Concerns about CURRENCIES

+ INTERNATIONAL: China, the G20, and the currency question

+ INTERVIEW: Antonio Delfim Netto and Raul Velloso

The new president’s CHALLENGES
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What lies ahead?

As Dilma Rousseff prepares to take office as president of Brazil in January, she is probably pondering what lies ahead. Brazil has a long history of populism, and the threat to economic stability that raises persists because social inequality remains extremely high. The president-elect will need to resist the populist appeal that other Latin American leaders have fallen for. The public accounts that the president will inherit are in worrying condition, barely disguised this year by accounting gimmicks. Her first test will be negotiating the minimum wage while keeping in mind how the new wage will affect public finances. She will be pressed hard by the demands of the governing coalition for more spending and large investments for the World Cup. She will therefore need to exercise great fortitude and determination to control and improve public spending.

The currency issue has been occupying much of the news media lately, both in Brazil and abroad. At the G-20 meetings in Seoul, the “currency war” was a major focus of debate, especially for developing countries. This month The Brazilian Economy delves into the subject. In the opinion of former Finance Minister Antonio Delfim Netto, adjusting the public accounts is the way for the country to align domestic and international interest rates. He believes that would reduce the appreciation of the real against the dollar, one of the challenges president-elect Rousseff must deal with. In the view of economist Raul Velloso, unless Brazil veers onto the wrong path, the U.S. dollar will continue coming in by several doors, so Brazil must learn to live with exchange rates at current levels.

The currency issue is also addressed in an interview with Li Daokui, one of the most influential economists in China and a member of the Monetary Policy Committee of its Central Bank. In Li’s view, the economies of China and Brazil are separating from the U.S. and a new cycle of trade and investment has started between the two countries. He explains that while the Chinese government still must pay attention to the possibility of speculative bubbles in real estate and financial areas, the Chinese economy has begun to adjust toward a model of development that is less dependent on exports. This, he believes, should allow for some kind of agreement between China and the U.S. on the imbalances in the global economy, despite the controversy about the existence of a “currency war.”

Meanwhile, high domestic interest rates and the prospect of further currency appreciation are factors that increase the interest of foreign investors in Brazil. However it seems inevitable that measures to curb the exchange rate appreciation will be needed, possibly including capital controls and some fiscal adjustment.
The new president’s challenges

In the end Dilma Rousseff, 62, won 12 million more votes than her opponent, Jose Serra (PSDB), backed by a highly popular president and a robust economy. She is the first female president of Brazil and the 11th in Latin America. The president-elect was little known to her fellow citizens until President Lula promoted her as his successor, after a number of high-profile candidates were forced out by corruption scandals during his administration.

Born in December 1947 in Belo Horizonte, in the coffee-growing state of Minas Gerais, Rousseff had a middle-class upbringing. Her Bulgarian immigrant father was a lawyer and entrepreneur and her Brazilian mother was a teacher. As a student she became interested in left-wing politics and was deeply involved in the underground resistance to the country’s military rulers, who held power from 1964 until 1985. Early in 1970 she was captured and jailed. After her release at the end of 1972 she studied economics and went on to become a career civil servant. She served as energy minister and then after 2005 as President Lula’s chief of staff until stepping down earlier this year to run as the Workers’ Party candidate.

Rousseff is expected to continue the market-friendly economic policies of her predecessors Fernando Henrique Cardoso and Luiz Inácio Lula da Silva that are credited with helping Brazil’s economy to record rapid growth in recent years and expanding the social programs that have lifted millions out of poverty. But some analysts also believe that in some areas she favors a large role for government in the economy.

She will need to resist the populist appeal that other Latin American leaders have fallen for. Despite recent success, Brazil has a long history of populism, and social inequality remains extremely high. According to sociologist Alain Touraine, “There is danger of a backlash, because the history of the
PT is far from perfect. Lula was not authoritarian, but segments of the PT are“ (O Globo newspaper, November 14). The PT has tried to limit the media, supporting or proposing projects of “social control” — a euphemism for censorship. “She may have populist tendencies or make a great government, we do not know,” says Touraine. Although José Serra was no match for President Lula’s popularity, he is highly respected, competent, honest, and earnest. As opposition, he will be a valuable asset for Brazil against the risks of irresponsibility and populism.

The president will need great fortitude and determination if she is to control and improve public spending. She will inherit public accounts that are in worrying condition, which was barely disguised this year by accounting gimmicks. Her first test will be negotiating a new minimum wage, during which she must keep in mind the consequences for government finances. She will be pressed hard by the demands of the PMDB and PT governing coalition for more spending and large investments for the World Cup. She also will face a rapidly growing current account deficit and appreciation of the exchange rate, which both have potentially negative effects on manufacturing. Finally, she has the daunting task of improving the business climate: The World Bank ranks Brazil at the bottom in terms of easy of doing business index (127).

Ms. Rousseff will need to combine expertise, austerity, and courage to make politically difficult decisions. Her choice of ministers will be critical. If as rumored Antonio Palocci, the former finance minister, becomes the president’s chief of staff and Henrique Meirelles continues as central bank governor, their influence will certainly be a force for government moderation and common sense.
An exceptional outlook for growth, employment, and income have caught the attention of investors around the world who are impressed by the Brazilian economy. A massive injection of capital into numerous sectors is expected in the next few years. The National Bank for Economic and Social Development (BNDES) projects that through 2012 infrastructure and mega projects related to deep sea oil and production for both domestic consumption and exports will attract investments totaling R$1.3 trillion (US$765 billion).

Brazil is in a position to take advantage of the positive change in capital markets in the last decade. Its stability, good macroeconomic fundamentals, modernized regulation, and international investment grade ratings have helped produce a diversity of investment instruments in capital markets. According to market projections, investment funds could double over the next five years, to R$3 trillion (US$1.8 trillion). The Brazilian Association of Organizations in Financial and Capital Markets (Anbima) reports that in September domestic investment funds had a net
worth of R$1.54 trillion (US$910 billion), of which institutional investors accounted for 41%. In September, Anbima reports, 101 funds were opened, bringing the total to 9,730.

This expansion of investment funds is welcome, since low domestic savings and the limited access of corporations to financing deter economic growth. “The biggest source of business financing is still companies themselves,” says William Eid, coordinator of the Center for Finance Studies at the School of Business Administration of São Paulo of the Getulio Vargas Foundation (FGV-EAESP). Carlos Rocca, director of the Center for Capital Markets Studies of the Brazilian Institute of Capital Markets (Ibmec), adds that “Even pension funds have not participated much in capital markets so far. In late 2009, almost 80% of public debt outside banks was in the hands of institutional investors, while the same proportion of stocks and private bonds was in the hands of foreign and non-financial investors.”

Claudio Maes, manager of the department monitoring investment funds of the Securities Exchange Commission (CVM), points out that this market has gradually been opening up, which may be part of what is attracting investment funds. Alternatives such as receivables funds (FIDCs) and real estate receivables certificates (CRI) have brought a new dynamic, he says. Private equity (PE — equity securities of corporations that are not publicly traded) and venture capital (VC

In September this year, according to Anbima, the domestic fund industry had a cumulative net worth of R$1.54 trillion (US$910 billion).
Investment funds — financial capital provided to early-stage, high-potential, startup companies) as well as real estate funds (FIIs) have been surging. Foreign demand for Brazilian assets abroad generates changes not only in the market environment — with banks creating mirrors of their funds abroad — but also leads to direct acquisition of PE and VC management firms. However, the rapid growth of investment funds is nourished by the hope that Brazil will reverse its extremely high domestic interest rates — a challenge for the next government.

Structured Support

Though lower interest rates have not yet materialized, the increased attraction of private equity is evident in Brazil. Investment in PE and VC funds grew to US$34 billion in 2009. Private equity offers alternatives to traditional bonds and stocks. The cost of listing on the stock market is one of the factors that limit corporations’ access to capital market funding.

The growth of PE and VC funds has impacted on mergers and acquisitions of Brazilian companies as well as generating employment and income. Today in Brazil, pension funds are major investors in private equity, holding 22% of the total. “These are important investments not only in themselves, but also because they are catalysts for other long-term funding sources, such as the BNDES,” explains Luis Carlos Fernandes Afonso, director of finance and investments for Petros, the pension fund for employees of Petrobras (the state-owned oil company), which has invested R$ 2.5 billion (US$1.5 billion) in PE and VC funds.

Owning R$500 billion (US$290 billion) in assets, pension funds have benefitted from the diversification options now available. As government securities began to be less profitable after 2003, pension funds began to search for other assets to meet their actuarial targets (inflation plus 6%) and cope with the increase in life expectancy of beneficiaries. The result so far has been a transfer of about 10% of assets from fixed income securities to equities.

For Valia, the pension fund for employees of Vale, the Brazilian mining multinational, private equity assets now represent 4% of the portfolio; the target, says Mauricio Wanderley, director of investments and finance, is 5%. “In 2001, Brazil had only three funds, today there are ten, with expected returns of 25%,” he explains.

Funcef, the pension fund for employees of Caixa Econômica (the federal savings bank), began to change its investment policy in 2004. “We began to focus on growth, adopting new strategies: increase the share of equities, reduce exposure to assets tied to interest rates, and extend the maturity of the portfolio of fixed income and equity,” says Mauricio Marcellini,
Funcef manager of investment. Funcef has created a growth profile consisting of real estate, funds of stocks, and shares in companies; its share in the total portfolio rose from 29% in 2003 to 44% in 2010. “The highlight is private equity, for which we have committed capital of R$3.6 billion, 8% of the whole portfolio,” says Marcellini.

**LARGE COMPANIES**

Marcellini also highlights Funcef investment in participation funds (FIP), which gives it a presence in large companies as well as companies with promising growth prospects. “This is the case with the power industry, in which we have Desenvix,” he says. The renewable energy company is a good reflection of the dynamism resulting from increased capital. Because of the Funcef investment, Desenvix in March launched a new subsidiary, Cevix, for hydroelectric projects, wind and biomass, with total capital of R$1 billion. It is preparing for an initial public offering of shares soon.

Private equity can encourage new public offerings, which São Paulo Stock Exchange transactions failed to do. International examples show the potential of private equity: Canada’s TSX Ventures Exchange, established in 2002, by this June had 2,360 listed companies and had daily movement of US$236 million and a market value of US$38 billion, and Hong Kong’s Venture

Today, pension funds, owners of assets of R$500 billion (US$290 billion), are the biggest investors in private equity, holding 22% of the total.

Data from the Brazilian Association of Real Estate Credit and Savings indicate that by 2013 demand for financing for housing will exceed the amount available.

The total stock of foreign investment in Brazil was US$1.13 trillion in August: 37% was for direct investment and 31% for shares.
Exchange, launched in 1999, by last June had 174 listed companies, average daily trading volume of US$84 million, and a market value of US$17 billion.

PE management firms are also concentrating on another promising segment: infrastructure funds, a new market instrument that has attracted about R$800 billion. These managers buy a majority stake in midsize businesses, helping management to focus on improved outcomes in order to build the company up to sell.

Real estate funds have also experienced significant growth based on both more ambitious housing plans and larger commercial building projects. Data from the Brazilian Association of Real Estate Credit and Savings (Abecip) indicate that by 2013 demand for funding will exceed the amount available. “The need for credit grows at a rate of 50% a year, but savings grow at 20%. The gap does not close,” said Luis Antonio França, Abecip president. Attracting long-term funding is also a priority for Brazil’s banks, so they can continue real estate lending over the next few years.

CHALLENGES
While the investment fund industry is very promising, not all is rosy. “The best environment for growth is in place; now the main factor that will dictate how far we can go will be the interest rate,” says Wanderley. What happens next will depend on whether the next government adopts policies that provide the right conditions for new financing instruments for business. “The priority will be reducing public debt, which pushes the interest rate up and increases financing costs for the private sector,” says Rocca. “Without doubt, the government needs to spend money well and reduce corruption, which makes money more expensive, but we also need the government to invest, too,” says FGV’s Eid. “What is lacking today is a scenario with interest rates of 4% or 5% to spur the appetite for risk,” says Marcellini, “It is essential that the market be prepared for this new reality.”

According to Rocca, to sustain average annual growth of 5.5% for 2001–2013, Brazil will have to mobilize more savings, both domestic and foreign, by leveraging the attractiveness the country enjoys abroad; currently investments in developed countries are less profitable because those countries are recovering only slowly from the global financial crisis. He supports tax exemptions for the capital market “to attract more foreign investors to the Brazilian stock exchange. For now, the word seems to already be out: the quality of foreign capital inflows is good. According to the central bank, the total recorded stock of foreign investment in Brazil was US$1.13 trillion (about 60% of GDP) in August: 37% was for direct investment (FDI) and 31% for shares. The United Nations Conference
on Trade and Development (UNCTAD) recently ranked Brazil as third among countries favored by multinational corporations for investments abroad.

Domestically, there is a need to improve liquidity in the secondary capital market, mainly by reforming taxation. Rocca gives an example: “Every time a private debenture changes hands, it is taxed, which undermines the capital market, while government bonds are exempt from income tax.” Also, Eid points out, it is necessary to enhance legal certainty for investments. “We have plenty of laws, but they are not necessarily enforced,” he says.

It is also necessary to stimulate increased savings by institutional investors, including pension funds. “Today’s pension fund assets represent about 17% of GDP, but in countries like the United States it is 80%,” Marcellini says. However, some pension funds have already reached their maturity level; slower resources growth means less to invest. Private pension reform would help to boost savings.

EDUCATING FOR SAVING
A long-term focus is needed not only for pension funds. Eid highlights the need to teach the importance of saving to those consumers who have just arrived in the middle class. “We are still oriented to consumption,” he says. The new middle class represents a universe of 95 million people who have the potential to save money. Credit for consumption accounts for 25% of GDP, while the new middle class’s share in investment funds accounts for only 10%. In contrast, in the past five years, private banking and high-income classes increased their share to 70% of the total invested in industry by individuals. This group is more willing to accept new products and risks, while the middle class has an aversion to any kind of risk. “Mutual funds are ideal for the middle class because it is difficult to pick individual stocks and assess market behavior,” says Eid.

Though today the middle class is marginal for the investment fund industry, the industry will have to educate these people to invest over the long term. “We need to simplify and create products tailored to the risk profile of each one,” says Eid. “Each may have different needs: Invest in low-risk securities for the education of children and on riskier ones when the goal is next year’s vacation — there is a trade-off between time and cost,” he explains. “This way, we will change the focus from short-term liquidity, which most Brazilians want (often not even knowing what for) and encourage them to save and invest.”

In Brazil today pension fund assets represent about 17% of GDP, but in countries like the United States it is 80%.

1 FIP allocate a preponderant part of their portfolio to stocks, debentures, and securities convertible into stocks. Brazilian regulation requires that the FIP participate in setting the strategic policy and management of companies in which they invest, especially through appointment of members of the board.
It all began in 2003, when Gustavo Caetano, a student of marketing, realized that the market for mobile games in Brazil was nonexistent. With financial support from a friend of his father and in partnership with a developer of mobile games from England, in 2004 he opened Sambatech, a company capitalized at R$100,000. “Because we worked with other people’s money, from the beginning our process was transparent,” he says. This good corporate governance was rewarded. In 2007, when the company expanded its focus to an Internet platform for video distribution, the company managed to attract R$4.7 million in venture capital from FIR Capital. The result? Growth of 300% since 2008, 50 employees (the oldest is 30), and net income of R$10 million in 2010.
Stories like Caetano’s are increasingly common in Brazil: innovative companies with potential for rapid growth have attracted the attention of investment funds that have provided seed capital, venture capital, and private equity to finance their rise. And there is other good news involving this market: negotiations take place in an environment where no specific region predominates, which has attracted the interest of foreign investors who have shifted their radar from the United States and Europe in search of promising economies.

Growth

According to a survey of the Center for Private Equity and Venture Capital (GVCepe) of Getulio Vargas Foundation of São Paulo (FGV-SP), released in April 2010, today in Brazil 140 firms manage financial resources amounting to US$34 billion, 2.2% of GDP. “Our estimate is that over the next five or six years, total investments in private equity will rise to 3.5% or 4% of GDP,” says Claudio Furtado, coordinator of GVCepe. The study also reveals good news about the lives of Brazilians. By the end of last year, about 1,700 jobs were created in Brazil with the help of private equity and venture capital, against 1,000 jobs in India and 800 in China.

The economic crisis, which peaked in 2008, has not shaken the morale of the private equity (PE) and venture capital (VC) business in Brazil. On the contrary, it has given impetus to mergers and acquisitions (M&A): in 2006, private equity participated in only 11% of mergers and acquisitions; so far through September 2010, it participated in 43% of this year’s 564 M&A transactions. “There has been growth year after year thanks to the presence of well-capitalized...
private equity firms making investments in sectors with growth opportunities,” says Alexandre Pierantoni, a partner at accounting firm PriceWaterhouseCoopers (PWC). And the numbers do not stop there. The GVCepe survey also shows that from 2004 to February of 2010, there were 118 initial public offerings (IPOs), equivalent to R$113 billion. Of these, 41 IPOs were from firms managing private equity (PE) and venture capital (VC) portfolios, representing R$28 billion.

**Energizing**

Entrepreneur Marcus Regueira, FIR Capital, which manages a fund supported by the government’s Financing Agency of Studies and Projects (FINEP), points out that the environment in Brazil is almost ideal for long-term investments like VC and PE initiatives, which generally demand eight to ten years from initial investment to sale. In addition, according to Regueira, the markets in China and India, major investment destinations for PE and VC a few years ago, are inflated: “Brazil has a balanced economy and democracy and a need for investments. Moreover, it has an adequate stock market, which is what those investments look for in public offerings.”

Alvaro Gonçalves, founding partner of Stratus Group, is of the view that the PE and VC firms have a special role in the ecosystem of the capital market: as debugger and energizer. He says, “Capital markets in which PE and VC firms operate in a relevant way tend to have a higher level of refinement. They are healthier, less concentrated.”

For the entrepreneur, the goal in Brazil is for more businesses to trade on the stock exchange. India is a smaller economy than Brazil, but it has nearly 7,000 public companies, compared to only about 500 in Brazil. “We have the smallest stock exchange in emerging markets, either because we have for a long time lived with high interest rates, or from decades of an investing culture relying on fixed income. And the average entrepreneur still thinks that issuing shares on the stock exchange is only for large corporations,” Gonçalves says.

**Attraction**

The PE and VC business in Brazil has attracted the attention of foreign investors, although 60% of its capital is still concentrated in the hands of domestic investors, according to the GVCepe study. “The business captures a lot of resources from institutional investors, such as pension funds, which are investing less in fixed-income securities so they can allocate more resources to private equity and venture capital options,” says Claudio Furtado. According to Sidney Chameh, president of the Association of Private Equity & Venture Capital (ABVCAP), it is now necessary to
attract smaller pension funds to this market to broaden the action.

The difference between investment committed and investment realized is still significant, however: while committed investment is 2% of GDP, investment carried out represents only a tenth of that, 0.2%. In the United States, where the business has existed for at least 30 years, the percentage is naturally much higher at 1.4% of GDP. In India the figure is 0.81% and in China 0.21%. Thus, there is room to grow, since most PE and VC funds are still well-stocked with capital. In addition, Brazil is following a global trend of investment funds broadening their portfolios. Traditional sectors such as construction and real estate are already flirting with these funds. Each accounts for about 13% of the business, as do computers and electronics, followed by agribusiness (6%), energy (7%), communication and media (8%), food and beverages (4%), retail (5%), and biotechnology (4%).

Volatility
Although the VC and PE business is promising, Brazil’s volatile exchange rate is identified as an obstacle to long-term investment, a concern that has increased with rumors of an exchange rate war. To work well, the business needs a stable environment, which has been a rare scenario in recent months. Also, the sudden government decision to raise the tax on financial operations (IOF)
Brazil’s volatile exchange rate is identified as an obstacle to long-term investment, a concern that has increased with rumors of an exchange rate war. as a way to prevent exchange rate appreciation has exacerbated the concerns. “The problem is that the government included the PE and VC business as among factors that may cause instability of the exchange rate. Currently, you could not make an exception, although there is not a penny of private equity going into fixed income. Private equity capital is investing in the productivity of the country. It helps the industrial base here,” Gonçalves says.

Gonçalves argues for exempting the PE and VC business from the new tax. Regueira agrees that the tax “is a very negative variable for the PE and VC business. Private equity flows as a share of GDP are not enough to significantly affect the exchange rate.”

“You cannot have on one side people making a major effort to attract private investment and international investors, while on the other people are raising the IOF for the international investor who will be in these funds for ten years. The government has two roles,” comments Patricia Freitas, FINEP superintendent of investments.

Despite all the challenges, in discussions about the future of PE and VC in Brazil, the opinion is almost unanimous: the market will grow and there will be new forms of investment funds in different areas. For instance, funds of funds, which allow access to portfolios of a number of investment funds, present an alternative for making the capital market more accessible to small investors interested in diversifying their portfolios.
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What should be done about the exchange rate?

Liliana Lavoratti, São Paulo

Former finance minister Antonio Delfim Netto thinks that doing the homework — adjusting the public accounts — is the way for Brazil to equalize domestic and external interest rates. In his view, this would reduce the appreciation of the real against the dollar, and President-elect President Rousseff (PT) can meet this challenge despite pressures for increased spending. But economist Raul Velloso, an expert in public finance, takes another view of the exchange rate issue: unless Brazil gets on the wrong path, he says, capital inflows will continue coming through several doors, so the country must learn to live with an appreciated real. Both agree, however, that manufacturing will decline if the new government does not adopt policies that can counter the negative effects of the exchange rates on manufactured exports.
**The Brazilian Economy** — Why has the exchange rate appreciated so much in Brazil?

**Antonio Delfim Netto** — The exchange rate today is no longer the variable that used to balance a flow of exports, goods and services, with a flow of imports, which would depend on the terms of trade. Today, the exchange rate is the price of a financial asset (currencies) that is in the portfolios of 140 countries. Stock exchanges trade currencies, chasing differences in the third decimal place of their exchange rates. Trade in goods and services now accounts for less than 5% of foreign exchange transactions worldwide. According to the Bank for International Settlements, the Brazilian real last April was the most traded currency (US$28 billion a day). In any model, the exchange rate can only reflect the relative prices of imports and exports if the domestic real interest rate is equal to the external interest rate. This is the central point. It is said that ports, transport, education, and government in Brazil are poor, and that electricity is expensive. That may be true but has it changed in the last three years? The institutions may have been equal, but not worse. What else is a factor? The exchange rate.

**Raul Velloso** — Brazil entered a virtuous cycle in 2003, peaked in 2006, and leveled off until late 2008 when the global crisis erupted. The flood of dollars, the gradual appreciation of the real, and the accumulation of reserves are not new. After the crisis, we again accumulated reserves as we had before, but now in a different context. The United States, Europe, and Japan are purging their excess leverage and debt. Because deleveraging is time consuming and requires more savings to pay down debt, consumption drops. Rich countries dump U.S. dollars in an attempt to revive their economies, and investors seek alternative investment opportunities. With interest rates low elsewhere and high here, it is obvious why Brazil, among the emerging countries, attracts so much capital.

**Will the world continue to be willing to provide funds to Brazil?**

**Delfim Netto** — Brazil has every reason to receive a bonus from abroad. We got rid of the external problems that persecuted us and we now have another bonus, deep sea oil, but if we do not use it properly, it will cause problems. One problem is that in 2030 we will have 240 million people and we must have good-quality employment for 140 million of them. We cannot depend only on export of agricultural and mineral products; they are not labor-intensive.

**Velloso** — The current world crisis will benefit us. While most other countries continue to suffer economically, foreign investors view favorably the export-oriented segments of our economy, such as commodities, and the ones directed to the domestic market, such as cars and buildings. They come here directly as business partners, lending resources, supplementing domestic savings. Attracting capital and increasing exports reinforces the natural tendency of

“The exchange rate can only reflect the relative prices of imports and exports if the domestic real interest rate is equal to the external interest rate.”

Antonio Delfim Netto
currency appreciation. China, for example, is completely different: the foreign market is favored because Chinese save a lot and consume little. Naturally, they are exporting capital.

Is there a way out of the currency appreciation predicament?

Delfim Netto — It is not simple. We need to move toward equalizing domestic and international interest rates. The new government, the finance minister and the central bank governor will together have to assert that they will control spending, which will grow less than GDP, and produce a primary surplus of about 3.2% of GDP so that the debt-to-GDP ratio declines to 30% to 35% in 2014. The obligation of the central bank is to control inflation and make the real interest rate 3%. This we will do in the next 15 months. The increased financial transactions tax (IOF) is a legitimate self-defense. It’s a joke to think that if we cannot control the exchange rate, we will control the current account deficit.

Velloso — Unless Brazil heads in the wrong direction, exchange rate appreciation is inexorable, as it was to some extent before the crisis. The country has to decide whether it can continue buying U.S. dollars and paying the high cost of carrying large international reserves without messing up the public accounts, which will require increased taxes and will further reduce the competitiveness of Brazilian industry.

“The current crisis will benefit us. . . Foreign investors view favorably the export-oriented segments of our economy, such as commodities, and the ones directed to the domestic market, such as cars and buildings.”

Raul Velloso

Is part of the solution a fiscal adjustment?

Delfim Netto — Yes, we have to do our homework. Chilean economist Ricardo Caballero, director of the Economics Department at the Massachusetts Institute of Technology (MIT), just said, “Let’s get out of Fantasyland and return to reality if we want to do something. Because today we are only consuming”

Velloso — The big challenge is how to handle the additional tax cost of accumulating reserves, which in a few years has jumped from US$60 billion to US$280 billion. There are other ghosts, such as the cost of the expansion of the National Bank for Economic and Social Development (BNDES). Will the new government watch passively the difficult adjustment of the manufacturing industry or will it be more proactive? Will we increase public savings or will we just defend ourselves against attacks on the public purse? Increasing public savings when there are pressures from all sides to increase spending requires twice as much effort. There are people advocating radical measures: the central bank would no longer buy U.S. dollars or restrict the entry of foreign capital, letting the currency appreciate. The external deficit would grow so much that it would help to devalue the real. But imports would grow so much that it would be necessary to recreate the Provisional Contribution on Financial Transactions to subsidize domestic industry.
I do not agree with this solution, but it illustrates the dramatic choices that must be faced.

**Why has the central bank not yet adopted a monetary policy that by forcing a rapid decline in interest rates promotes exchange rate depreciation?**

*Delphim Netto* — The latest minutes and the final report of the meeting of the Monetary Policy Committee (Copom) show that the light finally went on. Both documents cast doubt on what had been central bank certainties. Any monetary policy requires three pieces of information: The first is the lag between action and result: interest rates are increased, and in nine to twelve months demand falls. But it may only take six or seven months. It has become clear that this is a variable, not a constant. The second is potential growth: There is nothing more ridiculous than this economist’s invention. Of course, there is a point above which we cannot grow. Three years ago, the central bank was sure that Brazil could not grow more than 3.5%, then it said 4.5%, now it says 5% to 6%. The third is the neutral interest rate: The central bank was absolutely convinced that rate was between 7% and 8%. Now the bank does not say what the neutral rate is; it just says it has been dropping over the years.

Monetary policy should now improve dramatically because this doubt is creative. It will make the central bank much more capable of understanding the Brazilian reality. How did the central bank attract credibility? It underestimated real output and overestimated the neutral interest rate. This hurt growth, but inflation stayed where the bank wanted it. The social cost is huge.

**Velloso** — We attract more money from abroad not just because we export commodities and we are the “big ticket” for international investors. Another reason is the appreciation of the exchange rate because of the interest rate differential with the rest of the world — while elsewhere nominal rates are about zero, the benchmark interest rate here is about 10%, one of the highest in the world. The first two reasons are here to stay, and the third helped justify the dollar going from R$4 in 2002 to the current R$1.80. Nobody knows how much the dollar should be due to structural issues, but it would certainly be below R$4 and over R$1.60. But in two or three years, when the world returns to normal, international interest will be 4% and our benchmark interest rate between 8% or 9%, so our opportunities will continue to exist, China will continue buying minerals and food that only Brazil has to sell. Our goal for technological development is to make Brazil the largest exporter of commodities. Although there are doubts about future oil prices, with the deep sea oil, Brazil may well become one of the largest players in oil too, as it is in minerals and agricultural products. That is, the prospect is to continue attracting more dollars. And as we save little, we depend on foreign capital.

**Will a fiscal shock be necessary?**

*Delphim Netto* — No, because there is not a lack of control. We know that we cannot continue to expand BNDES lending; we must increase domestic

"Brazil remains the champion at taxing exports, and steps taken to alleviate this burden remain on paper only."

*Antonio Delfim Netto*
savings, improve the tax system to exempt investment from taxes, encourage savings, and return the VAT credit to exporters as guaranteed. Brazil remains the champion at taxing exports, and steps taken to alleviate the burden remain on paper only. All this can be done without changing the Constitution. Just changing the VAT will help a lot.

Velloso — The crux of this whole story is old: it’s fiscal. We have accumulated international reserves by issuing public bonds. And that creates large interest payments: 10% of U$200 billion is almost R$30 billion. If each year we accumulate US$50 billion, the annual cost will be about R$8 billion. There is also the additional expense to the Treasury of BNDES lending. It’s sad, because this huge increase in spending is not mitigating the situation of the manufacturing industry. As dollars continue to come in — for another two to three years, who knows? — how will we pay for these international reserves we are buying as we desperately try to stem appreciation of the currency? This is the great challenge of Brazil: how to handle the additional cost of international reserves in public accounts and adjust the manufacturing industry to confront this new reality.

Can the Rousseff administration, with a strong bias for continuity, achieve fiscal adjustment?

Delfim Netto — Rousseff is an excellent administrator. She follows up. Decisions must be complied with or an explanation given why not. There is a need not for fiscal shock but for relatively calm policy rules and better management. We must ensure that government spending — everything that is not investment — grows less than GDP. This will open space to increase investment. To the extent that the policy of lowering interest rates produces results and the country continues to grow between 5% and 5.5%, the savings in interest payments will make it possible to expand investment. This is a virtuous cycle.

Velloso — José Serra would have had more technical skills to deal with such problems, though experience does not guarantee success. But before long we will know how the president-elect will deal with pressures to increase expenditure, the fiscal cost of maintaining international reserves, and how to save industry from the appreciated exchange rate. Rousseff and her team will have to command a policy that can deal with all three crucial issues early in her government.

In this context, how do we save domestic industry?

Delfim Netto — The exchange rate is destroying the sophisticated industrial system that we built. It is essential to save the manufacturing industry, for industry and services are the sectors that may give some comfort to us. There is no need for a compensatory industrial policy. The exchange rate is an endogenous variable, a relationship between internal and external prices.

“This is the great challenge of Brazil: how to handle the additional cost of international reserves in public accounts and adjust the manufacturing industry to confront this new reality.”

Raul Velloso
If the interest rate is in place, the trend of the exchange rate would be moving in the right direction. And capital movements will be less important. We are funding the debt in domestic currency; we have international reserves and all the conditions for an adjustment. Then the exchange rate will seek equilibrium. The idea that a floating exchange rate adjustment will produce no trauma is absolutely false, because on the day that there is a doubt about the exchange rate, the adjustment will make the exchange rate overshoot, destroying government finances and businesses. We are again inducing companies to borrow abroad.

Velloso — Without an industrial policy the sector will decline. The auto industry will have to find a new role, with the help of government. But in what direction should this support go: a platform for exports to occupy the global space that Asians have not yet occupied? If we remain paralyzed, soon we will have many Asian automakers here. And the suppliers will go along. Unless we believe that high commodity prices have not come to stay, and that China is not here to stay.

Has exchange rate appreciation become a structural problem?
Delfim Netto — If the difference between domestic and foreign real interest rates is a random variable, on average constant and with little variance, the speculation disappears. The exchange rate will be whatever one has to adjust to. If the economy is less efficient, it will be a little higher; if it is more efficient, it will be lower. Our system is canonical: fiscal responsibility, declining debt, inflation targeting, and a floating exchange rate. The defect is that the exchange rate cannot float when the differential between domestic and foreign interest rates is huge and does not disappear. Suppose that the central bank got out of that business. How much would the real interest rate be today? Very close to the rate outside, because it is the central bank that keeps the interest rate where it is and brings in more capital inflows. If the central bank would leave, there would be an invasion of liquidity and the domestic interest rate would fall. The central bank is keeping the real interest rate high.

Velloso — For cyclical reasons, which will still last for two to three years, and structural ones, Brazil is being flooded with dollars. For the time being, commodity prices offset the negative effect of currency appreciation on exports, and the heating of the domestic market relieves industry from competition with imported products, but it is being squeezed by Chinese exports. We are increasingly competitive in agricultural and mineral products. China is indeed good in manufacturing.

Will Brazil have to learn to live with a higher exchange rate?
Delfim Netto — We live with the wage level, and the prices of bananas, coal, and oil. At some point, if we accept this system, which is far from ideal, the exchange rate converges to a proper level. We can say it would actually converge to produce the balance in current accounts, it should be higher, something like R$ 2, R$2.05, or R$2.08.”

Antonio Delfim Netto
current accounts. When this happens, we will not need anything else. Today, where should the exchange rate be? If we want the exchange rate to produce a balance in current accounts, it should be higher, something like R$2, R$2.05, R$2.08. It’s a guess, no one knows. But certainly there is an obvious overestimation. The dramatic point is that in the last three years all other things remained constant or improved. And the exchange rate has appreciated. So it is the exchange rate indeed. There is no other explanation.

Velloso — The greater weight of commodities in the economy is a change that is here to stay. Brazil has become more competitive in this area with the research of Embrapa (Brazilian Company of Agricultural Research), in spite of infrastructure bottlenecks. We moved from a country that produced little to one that produces a lot of commodities and technology-intensive products, contrary to what one may think. That appreciates the currency. If we had no obstacles, the country would become a star. We have come to occupy a different position in the world. At the same time, several things have matured together: the macroeconomy has been adjusted, which earned us an international investment grade rating, and we have reaped the fruits of a very long process.

“The greater weight of commodities in the economy is a change that is here to stay. Brazil has become more competitive, despite infrastructure bottlenecks.”

Raul Velloso
For the production of price indices and economic indicators, the Brazilian Institute of Economics (IBRE) has a unique structure of research in Brazil in size and quality: eight offices located in major capitals of the country, researching prices for all units of the Federation, both retail and wholesale. IBRE collects monthly prices of around 200,000 products and services with the help of 15,000 companies and informants. Apart from general indices, IBRE develops indicators specifically directed to a sector, activity or company.

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China, the G20, and the currency issue

China and Brazil are starting to decouple from the US economy and open up a new cycle of trade and investment between them. Chinese policy-makers must still remain vigilant about bubbles in the country’s property and financial markets, but the economy is already beginning to rebalance away from dependence on exports. That in turn should permit agreement between China and the US on international economic policy despite all the talk about “currency wars” — as long as US congressional politics does not get in the way.

These are the views of Li Daokui, one of the most influential economists in China. Li’s day job is professor of economics at Tsinghua, one of two elite universities in Beijing. But since the start of the year he has also been a member of the
Monetary Policy Committee of China’s central bank, which gives his opinions added authority. With one foot in academia and the other in policy-making, he is very well placed to give insight into how China views the global economy in this period of heightened trade tensions and uncertain recovery.

**Progress**

Li Daokui spoke to *The Brazilian Economy* shortly after the G20 finance ministers and central bankers met in South Korea in late October and before the full G20 summit in Seoul in mid-November. Although the international press is full of references to a currency war, Li takes a more relaxed view, arguing that the meeting of G20 finance ministers made “good progress” because the debate has shifted from “the surface issue” of nominal exchange rates to the “fundamental issue” which is real rebalancing.

He was referring to the proposal by U.S. Treasury secretary Tim Geithner to push for a commitment by the G20 economies to limit their current account surpluses or deficits to less than 4 per cent of GDP. Several governments, including Brazil, have argued against such a rigid target for current accounts, which they view as largely arbitrary. But Li thinks this is an important step forward because current account deficits and surpluses are at the heart of the problem.

“In China policy makers and scholars are more worried about our trade surplus perhaps than many American policy makers. We know it’s not healthy. It’s not maximizing our own citizens’ wealth.

Now [the G20 is] talking about the substance. The substance is world trade rebalancing. That to me is the fundamental issue, much more fundamental than the nominal exchange rate, and they are now even willing to talk about numerical targets for current accounts,” he says.

Such targets are likely to have some support in China, he says. “I think China is well positioned politically and economically to make adjustment numerically. . . . It is no big deal because market forces in China have been pushing the economy to make adjustments in this direction, even if we don’t want to. . . . China should not be afraid of numerical targets for reducing its trade surplus.”

He adds, “In China policy makers and scholars are more worried about our trade surplus perhaps than many American policy makers. We know it’s not healthy. It’s not maximizing our own citizens’ wealth. So [the Geithner proposal] is consistent with our targets, with our objectives.”

Not only is the proposal addressing the real issue, he says, but it is a way of damping down what he views to be the sterile debate about China’s exchange rate. Li is among the academics and officials who have been calling for some time for the
currency to be allowed to appreciate more rapidly, to help rebalance the economy away from exports and to encourage more domestic consumption. But he insists that this has to be done slowly and for domestic reasons.

“A higher nominal exchange rate certainly helps the Chinese economy to make adjustments that we need,” Li says. But the “political dynamics are extremely damaging in the long run if pressure from America or other countries turns into higher exchange rates.” If China were to appreciate its currency sharply, and yet after six months or a year there was no real impact on the trade surplus, he says, there would be demands for further appreciation. “There is no end to that, right? No policy makers in the world will be happy to see this kind of passivity. You want to do it on your own, you don’t want to be pushed around.”

Any change in the nominal exchange rate should be modest and gradual because that “is the best way of sending the signal to exporters to force them to make adjustments while giving them a time window of one or two years to either exit the business or upgrade their exports. To me, this is basic economics. You want to do it gradually.”

And even if changes in the nominal exchange rate will be modest, the real exchange rate is appreciating much more rapidly, he reckons — by maybe 10% over the last six months. Not only is inflation higher in China than in the U.S. and many developed economies (China’s CPI reached 3.6% in September), but wages are also increasing rapidly. “In terms of real exchange rate appreciation, it has been quite fast,” says Li.

American politicians are already using the exchange rate and China’s trade as excuses for their own problems. I worry that after the election, Congress will bring up this issue again.

Criticisms
In the run-up to the G20 summit, many governments in developing economies complained loudly about loose monetary policy in the US, which they believe is sending a wave of capital inflows into their countries that exacerbates inflationary pressures. Indeed, China has voiced such complaints. “United States issuance of dollars is out of control and international commodity prices are continuing to rise. China is being attacked by imported inflation,” Chen Deming, China’s Commerce Minister said in late October. “The uncertainties of this are causing firms big problems.”

Li takes a different view. He believes the Chinese economy is now large enough that it is much less vulnerable to surges in capital inflows — especially as China still has relatively strict capital controls. “If we have a large pool of water, a big elephant jumping in will not create as much of an impact as it would in a small pool of water,” he says. “In these domestic debates I always say, do not blame only the inflow of hot money — managing our
own issues properly is of first importance.”

But if he thinks the discussions about rebalancing between Beijing and the Obama administration are starting to move in the right direction, Li says he is very worried about what the U.S. Congress might do: “I am not so confident about American domestic politics. American politicians are already using the exchange rate and China’s trade as excuses for their own problems,” he says. “I worry that after the election, Congress will bring up this issue again.”

He adds, “I think it is possible for the two governments, and also other governments, to have a certain kind of, if not agreement, at least a good understanding. But the problem is that in the U.S., the administration may not have complete say. Maybe the US Congress will pass some legislation. That’s the uncertainty. That’s what I don’t fully understand and I worry about.”

**Optimism**

One reason Li is still optimistic about the outlook for the debate about global imbalances — the US Congress aside — is that he is cautiously upbeat about the way the Chinese economy is shifting its own growth model. For most of the last five years, the Chinese government has been talking about the need to change the balance of the economy from dependence on investment and exports towards domestic consumption. Chinese Premier Wen Jiabao has famously described the economy as “unsteady, unbalanced, uncoordinated, and unsustainable” on several occasions. The release in October of the outline of the country’s five-year plan for 2012–2017, which placed great emphasis on boosting consumption, has encouraged some observers that the authorities are going to put their weight fully behind the reforms needed to bring about that much-needed shift.

“In the communiqué of the fifth plenary, if you read it very carefully, they use particularly strong words to talk about structural change. The Chinese version says that in the next five years they want to make substantial progress in strategic adjustment of economic structure,” Li says.

Many of the reform ideas that are being mooted have been around for some time. They include abandoning the *hukou* system of urban residence permits that prevents tens of millions of migrant workers from settling in the cities where they work and becoming permanent residents and proper consumers. There is plenty of skepticism about whether the current leadership team of President Hu Jintao and Premier Wen Jiabao has the political capital to drive through some of these reforms in their last two years in office. But for Li, the important message from the
new five-year plan is that the top leaders are committed to pushing these ideas in the face of opposition from some local governments.

“The way I read Chinese general policies is that the senior leadership has for several years put significant and decisive political capital behind structural change. There is no question about it,” Li says. “What is new perhaps is that they want to send an even clearer signal to local governments. The central government’s political intention from the very top is already strong, because these are the people who travel to international conferences; these are the people who feel the international pressure first hand.”

Bubbles
The priority in the short term, he says, is to prevent the huge amount of liquidity in the Chinese economy from creating asset price bubbles, especially in housing. An important step in that direction was the decision in October to raise interest rates for the first time in nearly three years, which was designed to “show bank depositors that the authorities are concerned about inflationary expectations and are taking steps to address negative real interest rates.” The other important policy action, he said, was in the supply of housing — the government has to follow through on its pledge to significantly expand the stock of public housing that would be made available to low-income families. This would help both to keep prices under control by expanding supply and to reduce the political tensions surrounding high housing prices.

Another reason for Li’s optimism about the prospects for the Chinese economy is the rapid expansion in economic ties with other parts of the developing world. Before the financial crisis, there was considerable discussion about whether Asia was decoupling from the developed world — a debate that seemed to disappear when the crisis hit. Now China’s rapid recovery since early 2009 has brought new life to the discussion.

“Decoupling has already happened,” he says. “For China and the U.S., people said decoupling was impossible before. I said decoupling was going to happen and it did happen. Now the U.S. economy is not doing so well, while China and emerging markets are doing very well — this will further strengthen the trend of decoupling. Within emerging market economies, there are forces that reinforce each other’s growth. This has strengthened the decoupling trend.”

The key point, Li says, is that these economic links are not just based on trade and Chinese purchases of large volumes of raw materials; they are also now based on substantial flows of investment. “This is a new
development that we need to watch very carefully,” he says. “China is now working closely with all these fast-growing emerging market economies. Not only is China importing a lot of raw materials from these countries, it is also finding increasing ways of applying its currency reserves in these countries that need capital. This is not in the form of hot money — China is making real investments, direct investments in infrastructure and manufacturing.”

This shift toward the developing world is not an accident, Li says, or a temporary reaction to the crisis, but a realization that China had become too economically linked with the U.S. and Europe. “This is perhaps a counter-force against the previous policies,” he says. “Policies in the past two decades have been encouraging investments from the developed countries, technologies from the developed countries. Arguably, this went too far. People have seen the negative impact when developed economies slow down. Now people see that there are dynamic forces in Brazil, why not? I would say this is a natural reaction to the financial crisis.”

Promising partnership
Within this new push to reduce dependence on the U.S., Brazil is one of China’s top priorities, especially as in recent years China has come to appreciate the political stability that Brazil now enjoys, where changes of government do not cause abrupt shifts in policy. “What is most exciting to me is that the politics in Brazil, to me, as an observer, are very stable. Chinese policy makers and academics can understand the political dynamics in Brazil better. That gives confidence to Chinese investors. I think people are less worried about protectionist moves in Latin America and, especially in Brazil, we are less concerned about a sudden change of government, a sudden change of regime.”

The risk is that Chinese trade and investment creates a backlash in countries like Brazil, he says, and he often advises Chinese companies going abroad to try to avoid this by hiring locally. “I tell them to hire more local people, don’t just bring Chinese workers, hire local executives, hire local lawyers, and communicate with local political leaders.” But even with the backlash risk, he sees huge potential: “I do see a big future in increased investment in these countries. All the forces are working in the same direction. The two economies are complementary. Brazil has natural resources, needs capital, and you have your own domestic demand. We have extra capital to invest. So why not? This is a good direction to go.”

The two economies are complementary. Brazil has natural resources, needs capital, and you have your own domestic demand. China has extra capital to invest.