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Growth projections down, inflation up. The economy is expected to make a soft take-off by end-2012.

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The debate about market versus state capitalism resurfaced last month after the Dilma Rousseff administration announced an ambitious package of concessions to ramp up private investments in rail and highway infrastructure. João Augusto de Castro Neves analyzes whether the apparent turn to the private sector is a watershed moment for her administration.

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Despite the fall in economic activity, the labor market has been surprisingly resilient, but there are questions about how long it will last. Claudio Accioli and Solange Monteiro ask the experts: if economic recovery does not materialize soon, how long can employment stay high? They also look at where small and medium-sized businesses fit in. What they find is that there is clearly no unanimity about the future of the economy and employment in Brazil.

INTERVIEW
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The recent package of road and railway concessions does not necessarily mean that private resources will provide the financing, economist Rogério Werneck tells Claudio Accioli, since the funding will come primarily from BNDES. Werneck is concerned that the concessions will run into the same barriers that stall public investments. He is also concerned that careless monetary policy will keep inflation “persistently above the target.”

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Central and South America are not as immune to what is happening in global markets as was thought. To sustain growth, countries in the region need to advance reforms and increase productivity. Solange Monteiro reports on a recent IBRE seminar that discussed what these economies can do, with some thoughts on what to avoid.

REGIONAL ECONOMIC CLIMATE
28 The economic climate in South America has worsened more than in Latin America as a whole. In the first of a series that will appear quarterly, Lia Valls Pereira explains that Mexico’s economic climate index has improved slightly, while Brazil’s has become unfavorable, and suggests some reasons.

IBRE ECONOMIC OUTLOOK
29 The downturn in international trade and mixed economic indicators are generating uncertainty about domestic economic activity and inflation. The 2012 growth forecast has therefore been lowered to 1.3%, though growth in 2013 should be much more robust.
**ECONOMY**

**Job rise in July**
The Brazilian economy created 142,496 new jobs in July, up from 120,440 in June, the labor ministry said, a suggestion of hope for the long-promised economic recovery. Unemployment has remained near record lows despite the slowing economy as domestic demand, boosted by lower interest rates, tax cuts on certain consumer goods, and easier credit have encouraged employers to hire more workers. (August 16)

**Current account deficit narrows**
As Brazil’s trade surplus recovered from a deep decline in June, the central bank reported, the current account deficit fell from US$4.4 billion in June to US$3.8 billion in July, barely above the US$3.6 billion recorded in July 2011. The improvement was influenced by a widening of the country’s trade surplus, which rose to US$2.9 billion from US$0.8 billion in June. The 2012 deficit, however, was fully covered by foreign direct investment, which surged from US$5.8 billion in June to US$8.4 billion in July. (August 23)

**Economy grew 0.4% in the second quarter**
Brazilian GDP grew 0.4% in the second quarter of 2012 compared with the first, said statistics agency IBGE. Driving the growth was agriculture, which grew at 4.9%; however, industry shrank 2.5%, and investment grew only 0.7%. Growth in the first half of 2012 totaled only 0.6%. (August 31)

**Industrial production and car sales up**
Although still tentative, industrial production has somewhat recovered in recent months. In July it grew 0.3% month-on-month, close to market expectations and up slightly from 0.2% in June. A strong increase in car sales was also reported, due in part to a tax rebate. The rise in Brazilian industrial production adds to evidence that sweeping government stimulus measures to support the manufacturing sector are beginning to bear fruit. (August 4)

**Foreign reserves up US$1.1 billion**
Brazil’s foreign currency reserves were US$1.1 billion higher in August than in July, as the value of the country’s investments increased. Foreign exchange reserves, which are a significant part of Brazil’s protection against global crises, totaled US$377 billion in August, the central bank reported on its website. In the first eight months of 2012, Brazil’s reserves have increased by US$25 billion. (September 4)

**Inflation up 0.41% in August**
Higher food prices fueled consumer inflation in August, according to statistics agency IBGE. Brazil’s official consumer price index rose 0.41% in August, on top of 0.43% in July, and the trailing 12-month inflation rate rose to 5.24%. The government’s goal is to keep inflation between 2.5% and 6.5%. (September 5)

**LATIN AMERICA**

**UN revises regional growth downward**
Latin America and the Caribbean will expand less than expected this year due to softening demand both internally and externally, said Alicia Barcena, head of the UN Economic Commission for Latin America and the Caribbean (ECLAC). ECLAC now sees regional growth of 3.2%–3.3% this year, down from the forecast of 3.7% that was confirmed in June. The revised projection would be a steep drop from the 4.3% growth the region achieved in 2011, it results from worries about the eurozone debt crisis and a slowdown in China, a major trade partner for many Latin American countries. Brazil, Latin America’s biggest economy, is not expected to reach the 2.7% growth ECLAC had forecast for this year, Barcena said, but did not give a specific number. (August 28)
**ECONOMIC POLICY**

**US$66 billion stimulus for transportation infrastructure**

President Dilma Rousseff has launched a R$133 billion (US$66 billion) stimulus package to spur investment in Brazil’s creaking infrastructure and shore up ailing investor confidence. In the first of an expected series of announcements, Ms. Rousseff said the government plans to sell rights for private companies to operate 7,500km of roads and 10,000km of railways. Affected are 9 highways and 12 railways.

“We are starting with railways and roads but obviously we will take care of airports, ports, and waterways,” Ms Rousseff told politicians and businesspeople in Brasília. Transport Minister Paulo Passos, said the measures would double capacity on Brazil’s main highways. Of the total investment, R$79 billion (about 60%) would be spent within five years and the rest over 25 years. It would be funded on largely favourable terms by BNDES, the state development bank. (August 15)

**Brazil tax revenues again plunge**

Collection of federal taxes fell sharply in July from a year earlier; it was the second consecutive monthly drop as a stuttering economy hit corporate profits and prompted policymakers to slash industry and consumer tax rates. Federal tax revenues were R$88 billion, a fall of 7.4% from a year ago. (August 27)

**Stimulus for consumption and investment**

Brazil’s government unveiled new measures to promote investment and consumption, including an extension of tax breaks on home appliances, furniture, and cars. The tax break for automakers will be extended for another two months, Finance Minister Guido Mantega said. (August 29)

**Most public employees back to work**

Unions representing 90 percent of Brazil’s striking public employees agreed to return to work, accepting the tough terms set by President Rousseff, who insisted on putting fiscal discipline before the demands of her own political base. Rousseff, whose Workers’ Party began as a union movement, offered a 15.8% wage increase over three years, which will barely cover expected inflation; unions for 18 categories of public employee have agreed. Nevertheless, the wage rise will increase budget expenditures by R$10 billion in 2013. (August 29)

**Central Bank policy rate cut**

As expected, Brazil’s central bank has cut its policy rate by 50 basis points to a record low of 7.50%. It was the ninth cut since August last year, taking total relief to 5 percentage points. Analysts now expect the central bank to continue with cuts but at a slower pace. According to the minutes of the last Monetary Policy Committee meeting, the central bank believes any additional cuts should be done with “maximum” caution because recent spikes in food prices pose short-term inflationary risks. The committee also expects a recent jump in commodities prices to be less intense than similar situations in 2010 and 2011, the minutes said. (September 6)
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GOVERNMENT POLICIES to resuscitate the economy have again raised the long-standing debate about how deeply the government should be involved in the economy. Not only government officials but even some businesspeople argue for big-government-led growth. It’s true that today we do indeed have a big government. But since it still can’t deliver basic services, it doesn’t seem likely that an even bigger government would do a better job.

Not that long ago—in 1984–94—the economy was almost destroyed by unmanageably big government and public spending that fuelled hyperinflation. Now think about the fact that since the first Lula administration started, the federal government has hired 200,000 employees, and the present administration plans to add another 63,000 this year alone. Public employees’ wages and pensions take up so much of the government budget that there’s not enough money left to build roads and bridges. Moreover, all these workers don’t seem to be getting much done. An international publication said recently that Brazil has become famous for “first world taxes and third world services.” Not the ideal global image for an emerging country.

Even when President Rousseff and her colleagues want to work with the private sector, they’re reluctant to say the word “privatization”— the charge against his rival that got Lula his first term. The new package of concessions to get the private sector involved in building roads and railways sounds ambitious, but as Rogerio Werneck points out in the interview in this issue, the program is not really about private investment, it’s about private management. The bulk of the financing is from government’s development bank BNDES—and the Treasury will have to borrow the money to lend on to BNDES—and by setting the schedule, an unrealistic one, the government is really still doing a lot of the managing as well.

Although stimulus packages may have some immediate impact on the economy, they have unintended negative consequences in the long run. Championing certain industry segments worked for, say, Korea, but in order to sustain growth, it’s necessary to take the whole package of lessons available, not just the easy ones. The industries Korea championed were break-through areas for that country, areas where they could learn and innovate. Brazil’s stimulus went to sources of past economic growth, not new sources. It looks like another chapter in Brazil’s sad history of fostering a culture where corporations scramble for benefits from the government but do little if anything to create wealth and innovate.

What Brazil needs is an efficient and transparent government that is accountable to the people, not the party fiefdoms that dominate the ministries. It’s very noticeable that the most internationally successful Brazilian companies are those that are genuinely private, including some privatized state-owned companies, that do not seek subsidies or privileges. The best way for the government to accelerate economic growth would be to get serious about doing its real job—providing basic public services like justice and education at reasonable rather than bloated cost and improving the business environment. That would set the private sector free to do what it does best—producing products and services that will bring in the cash and customers Brazil needs.
President Rousseff’s turn to the private sector is a watershed moment for her administration. Beyond the obvious dissimulation brought about by the concession-is-not-privatization wordplay, the policy announcement is undoubtedly a step away from Lula’s opportunistic rhetoric. Regardless of ideology, the decision to go forward with concessions is in the end an acknowledgment that there are limits to the state’s role in the economy.

How far the government will go in the direction of more liberal economic policies is questionable, however. Although the concessions are undoubtedly a positive step toward boosting private investment in infrastructure, the government will find it difficult to deliver on the scale of investment in the time allowed. Note that in other sectors, such as oil and gas, the approach to developing promising deep-water oil fields is definitely statist and is not expected to change any time soon. Moreover, the administration’s proclivity for frequent and selective raises in import tariffs makes it clear that protectionism is very much alive in Brazil. Finally, even with some airport concessions that are expected to be
announced shortly, there is a considerable amount of skepticism about how market-friendly the model is.

But given Rousseff’s oft-praised pragmatism, it is reasonable to expect that ultimately policy will be driven by results—or the lack thereof. In some sense, the transport concessions package announced last month might be seen as an implied reaction to the inefficiencies of the government growth acceleration program (PAC) in terms of public investment in infrastructure. Despite the administration’s persistent desire to keep a tight grip on management of the economy and steer investments, whether these measures are successful will depend fundamentally on the private sector response to the government’s proposals.

**Policy and pragmatism**

The president’s pragmatism has been clear when it comes to fiscal policy. In the past few months Rousseff held a hard line with public sector labor unions that were demanding higher wages. Faced with the risk of disruption of essential services and of tensions with an important base of her Workers’ Party (PT), Rousseff opted to run the risk and keep payroll expenditures in check. While the government seems to be succeeding in forcing most unions to accept only modest wage increases, demands from organized labor will continue to be a major political challenge for Rousseff in the final two years of her term.

Earlier this year the administration passed an impressive pension reform for public servants, replacing the current pay-as-you-go pension system with one based on individual accounts. The reform is expected not only to relieve the pressure on public coffers in the coming decades but also to create a pool of capital that could potentially fund investment projects. Both the payroll decision and the pension reform are aligned with the broader government strategy that seeks to generate fiscal space to lower interest rates.

Clearly, there are many challenges ahead for President Rousseff. The risk of caving in to political pressure will always be a possibility. More importantly, regardless of policy preferences the government’s role in the economy will remain massive for the foreseeable future through its interests in state-owned enterprises and public banks. Nevertheless, some of Rousseff’s recent policy options could at least help to demystify the false polarization that cornered the opposition in previous elections.

If only there was an opposition today . . . but that is another story.
The employment puzzle

Despite the fall in economic activity, the labor market has been surprisingly resilient. But for how long?

Claudio Accioli and Solange Monteiro, Rio de Janeiro

A RESILIENT LABOR MARKET but low economic activity definitely do not go together, yet Brazil has been living with this situation for almost two years. After surviving the severe global crisis of 2009 with only a moderate decline of 0.6% and then advancing 7.5% in 2010, GDP has since been in free fall, recording 2.7% in 2011 and likely to fall below 2% in 2012. Yet the unemployment rate has fluctuated around 5.5% of the total labor force—the lowest level in history.

Possible explanations for this discrepancy are lower growth of the economically active population, relocation of workers from industry to services, and retention of workers (labor hoarding) because of both the high costs of firing workers imposed by the labor laws and expectations of economic recovery. The question for Brazil is this: if economic recovery does not materialize soon, how long can employment stay high?

DEMOGRAPHICS
The contradictory labor market outlook results from a combination of several factors. The first is demographics: as the population growth slows down, there is a decline in the number of new participants
The question for Brazil is this: if economic recovery does not materialize soon, how long can employment stay high?

slowed much less than industry or even continues to grow,” Camargo says.

Júlio Gomes de Almeida, an economist at the Institute for Industrial Development Studies (IEDI), draws attention to two aspects of transition: the significant growth of the construction industry, which is labor-intensive; and the emergence of 40 million new consumers in the domestic market, which has strengthened the services sector and increased demand for more specialized activities. Demand has increased for call centers and personal services, which are more labor-intensive than industry. João Felipe Santoro Araújo, economist at the National Trade Confederation (CNC), adds that the service sector pays higher wages and attracts professionals from other sectors, particularly industry.

Industry’s difficulties reinforce another hypothesis about the resilience of the labor market despite the fragility of the economy: the mechanism for the transmission of the slowdown throughout the economy. Industry, pressured by such adverse circumstances as an over-valued exchange rate, global competition, and the high wages in the service sector, was the
“Families today are able to keep their young people studying, and fewer retirees need to return to active duty.”

FÁBIO ROMÃO

first sector hit by the economic slowdown, although eventually it will be followed by the service sector.

Industrial production decreased 3.8% in the first half of the year compared to the same period of 2011, and manufacturing employment fell by 1.2%. Paulo Francini, director, Department of Economics, Federation of Industries of the State of São Paulo (FIESP), points out that “We recorded five straight quarters of decline in manufacturing, losing 89,000 jobs between June 2011 and July this year. The projection is that industry in São Paulo will end the year with 90,000 fewer jobs than in 2011.” Guilherme Mercês, manager of economic development, Federation of Industries of the State of Rio de Janeiro (Firjan), says that it has taken time for the decline in industrial production to affect employment in Rio de Janeiro state.

Francini points to the competition from imported goods as a major reason for the weakening of domestic industry and vehemently refutes the idea that Brazil’s transformation into a service economy is natural and beneficial. “There isn’t a virtuous transition, because we have not reached a level of income per capita [that supports a service-based economy],” he says. “It is instead a process of deindustrialization, the result of adverse policies and situations for Brazilian industry. In the 1980s, manufacturing accounted for 25% of GDP; today we are down to 14% while China is at 39%, Korea, 33%, and Germany 24%.”

The construction industry has also seen some decline in employment. “Nobody is immune to the economic downturn,” says Paulo Simão, president, Brazilian Chamber of the Construction Industry (CBIC). “Last year, we created 309,425 jobs and we closed the year with an unemployment rate of 3.1%, lower than the rate for the economy. Through July 2012, construction created 143,000 jobs, about 4% less than in the same period in 2011, and the jobs added in 2012 are expected to be about 250,000.” He adds that a reduction in the number of projects initiated is cause for concern: “Our industry has very particular characteristics. Contracting, hiring, and carrying out a construction project usually take two years . . . . All this requires more planning.” But he also adds that “the sector has not been affected so directly by the international crisis,” noting that the construction industry has grown above GDP for the last three years.

LABOR HOARDING

IBRE researchers attribute the divergence between employment and economic activity to companies retaining workers to avoid the costs of severance and
readmission and training, but also because they hope the economy will soon recover. IBRE researcher Leandro Rodrigo de Moura says, “The costs of adjusting the labor market in Brazil are very high . . . also, most unemployed workers today are unskilled.” FIESP’s Francini attests that “severance costs may be up to six times the monthly salary of an employee.”

Laying off workers in Brazil is expensive, agrees José Pastore, professor of labor relations, University of São Paulo. He wonders “whether the current crisis may precipitate a modernization of labor institutions, reducing, for example, the cost of labor liabilities, which are increasing significantly due to excessive interference of the government in labor negotiations.”

Flavio Castelo Branco, executive manager of economic policy, National Confederation of Industry, notes that “In the United States, it is perfectly possible to lay off a worker if the economy is not doing well and hire him again three months later, but here the lack of labor market flexibility prevents that.”

According to Firjan’s Mercês, the labor cost problem could be circumvented by indexing the social security tax (20% on the payroll) to the company’s revenues.

“If the country is to grow without generating pressure on [the labor] market, productivity must be increased.”

JOSÉ MÁRCIO CAMARGO

Rising incomes allow families to keep their young people studying, reducing the number of new workers.

(Percent, adjusted for inflation)

Sources: Brazilian Institute of Geography and Statistics, LCA calculations.

*Projection.
Solange Monteiro

MORE TRAINING, lower taxes, and more customers—that formula helped to confirm micro and small enterprises (MSEs) as an important source of employment in Brazil. Currently, MSEs employ more than half of Brazilians that have a formal job. Their businesses account for 40% of total wages and generate about 70% of new jobs, according to the Brazilian Service for Supporting Micro and Small Enterprises (Sebrae). “In the last decade, MSEs have created six million jobs in Brazil,” says Sebrae executive director Luiz Barretto.

A major driver of these businesses was the emergence of about 40 million lower-middle-class consumers, since more than half of the 6.5 million MSEs (56%) are in commerce. Barretto explains that “The survival of these companies depends more on the domestic market.”

Better-trained entrepreneurs have also contributed to this result and to a fall in MSE “mortality.” According to Sebrae, ten years ago half of new MSEs closed their doors within two years; today 73% survive this most critical phase. “Moreover, in the last decade real average wages (adjusted for inflation) rose more in the MSEs (14%) than in medium and large companies (4%),” says Barretto, noting that this contributes to the retention of employees.

Barretto says that reducing red tape and cutting taxes were important milestones for reducing informality. “The major breakthrough was the creation of the Simple [a greatly simplified tax system for MSEs]. Also the individual microentrepreneur has emerged, reaching 2.5 million people over three years, a fantastic milestone that no other country has achieved in such a short time,” he says. For payment of about R$35 (US$17.5) a month in taxes, individual microentrepreneurs maintain their place on the National Registry of Legal Entities, their right to issue invoices, and their social security benefits. Barretto adds that “We expect that the social security tax relief under the Greater Brazil Plan for sectors dominated by MSEs will allow these companies to continue hiring workers.

Growing micro and small enterprises

as was done in some segments of industry and services under the Greater Brazil Plan. “There are things we can do that do not need new legislation,” he says.

There are other costs that also weigh on the decision to retain workers. Júlio de Almeida of IEDI points out that besides paying higher wages, companies have invested more in expensive training programs so their workforce is more highly qualified. “In other circumstances,” he says, “a drop in industrial production of almost 4% would certainly lead to laying off more workers than has been the case. But … the entrepreneur is concerned that, if the economy recovers tomorrow and he has laid off more qualified workers, he must bear the cost of hiring and training [new workers]. If he thought that 2012 is lost, he will certainly lay off workers. But if he thinks that some time in the second half, there may be a recovery, he will think twice about it.”

Almeida cautions, however, that retaining a skilled and well-paid workforce in a sluggish economy takes a toll in the form of productivity losses, especially in industry. “In services, more productive segments are growing faster than the less productive ones. The most
noticeable decline is occurring only in the industrial sector,” he says. Similarly, IBRE’s Moura believes that “It’s a temporary drop, cyclical, due to underutilization of labor, assuming that the slowdown in economic activity will also be transitory. One way for companies to circumvent the problem would be to reduce the hours worked, if possible even the hours paid.”

THE FUTURE OF THE LABOR MARKET
Whether it is done to avoid costs or preserve skilled labor, the assumption behind labor hoarding is that the economic downturn will be short-lived. If recovery does not materialize soon, employment may suddenly sink, triggered by layoffs by companies that no longer can wait for an economic turnaround. The increased availability of qualified workers would reduce the cost of hiring, precipitating a cycle of layoffs.

The consensus among analysts is that the second half of 2012 is the turning point for company layoff decisions. According to the September IBRE Economic Outlook, expectations are deteriorating. Indications from consumers and different productive sectors are that the third quarter will proceed at the same moderate pace as the second. The worsened expectations reflect disappointment with the recent performance of the economy and uncertainty about the timing and speed of recovery.

On the other hand, there is a prevailing feeling that, even without the long-awaited recovery, the consequences may not be drastic, at least at first. Camargo says that “If in the third quarter of this year the economy continues to fall, it will be a clear sign that the policy of encouraging demand is not working. But I still do not think there will be a sharp increase in layoffs, because there is a perception that the government is taking more aggressive economic measures. Entrepreneurs are likely to wait to see what will happen.”

Moura and Pastore disagree. In Moura’s view, “Experience shows that in periods of prolonged recession, labor is not retained. If companies find that the crisis is deepening, there may be layoffs and a domino effect.”

There is clearly no unanimity about the future of the economy and employment in Brazil. Led by major infrastructure
Retaining a skilled and well-paid workforce in a sluggish economy takes a toll in the form of productivity losses, especially in industry.

works leading up to the international sporting events in Brazil in coming years, and more recently by a robust package of government investments in infrastructure, those in construction are most confident about economic recovery. CBIC’s Simão says, “We had been talking about this package for months, and now we are sure that there will be a renewal of work.”

Regarding commerce, whose prospects usually tend to improve as the year-end approaches, CNC data for the second quarter of 2012 testify to a climate of uncertainty. The Index of Business Confidence in Commerce has been declining since 2011, suggesting that merchants are pessimistic about the present situation of the economy. In contrast, the Index of Expectations of Commerce Entrepreneurs is still at levels that reflect confidence in the future. But CNC’s Araújo warns that “If these expectations are not confirmed, there may be an impact on employment levels in the near future.”

As for industry, the sector that has suffered most from the slowdown, although confidence indices for the present and the next six months are declining, a gradual recovery of economic activity in the second half of the year is expected. Firjan’s Mercês thinks “It is too soon to talk about large-scale layoffs. Job creation remains high and significant measures have been taken, such as cutting the central bank benchmark interest rate, that take time to produce results.” IEDI’s Almeida agrees: “We are moving toward better production, although not yet very substantial, [even] in industrial employment. In a negative scenario, if industry falls 3% or 4% in the second half of the year then yes, there will be layoffs. But I do not believe in that.”

Although CNI’s Branco is also optimistic, he says, “There is no way to plan for production without adequate manpower. Employment grows from new projects and investments, and these are not happening. If we start the fourth quarter with declining economic activity, there is a risk we will enter into a perverse labor market dynamic, with layoffs and a domino effect on expectations . . . The decreased productivity resulting from retention of workers is a cost that cannot be sustained for very long.”

### Employment increase by sector, May 2011 - May 2012

<table>
<thead>
<tr>
<th>Sector</th>
<th>Change</th>
</tr>
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<tbody>
<tr>
<td>Industry</td>
<td>-45,627</td>
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<tr>
<td>Construction</td>
<td>79,869</td>
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<tr>
<td>Commerce</td>
<td>16,857</td>
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<tr>
<td>Financial services</td>
<td>165,774</td>
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<tr>
<td>Services (including financial)</td>
<td>296,649</td>
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<tr>
<td>Public administration</td>
<td>60,528</td>
</tr>
<tr>
<td>Total</td>
<td>574,050</td>
</tr>
</tbody>
</table>

Sources: Brazilian Institute of Geography and Statistics, IBRE staff calculations.
BETWEEN 2003 AND 2007, the unemployment rate declined by more than 3.0 percentage points. Employment of young people (18 to 24) accounted for a third of the decline, not only because so many were absorbed into the labor market, but also because of their declining share in the economically active population.

Between 2007 and 2011, unemployment fell another 3.3 percentage points. This time employment of young people accounted for 44% of the fall, the same percentage as adults (25 to 50), mainly because more jobs were allocated to them. This is especially impressive in that group from the first period to the second this group reduced its participation in the labor force.

The rate of youth unemployment declined from 23% in 2003 to 20% in 2007 and then to 13% in 2011 (compared with 15% in the U.S. and 26% in the euro zone). One reason is that companies have trouble finding older workers because their unemployment rate is only 4.8%.

All sectors of the economy except for government and industry have shown a growing number of young workers as a proportion of the labor force. Industry accounted for 15.8% of the youth labor force in 2007 and 14.2% in 2012. In contrast, the service sector has absorbed numerous youth, especially in the financial intermediation segment, which also is able to retain young people because of higher salaries and the possibility of higher future earnings.

Some young people leave the labor market to continue their studies; many of these were working in the government. Although public jobs are stable, young people are investing more in education, partly because salaries for public positions that require less education are very low. The possibility of earning more increases with higher education, because jobs requiring more education are harder to fill. If this trend continues, soon Brazil should have a more educated workforce.
Rogerio Werneck
Professor, Department of Economics, Catholic University of Rio de Janeiro

Will public funding, private management work?

Claudio Accioli, Rio de Janeiro

ALTHOUGH IT REPRESENTS an acknowledgment by the government that alone it cannot carry out the large infrastructure investments the country needs, the recent package of road and railway concessions does not necessarily mean that private resources will provide the financing, warns economist Rogerio Werneck. “The Treasury issues bonds and transfers funds to the National Bank for Economic and Social Development (BNDES), which in turn transfers them to the private agent, financing 80% of the project long term at subsidized interest rates. It is like a public work, with the advantage of being managed by the private sector,” he says. Werneck is also concerned about carelessness in the conduct of monetary policy: “Everything indicates that in this presidential term inflation will be persistently above the target.”

The Brazilian Economy—How do you evaluate the government’s new package of concessions for infrastructure. Was it an ideological shift?

Rogerio Werneck—The government was being pragmatic because it really was not able to carry out public investment. For quite some time, the government has demonstrated a statist bias: it always opts for more intensive government action even when working with the private sector. It’s really difficult to make public investment happen . . . . In President Rousseff’s first year in office there was a succession of episodes of corruption. The government acted quickly . . . but failed to reconstruct the long chain of command that triggers public investment. With 40% of the term already elapsed, everything was paralyzed. Then, at some point the penny dropped. The concessions are the best evidence that something has changed. Yet there is no consensus in the
government core about whether this is the right thing to do. There are reactions from unhappy groups. The case of concessions at airports, for example, has motivated a completely surreal discussion involving vested interest groups connected to the Brazilian Airport Infrastructure Company (Infraero). I find it difficult to believe that any ideological shift did occur.

Is the program attractive to the private sector? It is a step forward in that the government acknowledges that it alone cannot get these investments done, but the program could have been much better structured to attract private resources for infrastructure. The ideal would be that private investors contribute a substantial amount of resources to finance the projects. However, as I understand it, what the government will do is replicate the current model: The Treasury issues bonds and transfers funds to the BNDES, which in turn transfers them to private agents, providing 80% of the long-term financing at subsidized interest rates. It is like public works with the advantage of being managed by private initiative, which reportedly has proved better able to carry out such projects. There are people in the government who prefer it this way because otherwise it might open the argument that what the government is doing is actually privatization. It is more comfortable to say that it is all public money; there are no private resources.

Is the package in time to promote economic growth? Strictly speaking, the same barriers that are stalling public investments could do the same with concessions. The government itself acknowledges that the timeline is ambitious. Everything will take place in one year: studies until December, public hearings in January, bids in April, contracts signed between May and July. That does not seem credible and will surely meet with adversity. I imagine the first investments will effectively occur only in late 2013 or early 2014, when the current presidential term is already ending.

The government has adopted several packages to stimulate the economy, but the results have been disappointing. Why is this? At the beginning the Rousseff administration was thinking it would prolong the second term of President Lula, which finished with 7.5% growth. But the projections for 2011 started at 5.5% and ended up at 2.7%. It was a cold shower. . . However, the government has recognized two important facts: the obstacles arising from deficiencies in infrastructure and public investment were beginning For quite some time, the government has demonstrated a statist bias: it always opts for more intensive government action even when working with the private sector.
to disrupt [the economy], and the economy is finally feeling the tax burden. Over the past 20 years, the tax burden in Brazil rose from 24% of GDP to 36%, which is extremely high compared to other emerging countries . . . . But granting tax relief only to some sectors is not the most appropriate way to deal with the problem.

In a recent article, you warn that lowering the basic interest rate associated with the expansion of credit by state-owned banks can worsen inflation. Are there risks for 2013?

Everything indicates that in this presidential term inflation will be persistently above the target, suggesting that combating inflation has been given less importance relative to previous years. There are signs that inflation will rise again in 2013, and even in 2012 it should remain substantially above target. This suggests a certain carelessness about monetary policy, because we are talking about an inflation target of 4.5%, which is high compared to other emerging countries. As for state-owned banks, unfortunately the country has learned little from past [banking] crises . . . . History has shown that encouraging these institutions to make loans at low interest rates always ends up being paid for by the taxpayer. The government opted for an easy solution—to quickly push down bank lending—that used the power of competition from state-owned banks to induce private banks to follow. But now the private banks are not following, because they always have the option not to lend, reducing market share rather than walking into bankruptcy.

The question of federalism, involving such issues as equity funds to states and municipalities, division of oil royalties, and state debts, is very much alive today. How do you see this debate?

I think any chance of solving the main problem, which is the sharing of the tax pie, has disappeared for this government, which is not willing to touch this hornet’s nest . . . . A revision of the fund participation of states and municipalities, for example, should be decided by December 2012, so we are nearing to the edge of a fiscal cliff. . . . Moreover, the federal government, which was worried about its inability to carry out public investment, decided to open the doors for state and municipal investments, which expanded their debt ceilings. Some states are in better fiscal condition, but others not so much . . . . The European crisis should have at least showed us how fiscal difficulties could become a huge headache.
President Rousseff is approaching the middle of her term. What is the balance so far? The government has some things to show, including a very low unemployment rate... But the momentum of the economy was lost and has not yet been found. The problem of the tax burden is sinking in very slowly, leading to discouraging solutions, such as tax relief for selected sectors. The issue of what will be the agent of economic growth and recovery is not being addressed convincingly. The government has realized that it cannot do it alone, but at the same time it wants to determine how the private sector will do it. I doubt that will work. I fear that some decisions now will be guided by time pressures—“let’s do it because the important thing now is to show good performance in some key variable before 2014.” Common sense may not prevail.

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Continent revisited

Latin American experts discuss what countries in the region must do to cope with a volatile global economy.

Solange Monteiro, Rio de Janeiro

AFTER A DECADE of healthy growth fueled by high commodities prices, capital inflows, and solid economic fundamentals—stronger currencies, robust financial systems, and sound fiscal policy—the larger Latin American countries are now moderating their optimism. Lower GDP growth projections in response to the protracted international crisis indicate that the continent is not as immune to what is happening in global markets as was thought. Analysts tend to concur that, to maintain growth, Latin America in general needs to advance reforms and increase productivity.

Strategies these economies could use were discussed at the seminar “Where Does the Economy of Latin America Go?” sponsored by the Brazilian Institute of Economics (IBRE) August 9–10 in Rio de Janeiro. Former Brazilian Finance Minister Pedro Malan stressed that the region must prepare to deal with a more volatile long-term external environment, warning that “The crisis will be with us for many years.” For cyclical downturns, the textbook advice is still to exercise well-constructed fiscal, monetary, and credit policies. Andrew Powell, principal adviser in the Research Department, Inter-American Development Bank, said that though much has been done, Latin American countries must continue to upgrade their economic defenses. “Since
the collapse of Lehman Brothers in 2008, the fiscal balance of these countries has deteriorated,” Powell said. Malan responded by pointing out structural risks that must be mitigated if regional economies are to become more competitive, adding, “Countries in the region will inevitably have to face their problems.”

**EXCHANGE RATES AND CREDIT**

The lowered expectations have been sobering. Even countries like Peru that still expect growth of above 5% this year know that behind the improved outlook hides a reality that is far from consistent with the initial euphoria. “In Brazil, we quintupled the size of our economy in less than a decade—but that speaks more to what happened with the exchange rate than the economy,” said Armando Castelar, IBRE coordinator of applied economics.

Similarly, in Colombia, according to Roberto Steiner, former director, Fedesarrollo, the Colombian research center, “The increased share of the oil sector in the economy and the appreciation of the currency raise concerns because they compromise the productivity of other sectors. However, from the macro viewpoint, this free float is the most suitable for a small open economy like ours.” José Guilherme Reis, International Department, World Bank, pointed out that Colombia has approved a fiscal rule, which will take effect in 2014, according to which part of the oil revenues will be saved just as Chile already does with copper revenues. “A significant part of the tax revenues comes from oil and mining, “ he said, “and we do not know what the future holds for these products,” he said, pointing to the need to save and plan public spending based on the possibility that oil prices will be lower.

The continent is not as immune to what is happening in global markets as was thought.

For Brazil, Castelar pointed out that more than the agricultural or mining sectors, what really boosted GDP were commerce, construction, and financial intermediation. “Brazil is becoming a service economy, with sectors that have grown much, and employ many,” he said. Carlos Valdovinos, IMF Resident Representative in Brazil, underlined the importance of domestic demand for GDP growth. “Consumption as a percentage of GDP on average between 2004 and 2011 was much higher in Brazil than in other G-20 countries,” he said, noting the imminent exhaustion of consumption-led growth. In addition to the pent-up consumer demand that was unleashed by rising incomes, Castelar pointed out that consumption-led growth was successful thanks to some slack—idle production capacity and appreciation of the exchange rate, which cheapened imports—that made it possible to accommodate increased demand without inflation as well as ample international liquidity, which allowed for expansion of domestic credit.
To maintain growth, Latin America in general needs to advance reforms and increase productivity

That was also true elsewhere in the region. “Latin America is where consumer credit grew fastest and became an important part of total loans,” said Augusto de La Torre, World Bank chief economist for Latin America. In Peru, for example, growth of domestic credit between 2004 and 2011 averaged 21%, especially for mortgage and microfinance. “Will normalization of the situation in Europe and the United States move us backward?” Castelar asked, mentioning the impact of capital outflows on output and the reduction of interest rates in Brazil.

PRODUCTIVITY AND INVESTMENT

To keep GDP growing when the outlook is more uncertain, IBRE Director Luiz Guillherme Schymura emphasized that countries must focus on improving total factor productivity. He said, “Today, we often see the struggle of interest groups over public policies, and economic discussion is put aside. . . . We need to ensure that production inputs are efficiently allocated.”

In Chile, where economic reforms came earlier, the fall in productivity is most obvious. “We look at the country as a star in South America, but in this first decade of the century growth was lower, which indicates the need for a new type of policy,” Lia Valls, coordinator, IBRE Center for Foreign Trade Studies, said. Rodrigo Fuentes, associate professor, Catholic University of Chile, described what happened in Chile: from 1990 to 1998, the Chilean economy grew on average 7.2% a year, and productivity explained half of total growth, rising 3%. From 1999 to 2010, however, growth declined to an average of 3.7% a year and productivity to 0.9%. “If we are to achieve per capita income equivalent to 70% of the U.S. in 2030, we would have to grow 5.3%,” he calculated. Fuentes recommended that Chile give priority to absorbing technology rather than investing in innovation: “The jump that we can give will depend on our ability to absorb technology, which in turn depends on eliminating institutional barriers and investing in research and development and the quality of human capital.”

IBRE’s Castelar pointed out the connection between investment and productivity, saying, “The issue is urgent because productivity has been stagnant or dropping; otherwise we will have to greatly increase the level of investment.” Here, he thought, Brazil has not been very successful: “Brazil has serious problems with its investment climate, property rights protection, and high taxation. We have tried to solve this through loans by the National Bank for Economic and Social Development (BNDES), which increased from 1% of GDP in 1995 to 5% in 2010. This, however, has had little effect on investment. Our problem is not financing.”

In Colombia, the situation has been changing. Steiner said, “We recorded an
investment-to-GDP ratio of 28%, with almost continuous growth over the past 12 years.” In Chile, the investment-to-GDP ratio is about 23%, but Fuentes considers this less than ideal: “The ratio is lower than for other natural resource-rich countries when their per capita income was the same as ours today.”

Claudia Cooper Fort, chief economist, Research Center, University of the Pacific, said that Peru has difficulties carrying out investment projects: “Today, we have a level of savings that may even be excessive. But we have problems, especially in regional governments, where leaders and officials are not properly prepared and are not willing to continue with projects when there is a change of government.” Renato Fragelli, Graduate School of Economics, Getulio Vargas Foundation (FGV), pointed out, however, that “Peru has improved its regulatory framework and currently welcomes foreign companies in various sectors.” Fort explained that the country guarantees equal treatment for domestic and foreign investment while offering complete freedom of capital flow. This has attracted foreign investments in the mining sector, although projects take longer to carry out due to conflicts with local communities. She added that “Currently, the concern is whether Peru will have the capacity to absorb all the projects that are in the portfolio and will have an adequate supply of engineers, construction companies, etc.”

In Argentina, meanwhile, the interventionist bent of the Cristina Kirchner administration—such as the nationalization of the YPF oil company earlier this year—deters private investment. “Until 2010, our investment-to-GDP ratio was not bad, but there has since been a steep fall,” Daniel Artana said, Foundation for Latin American Economic Research (Fiel). Artana estimates that Argentina’s investment-to-GDP ratio, which reached 24% in 2010, will soon drop to Brazil’s level.

“Today, we often see the struggle of interest groups over public policies, and economic discussion is put aside. . . . We need to ensure that production inputs are efficiently allocated.”
Luiz Guilherme Schymura

OPEN THE MARKETS
Although Brazil has low savings and investments, Edmar Bacha, director, Institute for Economic Policy Studies, argued these are not the factors most responsible for the growth decline. He said that investment costs have increased and capacity to produce declined, and the situation will only change with more openness to imports, stimulating competitiveness. “Despite all the opening of the economy in the last 15 years, Brazil still imports just 11% to 13% of GDP, while Chile imports 32%, China 22%, and Russia 22%. Unless there is a Brazilian miracle to open up the economy, we will continue to grow at 3.5%, “Bacha said.
Here Brazil has a lesson to learn from Mexico. Although it did not have as economically positive a decade as Brazil, Peru, or Colombia, Mexico now is praised by international markets and has good growth prospects. “At first we feared that the trade agreement with the United States would bring about the de-industrialization of Mexico, but exposure to international competition strengthened us. Now we are competitive in industries such as aerospace, automotive, and electrical and electronics,” said José Gerardo Traslosheros, Mexican consul in São Paulo city. In 2011, the country recorded exports of US$350 billion (80% manufacturing) and imports of US$351 billion. “We need to import intermediate goods and capital so we can expand exports,” Traslosheros explained.

While still concentrating its sales on the United States, Mexico has 12 free trade agreements with 44 countries—9 through the Latin American Integration Association and 28 for the Promotion and Reciprocal Protection of Investments. Mexico, Chile, Colombia, and Peru recently formed the Pacific Alliance. “We do not want a customs union like that sought by Mercosur, we want to integrate our production chains,” Traslosheros noted.

“The challenge now is to start replacing some imports of capital goods in an open environment,” Traslosheros went on. To ensure competitiveness, he said, it is necessary to fight monopolies in the energy, transport, and telecommunications sectors that raise production costs. “Currently, the struggle is to strengthen the regulatory agencies that have begun to address these powers,” he said.

Mónica de Bolle, director, Institute for Economic Policy Studies, noted that despite differences in the degree of economic openness, Mexico still has challenges similar to Brazil’s: “The perverse similarities are poor educational systems, a technological gap, high income inequality, and deficient infrastructure.”

THE GOVERNMENT ROLE
Despite considerable gains in good times, especially macroeconomic reforms, countries have not addressed major traditional problems. “In sum, we can say that Latin America is doing well. This does not mean, however, that there are no problems; institutional weaknesses challenge our competitiveness,” said IBRE researcher Regis Bonelli. Ambassador Luiz Augusto de Castro Neves, president of the Brazilian Center for International Relations, said that
in a world with very open and integrated markets there is no time to delay reforms: “If we want sustainable growth, it is absolutely essential that regional economies undertake structural reforms, such as tax reform.”

The largest economies in the region must all deal in one way or another with the challenge of better collecting and distributing tax revenue. While Mexico needs to increase tax collection, Colombia needs to reform it. “A country that has an unemployment rate of 12% cannot focus the majority of taxes on formal work,” said Steiner, who has led Fedesarrollo. Former Brazilian Finance Minister Marcílio Marques Moreira looked at the implications of high taxes and failure to modernize the business environment: “The World Bank Doing Business report indicates that Brazil’s bureaucracy demands a huge investment of time, including time to pay taxes.” Artana pointed out that in Argentina the tax burden has increased in recent years more than the average for the region, without sufficient consideration of public sector service quality. “With taxes like Sweden, we finance an African level of service,” he said.

For Samuel Pessôa, consultant to IBRE, the combination of high taxes and a low-growth scenario throughout the region may become perennial, noting that “The political literature of the 1990s suggested that very unequal societies grow less because they favor higher taxes and income redistribution, which affects productivity and growth; this seems to be happening in the region now.” Pessôa noted that from 1990 to 2009 there was a tendency to increase the tax burden throughout the region, not just in the countries with more populist governments, adding, “This could continue as the democratic process advances.”

“The World Bank’s de la Torre indicated that these choices are closely related to the government’s role in the economy in each country and the promotion of social policies: “Today, there are two major groups of countries in terms of the relationship between the government and markets: those that are trying to prudently explore ways to expand the complementary role of the government to attract the private sector and not stifle markets, and those that are going the way of a more interventionist government, looking for quick results.” Artana said Argentina has surpassed Brazil as the Latin American country where the government has the largest share in the economy. This year, he estimates, Argentina’s public spending will reach 42% of GDP; he noted that “Since 2003, Argentina’s government has increased its share in the economy by more than 13 points of GDP.”

“In the 2000s, the region had improvements in social welfare and stronger social policies,” de la Torre went on. “The downside risks of high dependence on commodities asked for government intervention, but we need a government model that is complementary [to the private sector] and does not resurrect the ghost of government interventionism of the type we can already see in Argentina, Bolivia, Ecuador, and Venezuela.”
The economic climate in Latin America worsened as the expectation of an improvement in international economic conditions had dissipated. South America has worsened more than Latin America as a whole.

Lia Valls Pereira
Center for International Trade Studies, IBRE.

AFTER TWO CONSECUTIVE quarters that demonstrated improvement, the Economic Climate Index (ECI) for Latin America recorded a fall in July. The two indices that constitute the economic climate—the current situation and expectation indexes—both fell. However, the decrease was greater in the current situation index, which had been favorable for some time but is now unfavorable. Last April, the European crisis seemed headed for a solution, and there was some optimism about the recovery of the U.S. economy, though there was uncertainty about China’s growth projections. By July, the expectation of an improvement in international economic conditions had dissipated, and experts consulted for the survey had revised their projections for economic growth downward.

Until April 2012, the indices for South America were consistently better than those for Latin America as a whole. However, in July this situation changed when the South America indexes fell farther than the Latin American ones. Although indices in both regions were unfavorable in July, South America seems to be in a relatively worse position.

The reason was that the two largest economies in both regions, Mexico and Brazil, saw their ECIs heading in opposite directions. Mexico’s current situation index has remained moderately favorable and its expectation index, though still unfavorable, has improved, helping bring about a slight improvement in the ECI as a whole. However, note that the small improvement in Mexico’s ECI may be a reflection of the presidential elections in July. In contrast, Brazil’s current situation index dropped 22 points, from favorable to unfavorable, while its expectations index, though remaining positive, fell 16 points. As a result, Brazil’s ECI fell 16% between April and July, to 104 points. In South America, only Bolivia and Paraguay have improved their ECIs, but they are both neutral, close to 100.
The Brazilian economy continues to muddle through with an unfavorable external environment and mixed signs of domestic recovery. The economy is expected to make a soft take-off by the end of 2012. Accordingly, growth projections have been revised down for 2012 and 2013.

THE EVOLUTION OF the economy has been constrained by the unfavorable external environment, especially the downturn in international trade, and mixed economic indicators that are generating uncertainty about domestic economic activity and inflation. Also, it is still difficult to determine the effects on the economy of the government stimulus packages and the price shocks coming from the drought in the U.S.

The likely scenario for Brazil is that the level of economic activity will have a soft take-off as the multiple government stimulus measures and cuts in the central bank’s policy rate start to energize domestic consumption and investment. We expect that the economy will slowly and gradually accelerate by the end of 2012 and that the labor market will remain buoyant.

The acceleration of GDP growth from 0.1% to 0.4%, from the first to the second quarter indicates a pick-up in economic activity in the third quarter, possibly by about 0.8% (quarter-on-quarter). However, half of the growth in the second quarter was due to the strong agricultural expansion; meanwhile, commerce, construction, and transport have slowed down. These sectors are important to the labor market; how their activity evolves should be followed with special attention.

Brazil is expected to grow below the world average in 2012 and 2013

Growth projections down, inflation up

The weak GDP result for the first half, added to recent indicators of economic activity, supports the scenario that growth in 2012 will be well below the 2.7% of last year. Even with an acceleration of economic activity in the second half, GDP is expected to grow just 1.3% in 2012. That is well below our June forecast of 1.8%. For 2013 we project that growth will be much more robust at 3.4%; however, there are still considerable risks. Inflation is projected to be higher in 2012 and 2013 as a result of the measures to stimulate domestic demand and the increase in international grain prices due to drought in the U.S. The central bank is expected to tighten its monetary stance raising its policy rate to 8.5% at the end of 2013.

Brazil economic outlook. 2012-2013

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Source: IBRE staff projections.