printing money to pay for public spending.

Municipalities also suffer



DURING THE PUBLIC HEALTH crisis in Rio de Janeiro state, many were surprised that the mayor of Rio de Janeiro city, Eduardo Paes (Brazilian Democratic Movement Party, PMDB), released R$100 million to help governor Luiz Fernando Pezão (PMDB) to deal with the problems that were piling up. Paes even took over management of two major state hospitals.

Does this suggest that although Brazilian states are doing badly, municipalities are not? Not at all. What happened, according to Alberto Borges, director of Aequus Consulting and former Secretary of Finance for Vitória city (Espirito Santos state), was that the crisis did not hit municipalities until a year later than the states.

Borges says that while state revenues were already falling in 2014, the problem did not start in the cities, especially state capitals, until May and June 2015, when revenues from municipal taxes (the tax on services, ISS) started to fall. The economic crisis had hit industry earlier than services, Borges explains.

Now the fiscal crisis has also reached municipalities. According to Aequus data, in the first 10 months of 2015 current revenues of state capitals were on average 1.3% lower than in with the same period of 2014. What kept the average from being worse was that São Paulo, the biggest city in Brazil, had managed to increase revenues by 1.8%.

For January–October 2015 revenues fell by 2.5% for Belo Horizonte and 3.2% for Rio de Janeiro city but by as much as 6.7% for Recife and 9.2% for Salvador. Meanwhile, collection of the ISS tax by capitals was down by 3.2%. Property tax in the capitals did go up in the 10-month period, by 0.5%, but Aequus estimates that it would have grown by an annualized 3–4% were it not for rising unemployment and declining income that drove taxpayer nonpayment.

As a reflection of the drop in the entire Brazilian real estate market, in the first 10 months of the year collection of the tax on transfer of real estate (ITBI) in state capitals fell by 5.1%, although it grew by 7.8% in São Paulo.

Proof that state capitals were already feeling the crisis in the fourth quarter of 2015 is that investment fell 3.3% through October, one year before municipal elections, when usually

administrations seek to invest more to impress voters. Investment by capital cities did not fall more because Rio de Janeiro city is experiencing an investment boom in connection with the August 2016 Olympic Games. Without Rio's 39.2% increase in investment (from R$4.7 billion to R$6.5 billion), state capital investments would have fallen by 22.5% through October 2015. But Borges believes that Rio de Janeiro city's investment expansion has already peaked and is now on the downswing.

In the capitals as well as in the states, although revenues are going down, personnel expenses are going up, though more modestly. In the first 10 months of 2015 they went up by an average of 1.8%, a result of the natural increase of the wage bill.

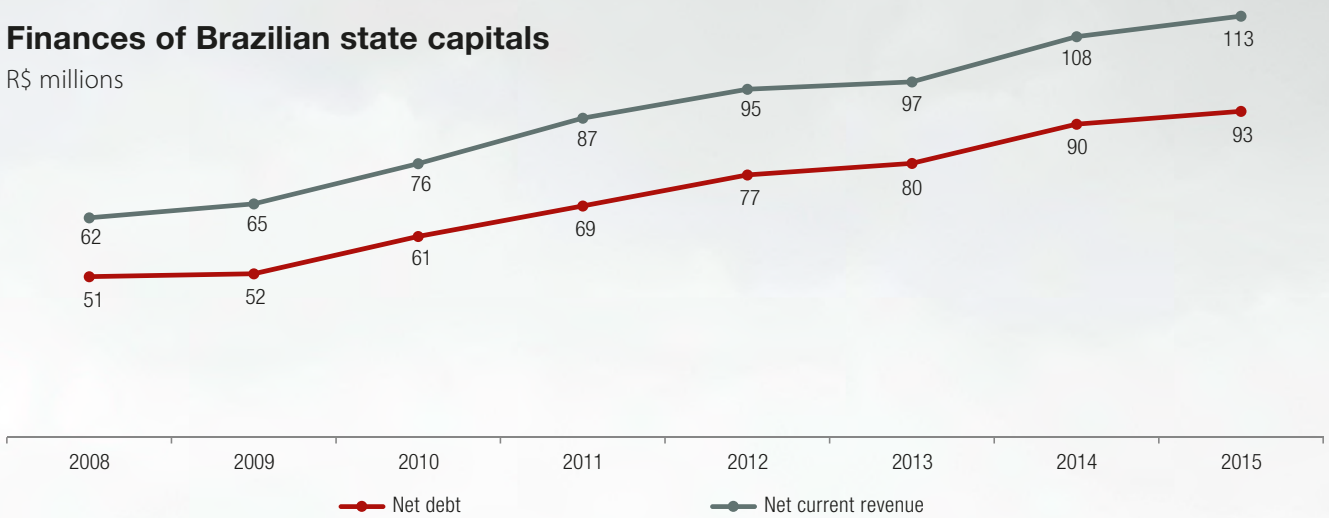
Marcio Lacerda (Brazilian Socialist Party, PSB) is not only mayor of Belo Horizonte, he is president of the National Front of Mayors (FNP). He says, "The current fiscal crisis was already apparent in 2014 and worsened in 2015, after a drop in major transfers to municipalities from both the federal government and the states." Lacerda says that "although the slice of the pie of public sector revenues for municipalities was 19% in 2014, the largest in the last 12 years, this share is not sufficient to pay for the increasing municipalization of public services."

The crisis did not hit municipalities until a year later than it hit the states.

Lacerda says the FNP has been working for "a comprehensive fiscal and tax reform" that would give more balance to the distribution of resources between the members of the federation. FNP has advocated for creation of a "federal forum" with the participation of federal, state, and municipal governments to discuss common problems. Emphasizing that political and economic crises feed back on themselves, he called for political agreement between the main leaders of the country as a precondition for addressing the current economic crisis.

Finances of Brazilian state capitals

R$ millions



Source: Compara Brasil.



More uncertainty about inflation

With little clear about the direction of monetary policy and fiscal adjustment, curbing inflation expectations and meeting the inflation target has become more questionable.

Solange Monteiro

THE DECISION OF THE MONETARY Policy Committee (Copom) in January to keep the central bank policy interest rate at 14.25% surprised the market. The Copom announcement contradicted previous signs that the central bank would raise the rate and generated speculation that the government, concerned to revive the economy, had influenced the decision. "On the technical side, there are many who argue that it was a wise move. But the way it happened



More than expected
In January, the increase of bus fares in four capitals was **9.8%** on average, and may set the pace of adjustment in other cities.

involves a difficult element to incorporate into numerical estimates, and that is the credibility of the central bank. Since the central bank is responsible for guiding the market, a context of very divergent expectations about inflation is damaging," says Salomão Quadros, IBRE deputy superintendent of general price indexes.

The January decision added more uncertainty to an already difficult inflation outlook. Like other analysts, in early February IBRE revised its 2016 inflation projection from 7.5% to 7.9%. Quadros points out that the revision incorporates recent adjustments to bus fares in São Paulo, Rio de Janeiro, Salvador, and Belo Horizonte cities. On average, the adjustment was 9.8%—lower than the 13.3% in 2015 but higher than what had been expected for 2016. "The bus fare increases have contradicted the principle that in an election year the adjustment is low, or even zero," he says, though noting that the cash problems of municipalities limit their room for maneuver and have forced local governments to take unpopular measures, which may set a precedent for increases in other cities.

Another element that weighed negatively was fresh food, the prices of which began rising in December. "The drought last year reduced the production of tomatoes, potatoes and onions, raising their prices," says André Braz, IBRE coordinator of prices. On the other hand, the rigor of El Niño this year may bring more rain, which would bring some relief not only for food producers but also for hydropower plants, which would take some pressure off electricity costs.

The Copom announcement contradicted previous signs that the central bank would raise the rate and generated speculation that the government, concerned to revive the economy, had influenced the decision.

However, the depreciation of the exchange rate early this year is considered to be a clear indication of a new round of pressure on prices. "If this trend intensifies, we must extend the impact of the exchange rate even to items that had been spared in the 2015 devaluation, such as food," Quadros warns. He points out that the speed of transmission of the exchange rate is different for each sector, depending on its ability to survive with narrower profit margins than desired. Quadros notes, "We have identified residual devaluation pass-through especially on durable goods—refrigerators, TV sets, cars—that have imported inputs.

The monetary policy problem

IBRE researcher Vinicius Botelho believes the exchange rate effects in January have consolidated the market view that the rate will fluctuate around R$4.50 to the US dollar in 2016. "When there are negative surprises in fiscal adjustment, the heightened perception of risk tends to weaken the Brazilian currency," he says. This, in turn, has a negative impact on prices.

"Since the central bank is responsible for guiding the market, a context of very divergent expectations about inflation is damaging."

Salomão Quadros

Quadros says that the fiscal deterioration has complicated the large necessary correction in controlled prices (fuel and electricity tariffs) in 2015: price adjustments have spilled over future prices, bringing about inflation inertia.

José Julio Senna, head of the IBRE Monetary Studies Center, is convinced that the monetary policy that accompanied the correction in controlled prices in early 2015 was correct: "At that time, the central bank took advantage of the new climate prevailing in the country that an economic adjustment policy would be carried out and tightened monetary policy. It achieved a very reasonable result, particularly with regard to the reversal of inflationary expectations for 2016, which declined to 5.4% for the year." He emphasizes, however, that the reversal of expectations was short-lived — when the second half of 2015 began, it became clear that the fiscal imbalance was very serious but the desire to make the macro adjustment was not that strong. "Then the central bank lost the rationale to continue taking action. It would not be all bad if inflation expectations had remained stable, since real interest rates reached about 8% per year, a pretty strong dose. [But] inflation expectations went out of control because of the worsening of the fiscal stance, the political crisis, and ever clearer signs that the macro adjustment would not materialize," Senna says.



The drought has pushed up food prices.

In contrast, Botelho believes that the fiscal deterioration was not the major factor in the loss of the power of interest rates to keep prices from rising. He attributes rising inflation to monetary policy inertia: "The issue is not that the interest rate policy lost effectiveness because of the fiscal deterioration, but rather that interest rates are simply not being used aggressively." Botelho argues that today the country is still paying for the

accumulated inflationary pressure resulting from the low policy interest rate after the 2008 international crisis—7.25% between 2012 and 2013—and real interest rates below 2%. "We lived with this repressed inflation for too long, and when we finally decided to fight inflation, we decided to do so gradually," Botelho says. "If, instead, we had been more aggressive, we would have generated a much stronger contraction in demand, and the economy would have responded [by reducing prices]." Botelho points out that opting to raise interest rates by half a percentage point to the current level opened up space to maintain the inflationary pressure of demand for longer than was prudent.

Botelho estimates that the tightening of interest rates after 2008 took 60% longer than between 2001 and 2008: "Instead of fighting inflation, the gradual rise in the interest rate increases the inertia of the monetary authority and has inflationary effects because shocks take longer to dissipate." He emphasizes that the central bank seems uncomfortable with hiking already high interest rates, especially given the questions in the market about whether the government was interfering in the monetary authority's decisions. This creates an expectation bubble that is more inflated than it should be.

Botelho recognizes that to combat inflation more aggressively, interest rates need to be much higher in the short term, which increases

"Inflation expectations went out of control because of the worsening of the fiscal stance, the political crisis, and ever clearer signs that the macro adjustment would not materialize."

José Julio Senna

payments on public debt. But, he emphasizes, "On the other hand inflation gives way sooner and opens room for interest rates to fall sooner too—a fact that, in Brazil, could have a positive impact on the debt." He believes that maintaining the current situation—with the central bank slow to act to curb inflation, expectations of currency depreciation, and the deterioration of the fiscal balance—jeopardizes plans to bring inflation down to the central bank target (between 3% and 6%) in 2017, pushing the deadline into an indefinite future. "This combination of factors may leave us with long-term high inflation," he concludes.



A shaky trade balance surplus

Sustaining a trade balance surplus will depend crucially on how manufacturing exports perform.

Solange Monteiro

THE RECOVERY OF THE BRAZILIAN TRADE BALANCE in 2015 was a relief point in an otherwise dismal economy, but if it is to become sustainable in 2016 the surplus will need to be reinforced, especially by manufacturing exports. Last year the trade balance rebounded from a deficit of US$4 billion in 2014 to a surplus of US$19.7 billion. However, José Augusto de Castro, president of the Brazilian Trade Association (AEB) considers this to be a "negative surplus," because the reason the trade balance improved progressively was that economic activity deteriorated; as a consequence, demand fell, reducing imports by 24.3%, which topped the 14.1% reduction in exports,

A major reason that exports fell was the sinking prices of commodities, which account for 60% of Brazilian exports. The IBRE international

A major reason that exports fell was the sinking prices of commodities

Change in 2015 (%)

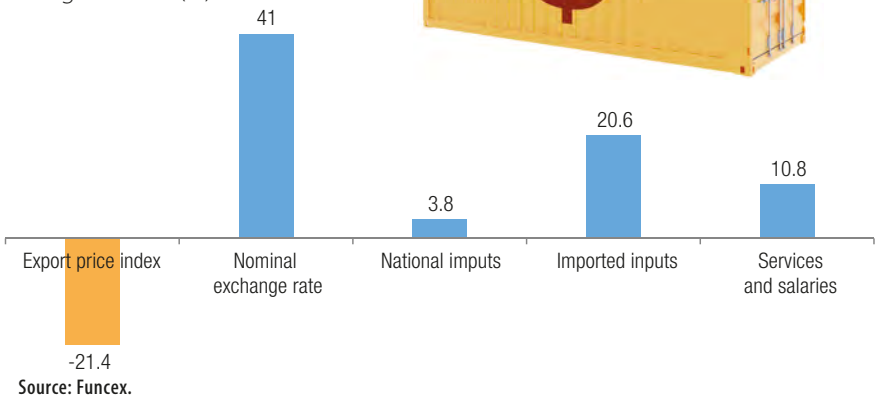
	Prices	Volumes
Soy products	-22.9	24.1
Meat	-13.8	0.6
Other agricultural products	-11.8	7.9
Iron ore	-49.1	7.7
Other minerals	-25.6	41.0
Oil and oil products	-50.1	33.9
Ethanol	-23.5	20.4
Total	-29.3	14.9

Source: IBRE.



The exchange rate devaluation helped to mitigate the effects of falling prices and increases in costs

Change in 2015 (%)



Source: Funcex.



In 2015 the fall in the prices of exports more than offset the 15% increase in their volume, so that growth in export value was cut by 20%.

commodity price index declined by 29.3% in 2015. IBRE researcher Lia Valls points out that the fall in the prices of exports more than offset the 15% increase in their volume, so that growth in export value was cut by 20%: "The biggest commodity price changes were recorded in oil and oil products (down by 50.1% despite an increase in exports of 33.9%) and iron ore (down by 49.1% despite an increase of 7.7% in shipments)."

Exports of manufactured goods also declined, although to a lesser extent. According to Foundation Center for Foreign Trade Studies (Funcex), while the

Argentina: On track for recovery?

Despite the optimism of the market with the end of the Kirchner administration and the openness policy of the new president Mauricio Macri, observers say it is too early to see whether the country is on the path of economic recovery. Lia Valls, an IBRE researcher, says one of the main risks relates to the currency free float. "Some estimate that the exchange rate would have to depreciate much more than it already has to make a difference in the competitiveness of Argentine products. However, others argue that allowing free float of the peso but maintaining the current wage-setting system could lead to an annual inflation rate of 70% a year—more than double 2015 inflation of 30%," she says. However, since Argentina's price indices have lost credibility, the difficulty of calculating alternative scenarios starts with what inflation numbers to use to measure the real depreciation of the currency.

Another uncertainty is fiscal policy. In this respect, Valls emphasizes two factors: Argentina's need to streamline public sector jobs, which helped to keep unemployment low in recent years, and the cut in subsidies to public tariffs, such as energy and transport. "The government will have to be successful in communicating that these subsidies benefit the middle class much more than the poor," Valls says. Despite the doubts that still persist about Macri's success, Valls notes that at other times of deep recession, output responded quickly. In the 1999 crisis, after four years of negative growth, GDP grew by 11% in 2002. So it would be unwise to rule out the possibility of a significant reaction now. "The recovery of Argentine economic activity is important for the resumption of Brazilian manufactured exports," Valls says. However, Argentina would also like to rely on strong demand in Brazil, the main destination of its exports. Brazil may be unable to reciprocate.

The exchange rate devaluation helped to mitigate the effects of falling prices, but it also raised the costs for sectors that have to import inputs.

volume of manufactured exports went up 2.3% in 2015, their value fell by 11.3%. According to the Funcex index, most sectors saw export prices go down, among them food products (-16.1%); leather and footwear (-14.7%); machines, equipment, and electrical materials (-16.9%); and chemical products and metallurgy (-16.9%). Daiane Santos, a Funcex economist, points out that the exchange rate devaluation helped to mitigate the effects of falling prices, but it also raised the costs for sectors that have to import inputs. Among those that suffered the most were computer equipment, electronics and optical (-41.9%) vehicles (-34%), and leather and footwear (-31.9%). Meanwhile, manufacturing costs were being pushed up by service prices and salaries, which rose on average by 11%.

Markets and competition

Valls underscores the speed of the 2015 trade balance adjustment. The last time there was an external adjustment by a major devaluation, in 1999, the trade balance surplus did not recover until 2001. From 2001 to 2004, she says, manufacturing exports, growing at an annual average of 15%, exceeded the 12% annual growth of commodity exports. At that time the US was the main buyer of Brazilian manufactured goods, followed by Mexico and the European Union. After 2004 growth in manufacturing exports slowed, and after 2008 it fell. Although between 2002 and 2011, the IBRE international commodity price index rose by 270% and commodity export volume went up by 68%, between 2011 and 2015, volume grew 21% but its value dropped by 42%.

This year, the estimate is that the trade surplus will reach about US$30 billion. AEB's Castro says a boost



A sluggish US economy

The almost zero growth of the US economy in the fourth quarter of 2015 the year sparked alarm among analysts about the possibility that the country—the main market for Brazil's exports of manufactured goods—may dive into recession. However, Samuel Pessôa ,IBRE research associate, believes this is a cyclical situation, restricted to the extractive sector, especially oil and gas, and to export industries.

Pessôa points out that after the crisis the United States lost 1 percentage point of potential GDP, making a robust recovery in economic activity harder. With deflation imported from Asia, he notes that the growth of American industry will converge toward that of Europe, opening up space for the service sector to grow. "The US labor market is still heated and wages should record high rises," he said. Pessôa notes that low oil prices reflect excess supply rather than low demand, which is positive. But he considers that the stabilization of international oil prices below US$40 per barrel could limit the Fed's plan to raise interest rates, which could be identified as a signal of inconsistent policy. That would undermine investor confidence and economic recovery.

in the share of manufacturing exports will be necessary to ensure that export values increase. He estimates that an exchange rate averaging R$4 to R$4.50 per US dollar this year would have a solid positive impact on manufacturing exports, even if costs rise initially. "This kind of export change is not immediate. It is made by contracts that may have terms from months to years, so it may take time to react," he said. However, to get Brazilian manufactures back in the game, the country should not just take advantage of the competitive advantage of a weak currency. "To be competitive we need to reduce costs," says Funcex's Santos, setting out a competitiveness agenda based on improving infrastructure, reducing bureaucracy, and increasing productivity. "The exchange rate helps us grow, but does not solve all our problems. In recent years, Brazil turned back. We will have to resume working [to improve competitiveness] from a lower volume of manufactured exports than in 2006," Castro adds.

IBRE's Valls points out that in the last decade Brazil was the only country that increased its share in world trade flows but lost ground in manufactures. "While the share of Brazilian manufactures in the world total fell from 0.8% in 1980-89 to 0.7% in 2010–14, China jumped from 1.1% to 16.5%, Korea from 2.2% to 4.1%, and Mexico from 0.8% to 2.3%," she says; Brazil is now facing fierce competition with global demand low. Castro believes that the only market where Brazilian manufacturers have room to grow consistently in 2016 is the United States, where Europeans and Asians will also be competing.

"The exchange rate helps us grow, but does not solve all our problems. In recent years, Brazil turned back. We will have to resume working [to improve competitiveness] from a lower volume of manufactured exports than in 2006."

José Augusto de Castro

"South America, another traditional market for Brazil, is also contracting because most countries are commodity exporters," Castro points out. "Even with competitive prices, Brazil cannot significantly expand sales in the region because countries are reducing purchases." For instance, in the specific case of Argentina, Castro says the steep devaluation of the real has not proved advantageous. "Importers know this situation and negotiate discounts. Prices of manufactured products drop without necessarily increasing sales," he says. Will trade between Brazil and Argentina improve now that Argentina has eliminated import restrictions? Castro believes it will, but it will take time. "Initially, we will suffer a negative impact on the price of agricultural commodities because of the releasing of the stocks of Argentine producers, who were waiting for the new government to eliminate taxes on exports. After that the country will again have foreign currency to import manufactured goods from Brazil," he says.


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Photo: Claudio Araújo



Is Brazil's health care model misguided?

Eugênio Vilaça Mendes

Public health consultant, former deputy secretary of health for Minas Gerais state, and former consultant to the Pan American Health Organization.

Solange Monteiro

THE PUBLIC HEALTH CRISIS IN RIO DE JANEIRO has set off alarms across the country about how one of the most important public services for Brazilians has deteriorated. Eugenio Vilaça Mendes, public health consultant and former professor in the Dentistry and Medicine Schools of the Federal University of Minas Gerais, points out that the health sector's problems go far beyond the financial. "The 1988 Constitution established that health care is a right for all and a responsibility of the government, but it did not provide the resources to support universal health care," he says. Mendes highlights the need to ease the predatory competition between public and private health systems and redefine the health model that the country wants and can afford. He also advocates enhancing health management to make the health system sustainable and prepare it for the technological, demographic, and disease profile changes in store for the country. "What produces the most diseconomies in the health system is a misguided health care model," he says.

One item of bad news as 2016 began was the public health crisis in Rio de Janeiro that was attributed to the fiscal crisis of the states. How do you see this situation?

The health crisis in Brazil has two perspectives: structural and cyclical. The cyclical that we see today is an intensification of the structural problems that arose when the Unified Health System (SUS) was established. It was conceived as a universal public health system like those in Western Europe, characterized by funding through general taxes, universal access, public

To generate efficiency in a health care system we need good interdisciplinary primary care, using new technologies and networking.

management, and delivery of health care services by public and private providers.

In practice in Brazil this aspiration has devolved into a health system consisting of three subsystems—SUS and two private options, health insurance and direct payment—which do not communicate and which compete with each other. When the 1988 Constitution established the SUS, Brazil already had private health insurance. Shortly after the Constitution was adopted, the Itamar Franco government ended public health insurance for workers and transferred its large revenues, estimated at today's prices at more than R$100 billion, to the Social Security program, and what was left for SUS was not enough to fund a universal public health care system.

SUS has good points. It delivers significant services every year: more than two billion outpatient procedures, 11 million hospital admissions, health programs that are internationally respected, such as the program to control HIV-AIDS and the National System of Organ and Tissue Transplantation. The Family Health program, which covers 120 million Brazilians, is the most comprehensive primary health care program in the world. … Moreover, according to the 2015 World Health Organization report, total Brazilian spending on health was 9.5% of GDP, similar to several developed countries. But public health spending is only 4.5% of GDP, compared to 7.8% in the UK, 7.6% in Canada, 5.5% in Uruguay, and 4.8% in Argentina. These numbers say, eloquently, that SUS is underfinanced. At the current level of public spending, we cannot have a quality universal health care system.

Was the creation of the SUS too ambitious?

I don't know. The 1988 Constitution had a very strong social democratic approach, not just in health care. The constitutional assembly conceived of health care as a right for all and a responsibility of government, but it did not provide the resources to support universal health care. As a result, those who can pay have moved to private health insurance. In countries that have truly universal public health care, private health insurance is effectively just a supplement. In Canada, for example, private health insurance covers services not provided by the public health care such as some types of eye, dental, and home care. In theory, Brazil has a universal health care system, but in practice we have a dilemma about whether the health system is universal or segmented.

Given Brazil's fiscal constraints, to what extent do you think the earmarking revenues for specific uses may have contributed to the health care crisis?

In theory we can agree with most economists that earmarking revenues to specific uses is a problem in the long run because it makes it harder to create a more efficient economy.

Other economists, however, argue that in countries where the Congress is unlikely to respond to the interests of the majority of the population, revenue earmarking is necessary; they argue that had we not earmarked revenues to health and education, today we would have a lot less money directed to these two sectors. There is a certain rationality to that argument, and to this day any survey shows the population's main concern is health care.

But, compared to the current need for fiscal adjustment, there are proposals for at least reducing earmarking revenues. Do you think that could be possible?

To have a health care system that works, the discussion at the macroeconomic level is not, in my opinion, about economic technicalities but about the system the population wants, and is willing to pay for. When you segment the health care system so that public health care goes mainly to the poorest, it will always be underfinanced.

What do you think would be a possible health care system in the Brazilian case?

I am in favor of a universal public health care system. The evidence is abundant that such a system is more efficient, more effective, offers better services, and is more equitable. We could conceive of gradually building a strong universal public health care system over the long term. Alternatively, we could consolidate the current system: the SUS would continue to serve the low-income population and keep private health care. … Building a universal public health care system is possible, but not likely today; the second alternative is more likely. It would be kicking the can down the road, leaving the health crisis deepening

What we see today is an intensification of the structural problems that arose when the Unified Health System (SUS) was established.

in both the SUS and the private sector. A segmented health care system is inherently expensive, ineffective, and poor quality. The best example is American health care: Today the United States spends almost 18% of GDP on health. Per capita spending in 2012 was US$8,845—more than double the UK, which has better health outcomes and higher-quality services. But we do not have as much money as they have, which makes this choice unsustainable in the long run.

A third alternative is Obamacare: It provides access for all to both public and private health care systems. It is based on a reformulation by the World Health Organization (WHO) of the concept of universal health care that emphasizes universal coverage: Instead of the government doing everything, it seeks to overcome the public/private segmentation by enabling access for all to both systems, with the public and private sectors organizing to ensure health coverage for all the people.

What would be the main challenge to building a similar system in Brazil?

Although in the short term it is impossible, we could invest in building a universal health care system based on a long-term plan with assurances that funding for public health care

To have a health care system that works, the discussion at the macroeconomic level is not, in my opinion, about economic technicalities but about the system the population wants, and is willing to pay for.

in Brazil would be gradually increased along with an efficiency and quality agenda. This is important. So far we have been discussing macro-level health care organization, but the essence of the system is closer to its micro-level performance. At the microeconomic level we have the issue of how health care is delivered —the difference between fragmentation and integration that influences the efficiency of a health care system. Why is health care so expensive in the US? The American system is totally fragmented at the micro level. There is no coordination, no primary care that integrates the system and communicates with specialty medical centers, hospitals, clinical analysis laboratories, and imaging centers, among others.

In Brazil it is necessary to have an efficiency agenda because the system is also very fragmented. In recent years, the Ministry of Health has been spending much less on primary health than on medium and high-complexity medical procedures. In Brazil, I estimate that systemic health care inefficiencies—technical, scale, or allocative—consume 30% of the already limited resources, and that is not even mentioning private health insurance. You do not have scale, and in health care scale is important for both economic efficiency and quality. Think about hospital care: Most hospitals (58%) have fewer than 50 beds and about 45% of hospitalizations are unnecessary. The average Brazilian hospital produces a third of what it could produce with the same resources. Brazilian hospitals have on average 50% more employees per bed than hospitals of member countries of the Organisation for Economic Co-operation and Development. Low scale is associated with a lower quality of care.

There are other important micro factors. Payment for health care is based on fee-for-service, which encourages the use of technology-intensive services, rather than services patients need. The fee-for-service system increases the number of services provided and encourages provision of unjustified services. In contrast, the value-based payment system aligns the incentives of health organizations and health care providers, improves clinical outcomes and the experience of patients, reduces costs, and raises efficiency.

How are changing demographic and epidemiological profiles affecting the financial sustainability of the Brazilian health system?

Health systems undergo transitions. Brazil is experiencing a fast and profound demographic transition: the population is aging and that means more old people with chronic diseases. A second deep and fast transition is nutritional: half of adults and a third of Brazilian children are overweight or obese, which means more people with

chronic diseases like diabetes. A third transition is that health technologies are emerging tremendously; the number of medical papers published doubles every 10 years. But several authors have pointed out a paradox: there is an avalanche of new technologies but we are unable to use the technologies rationally. The United States is a model of excessive use of medical technology in tests and treatment, but health care outcomes are no better and there is unnecessary expense.

The fourth speeding transition is epidemiological. In the middle of the last century, half of the deaths registered in Brazil were due to infectious diseases and maternal and perinatal causes. Today, they represent less than 4% of total deaths. Instead, since the 1970s, we now have what some authors call an epidemic of chronic diseases. Cancer mortality has risen and cardiovascular diseases now constitute 66% of the disease burden (which encompasses both illness and mortality). We have also begun to see increased illness and mortality from external causes, such as traffic accidents and homicides. Brazil today has a triple burden of disease: 14.8% infectious diseases and malnutrition, 10.2% externally-related diseases, and 66.2% chronic diseases. Rich countries have got rid of infectious diseases; some, like Sweden, are already moving to do away with externally-related diseases; but for a long time Brazil will continue living with its triple disease burden.

We still have outbreaks of dengue and other diseases like cholera that should have been eradicated long ago....

Obviously, we must be alert to emerging situations like the zika virus, or reemerging infectious diseases like cholera. But this is not our biggest problem. While in Brazil dengue, unfortunately, kills 600 people a year, together heart attack and stroke kill 500 a day.

The Itamar Franco government ended public health insurance for workers, transferred large amounts, estimated at today's prices at more than R$100 billion, to the Social Security program, and what was left for SUS was not enough.

Today we have the situation of a 21st century triple disease burden being addressed by a mid-20th century health care system that focuses on acute, infectious conditions, while today chronic diseases like diabetes, hypertension, and mental diseases predominate.

To generate efficiency in a health care system we need good interdisciplinary primary care, using new technologies and networking. For example, a doctor without the support of a nutritionist does not cure diabetes.... People diagnosed with hypertension at 40 who do not control their blood glucose will be diabetic at 45, and after that risk having a heart attack, going blind, or suffering amputation. That's where the money goes. Health care is unique in this: What produces the most diseconomies is a misguided health care model.