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Brazil jobless rate rises in March
Although Brazil’s jobless rate rose slightly more than expected in March, the local labor market remains strong. Unemployment rose to 6.2% in March from 5.7% in February, the government’s statistics agency IBGE said. Real wages, or salaries discounted for inflation, rose 1.6% month-on-month to R$1,728 (US$919) and gained 5.6% from a year earlier. (April 26)

Domestic credit grew in March
Domestic credit growth increased from 17.3% year-on-year in February to 18% in March as central bank rate cuts stimulated corporate lending. (April 26)

Company defaults rise
In the first quarter of 2012, the corporate default rate was 21.1% higher than it was a year earlier, according to Serasa Experian. The 18.8% default growth rate in March compared to the same month last year was the highest increase for March in two years. (April 30)

Trade balance in surplus in April, but imports rise
The Brazilian trade balance had a surplus of US$881 million in April, the Ministry of Development, Industry and Foreign Trade reported. This was 53% lower than in April 2011 (US$1,861 billion). April imports totaled US$18,685 billion compared to US$18,312 billion in 2011; exports were US$19,566 billion, 8% less than in 2011. (May 2)

March industrial output falls
Output of Brazil’s mines and factories fell unexpectedly in March as they struggled with high inventories and increased competition from imports. Production declined by a seasonally adjusted 0.5% in March compared with February, and by 2.1% compared to March 2011. (May 3)

Inflation soars
Official IPCA inflation was 0.64% month-on-month and 5.1% year-on-year in April. The main contributors to rising prices were personal expenses, apparel, and housing. (May 9)

INFRASTRUCTURE

43% more investment in private roads than public
According to IPEA (Institute of Applied Economic Research), in 2011 R$253,900 per kilometer were invested in private roads compared to just R$177,200 invested in public roads, though that represented an increase in government investment. Last year the National Confederation of Transport rated just 34% of public roads as good or great compared with 87% of private roads. (April 19)

DEFENSE AND SECURITY

Amazon anti-crime operation launched
More than 8,500 Brazilian troops in Operation Agata 4 are tackling drug trafficking, logging, and illegal mining in the Amazon, patrolling an area of about 5,000km (3,100 miles) along the northern border. The Brazilian government says it is keeping concerned neighboring countries informed. (May 2)

POLITICS

Brazil land law a defeat for Rousseff
Congress has eased rules on the amount of forest farmers must preserve, a victory for the powerful agriculture lobby and a political defeat for President Dilma Rousseff, though the bill still requires that millions of hectares of cleared land be replanted. Farmers have been responsible for much deforestation in the Amazon and other swaths of environmentally sensitive land. Rousseff may still veto the bill, one of the most controversial in recent years. The bill made it through the lower house despite Rousseff’s overwhelming majority there because of pressure from powerful agribusiness interests. (April 25)

Corruption higher than under Cardoso?
In an interview with Folha newspaper, Fernando Henrique Cardoso said corruption has increased since he was president. President Dilma Rousseff’s “housecleaning” is important, Cardoso says, but warned that “she may not be assessing the political risk that she is running.”

He also complained about Brazil’s aversion to long-term planning: “What do we do with the money from deep-sea oil? You have to put it into science, technology, education … Qatar has goals for the year 2030. They have a long-term strategic vision.” (May 1)
FOREIGN POLICY

Obama-Rousseff talks productive
Barack Obama expects the recovery of the U.S. economy to be “slower than seen so far,” he told President Rousseff in Washington, and expressed great interest in Brazilian oil and ethanol. The two indicated that a partnership in biofuels could be announced soon.

The conversation was dominated by the global economic crisis. Rousseff blamed the U.S. for the cheap dollar, and was told that the problem is China.

Although Iran’s president, Mahmoud Ahmadinejad, noticeably bypassed Brazil on a recent Latin America tour, and Brazil voted recently in the United Nations to censure President Bashar al-Assad of Syria, there are still qualms in Brasília about intervening in Middle East conflicts.

Meanwhile, Washington has been reluctant to explicitly support Brazil’s bid for a permanent seat on the Security Council, even after it backed India’s bid two years ago.

(April 12)

Clinton categorizes governments as open and closed
In Brasilia at the 1st High Level Conference for Open Government in April, U.S. Secretary of State Hillary Clinton said that the world will soon be divided between open and closed governments, rather than between north and south. She also said that President Rousseff’s fight against corruption can serve as a model. Corruption, she said, “kills the potential of countries, draining resources.” The U.S. and Brazil are leading an initiative establishing a commitment to open government, which 55 countries have already formally signed.

Clinton also said that the key to economic success for both Brazil and the U.S. is innovation coupled with concern for the environment. Between the two, she said, “There are opportunities and potential for more investment, more trade, more jobs.”

(April 17)

ECONOMIC POLICY

Interest rates falling
In response to calls from Finance Minister Mantega and President Rousseff to boost growth, state-controlled banks announced plans to lower interest rates on loans to consumers and small and medium companies. Caixa Economica Federal, the country’s fifth largest bank, will also offer more credit to small companies.

(April 10)

Benchmark interest rate drops to 9%
The central bank Monetary Policy Committee announced a 0.75 percentage point reduction in the policy interest rate, dropping it to 9% a year. The unanimous committee decision justified the drop because of the “fragility of the global economy.”

(April 18)

Primary budget surplus posted in March
Brazil’s consolidated primary budget surplus was R$10.4 billion in March, the central bank said. This figure measures a country’s ability to service its debt. In the 12 months through March, the primary surplus, which excludes debt servicing, was equivalent to 3.22% of gross domestic product, down from 3.33% in February.

(April 25)
In addition to producing and disseminating the main financial and economic indicators of Brazil, IBRE (Brazilian Institute of Economics) of Getulio Vargas Foundation provides access to its extensive databases through user licenses and consulting services according to the needs of your business.

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Brazil’s domestic economy is faltering. What can be done?

For one thing, we can look around us, as we do in this issue. Argentina has just effectively nationalized a major oil company, YPF. How much is that likely to help its economy? Not much. Starting in 2003 Christina Kirchner and her predecessor as president Nestor Kirchner nationalized the postal service, the railways, a radio spectrum operation, a shipyard, a water company, Argentina’s private pension funds, and its flagship airline. The results have been described by economists as “mediocre to dismal.” In 2011 alone the government spent nearly US$3 billion to prop them up.

Meanwhile, the economy of Mexico, which was the largest in Latin America until Mexico lost U.S. markets and investment to China, is surging ahead. Last year Mexico’s GDP grew 3.9% compared to Brazil’s 2.7%, and the outlook for this year is similar. Perhaps recognizing that the government is not great at running a business—the national oil company Pemex is a case in point—Mexico has instead sought to expand its markets and now has 14 commercial treaties, though it is still heavily dependent on the performance of the U.S. economy. When it lost labor-intensive maquiladora industries to China, Mexico promoted sectors with high added value and extended supply chains. As Manuel Molano, director general, Mexican Institute for Competitiveness, said, “We gained market share with world-class products, not protectionism or local content rules.” Meanwhile, Brazil has been putting pressure on Mexico to limit its car exports to protect the Brazilian car industry.

This issue’s discussion of what is happening in neighboring economies is a natural follow-up to the last issue’s cover story and interview with Ozires Silva, once a minister and president of the successful aircraft maker Embraer. The April cover story analyzed the government bet that an aggressive protectionist policy will make Brazilian industry more competitive, though the history of protectionism is not promising. Ozires Silva pointed out that Chinese and South Korean companies are successful because “government and business interests are working together to create a competitive direction for those countries,” yet in Brazil bureaucrats seem to actively distrust entrepreneurs. Moreover, in Brazil, “The government is in every corner of human activity ... we cannot take a step without a government permit.” He added that “what the government does is crucial in determining whether Brazilian businesses manage efficiently,” which in turn is crucial to Brazilian competitiveness.

Brazil is at a defining moment where it must stop dithering and commit to a direction ... such a commitment comes down to a choice between going backward, like Argentina, or forward, like Mexico.

“Protecting” industry with more government control and more red tape, is likely to do little more than drive away foreign investment and jeopardize the gains in economic equality Brazil has made in recent years. Are those really the government’s goals?

Or, like Mexico, Brazil could move forward, honestly identifying (and doing) what needs to be done to become more competitive in global markets and build on the gains its people have made economically. For years the same problems have been diagnosed—lack of infrastructure, unbalanced taxation, the high price of electricity, an education system that doesn’t properly prepare students for employment—and an occasional bandage has been applied, but there has been no real effort to cure, much less prevent, such problems. Doing something about them will help Brazil to move forward. Doing nothing means going nowhere but backwards.
At first glance, Brazil-U.S. relations seem to be booming. April began with President Dilma Rousseff’s first visit to the United States to meet with President Barack Obama. Then U.S. Secretary of State Hillary Clinton traveled to Brasilia to talk to Rousseff and the Foreign Minister, Antonio Patriota. A few days later U.S. Secretary of Defense Leon Panetta swung by Brasilia to chat with Celso Amorim, the Defense Minister.

In Washington, President Rousseff’s agenda was more concerned with business than politics. Her trip was intended to underscore the importance of economic partnership at a time when Brazil is trying to respond to the effects on its currency of the global financial crisis by implementing policies to make its own industry more competitive. She and President Obama gave particular attention to agreements on educational exchanges, innovation, and energy cooperation. Rousseff left Washington not only with a stack of memoranda of understanding—ranging from aviation to food security—but also with U.S. recognition of cachaça as a distinctly Brazilian product (it was classified as rum before), a decision that will probably lower its tariffs.

In Brasilia, Secretary Clinton and Minister Patriota conducted the Brazil-U.S. Global Partnership Dialogue (GPD), a mechanism for advancing cooperation and promoting shared interests around the world. This year’s GPD addressed such areas as education, science and technology, social inclusion, human rights, and sustainable development. Later Secretary Panetta and Minister Amorim launched the U.S.-Brazil Defense Cooperation Dialogue, which deals with science, innovation, technology transfer, humanitarian assistance and disaster response, cooperation in support of African nations, cybersecurity, and defense support to civilian authorities at major international events.

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The succession of high-level meetings highlights the growing economic importance of the relationship between the two largest economies in the Western Hemisphere. With a US$60 billion trade flow in 2011, the U.S. is Brazil’s second leading trade partner; it is an important market for manufactured goods as well as commodities. For the U.S., trade with Brazil produced one of its highest trade surpluses in 2011, US$11 billion. Investment and tourism numbers are also impressive. Therefore, despite the lack of a major trade deal, the economic engagement is promising.

More broadly, these meetings underscore the fact that the two countries share a mutuality of interests not only bilaterally but in the global arena as well. After misunderstandings related to Colombia, Honduras, Cuba, and Iran in the final years of President Lula’s administration, Washington and Brasília seem to have established a more consistent framework for consultation. This does not necessarily imply a common view...
Brazil could do a better job explaining to the U.S. (and the world!) how it would behave as a global power with a permanent seat on the U.N. Security Council.

Even if some of these considerations may hold elements of truth, ultimately they keep relations between the Western Hemisphere’s two most important democracies from reaching their productive potential. Brazil could do a better job explaining to the U.S. (and the world!) how it would behave as a global power with a permanent seat on the Security Council. The U.S. could also rethink some of its arguments against that.

For example, the fact that Brazil is not a nuclear power and that South America is not a strategic region should count in favor of, not against, Brazil’s aspirations. If the region is relatively calm, it is because Brazil and Argentina made a collective effort to end their economic and military rivalry in the 1980s. That rapprochement also defused the nuclear component of the rivalry, something that India and Pakistan have not been able to do.

The U.S. decision to endorse India’s bid and ignore Brazil’s sends a perverse message: It rewards a country that has snubbed every major nonproliferation regime, while punishing a country that has willingly adhered to all those regimes.

The question of whether Brazil deserves a place on the Security Council and whether it is capable of bearing the burden of global leadership is another story. It will certainly give Brazil and the U.S. a lot to talk about at any of the many strategic dialogue forums that have been created.

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Brazil owns about 10% of the world’s fresh water—an essential resource for food production. However, water is unevenly distributed across the country: the northern region, where there are the fewest people, has most of the water, while the Southeast, which has two of the largest cities, Rio de Janeiro and São Paulo, is threatened with water scarcity.

With passage of the National Policy of Water Resources (the Water Law) in 1997, Brazil acknowledged that water is a limited valuable natural resource. Since then, water management has begun, with division of watersheds, a plan for water resources, allocation of water rights among consumers in each region and sometimes charges for its use, and data collection for a national water information system.

However, 15 years later, the results fall short. The institutional framework that the law envisaged was not disseminated throughout the country but was concentrated in the Southeast. Charging for water use, which would encourage sensible consumption and raise funds to improve the watershed, is still the exception. Of watersheds under federal jurisdiction, only four charge for water use: Paraíba do Sul, Piracicaba-Capivari-Jundiaí (PCJ), São Francisco, and Rio Doce. By 2011 the four had taken in R$209 million. Charges are negligible by international standards.

Marilene Ramos, director, State Environmental Institute (INEA), has tracked the efforts to carry out water policy since its beginning, such as...
“Today we have the awakening of a global consciousness that the water issue is really critical.”

*Marilene Ramos*

creation of the Paraíba do Sul River committee, which began charging for water in 2003. “In France, revenues from charging for water use represent 30% to 40% of the investment budget of the watershed agencies,” she says. “Here, the average is 6% to 7%. There, annual water revenue is equivalent to US$30 per capita; in Brazil, it is not even US$1.”

**A FEE, NOT A TAX**

For Vicente Andreu Guillo, director, National Water Agency (ANA), revenue collection is inversely proportional to resistance to pay for water use. Laura Stela Perez, technical advisor of the Department of the Environment of the State of São Paulo adds, “There is widespread misunderstanding. Many believe it is a water tax. But how could it be a tax if users are defining what they pay?” For years, Perez has been involved in the rather sluggish debate on water use charges in the Alto Tietê Basin.

ANA’s own study of users in the Paraíba do Sul Basin found that after water charges were established only 25% of respondents took measures to use water more rationally. But Giordano Bruno Bomtempo, an ANA expert, is seeing signs of change in consumer attitudes. “In the Rio Doce Basin, which established water charges at the end of last year,” he says, “collections are higher than those charged in other basins.” He adds that, “While in the Paraíba do Sul Basin each cubic meter captured costs 1 cent of Brazilian real, in Rio Doce Basin it costs 18 cents, and charges for organic matter released into rivers are 7 Brazilian cents per kg/BDO compared to 10 Brazilian cents in the Rio Doce.”

**A COLLISION OF INTERESTS**

In a participatory and decentralized system, each sector will seek to look after its own interests. According to experts, irrigated agriculture, which uses the most fresh water, is the sector that most opposes water charges. “Can you imagine an industry with an interest group so strong that it can bring down a forest code?” INEA’s Ramos asks. “It is very difficult to collect water charges from farmers. France and Germany could not do it either. In France, collection of water charges from the agricultural sector accounts for less than 2% of total revenues.”

Representatives of agribusiness, such as former minister Roberto Rodrigues, argue that irrigated agriculture uses water but does not necessarily consume it: 90% of irrigation water returns to the hydrological cycle, they say. ANA data, however, shows that agriculture takes 54% of total water consumption, of which it consumes 72%; industry takes 17% and consumes 7%; and cities take 22% and consume 9%.
Laura Antoniazi, Rede Agro researcher, says that agribusiness generally works with tight costs and volatile margins, which makes it sensitive to any new charges. “We cannot deny that in Brazil, water is indeed wasted by some crops. But there are also advances. In Rio Grande do Sul rice cultivation—one of the most water-intensive crops—has reduced water use from 15,000 cubic meters per kilogram in the 1970s to 8,000 today,” she explains.

Guillo also sees room to improve efficiency, since the loss of treated water can reach 50%. “Today, industry is working to improve efficiency quickly because it can be directly reflected in productivity gains,” he says. Examples abound, even among heavy users of water. CSN, the national steel company, used to use 10 cubic meters of water per second. Today that has been cut to 5 and CSN is planning to reduce that to 2.

“If companies do not become efficient, the cost of water can shoot up. An example is the new Petrobras chemical plant being built in Itaborai. Because water supply in the region is insufficient, Petrobras had to make an expensive decision: the company will bring in water from the Alegria water treatment station through a pipeline under Guanabara Bay, an investment costing about R$600 million. Ramos comments that “Petrobras will also need to invest another R$250 million to build a dam on the Guapiaçu river to provide safe water to the expected increase in population at its new plant site.”

The risks of water shortages are stimulating industry to undertake water-saving projects, says Demetrius David da Silva, vice chancellor,
University of Viçosa, Minas Gerais state. He spent the last two years coordinating a study to establish a coefficient matrix of consumption so that industry can estimate the water resources necessary to expand a given economic sector. “It was only quantitative; we didn’t study the quality of water returned,” he says. “Nevertheless, it was an important initiative given that the latest data for Brazil was from the 1970s.”

The study was delivered in April to the Ministry of Environment. There has been progress in some areas of water use. The pulp and paper industry, for example, reduced its water use from 200 cubic meters per metric ton of product to between 10 and 46 cubic meters. For iron ore production water use has been reduced from 6 cubic meters to 1 cubic meter. “We are beginning to establish an important relationship with industry, and see that there has been significant progress,” da Silva says.

**ADJUSTMENTS NEEDED**

Jorge Peron, environmental expert, Federation of Industries of Rio de Janeiro (Firjan), argues that Brazil needs to not only collect more in water charges, but also improve the way the funds raised are used. He says that from 2004 through 2011, the Paraíba do Sul River watershed collected R$69.8 million in water charges plus R$14 million in other income; yet of the R$83 million total, so far only R$25 million has been invested. “Why should we collect more in water charges, when we have almost R$60 million in cash?” he asks.

To ensure more efficient use of water resources, the ANA and the National Confederation of Industries in February signed an agreement for technical cooperation. The partnership, effective through December 31, 2014, will look into ways to allow water customers to access part of the water charges collected to buy equipment and production processes to make water use more efficient. Currently, collected water charges cannot be transferred to private companies because they are a public resource.

Another key issue in Brazil is how to revise the institutional framework for water management, which is complex and slows the pace of work. For instance, there is an excessive number of watershed committees. France has five; Rio de Janeiro state alone has 9 and São Paulo
state 20. Then there is the problem of overlapping jurisdictions when a river crosses more than one watershed or state and federal administrations—something that happens in 50% of cases—and is thus subject to multiple decisions. Ramos argues that the ideal would be to replicate the model of Rio de Janeiro state, where all consumers are charged for use of water regardless of whether their region has a watershed committee or agency. The priority should be streamlining, says ANA’s Guillo. “We are seeking to harmonize management of watersheds with the administrative boundaries of each region,” he says.

“Today, industry is working to improve water efficiency quickly because it can be directly reflected in productivity gains.”

Vicente Andreu Guillo
Thais Thimoteo, Rio de Janeiro

Although believed to be the sixth largest world economy, Brazil has many shortcomings in areas considered central to economic and social development. These start with the minimum requirement for an acceptable quality of life: water and sanitation infrastructure that gives the whole population access to safe water, sanitation, solid waste management, and storm drainage.

In recent years, Brazil has achieved almost universal safe water supply in 5,564 towns, but collection and treatment of sewage is still very worrying. Data from the 2011 Atlas of Sanitation from the Brazilian Institute of Geography and Statistics (IBGE), based on the 2008 National Survey of Sanitation (PNSB), show that less than half (46%) of Brazilian households have access to sewage systems, but the percentages vary widely by region. In the Southeast, 70% of households have access, in the Midwest 34%, in the South 30%, in the Northeast 29%, and in the North just 4%. Sanitation infrastructure is most lacking in rural areas and the outskirts of large urban centers.

“There is a serious imbalance in the supply of sanitation services. We have seen an evolution since the 1970s in supplying safe water, which today covers 90% of the country. But when it comes to sewerage, especially collection, we are more than 20 years behind. About 70% of waste returns to nature without being treated, and this affects health,” says Édison Carlos, CEO, Institute Trata Brazil.

Losses
Lack of sanitation has major economic impact—especially absence from work and school and falling productivity due to gastrointestinal problems. The 2010 study conducted by the Institute Trata Brazil and the Getulio Vargas Foundation (FGV), published as Economic Benefits of Brazilian Expansion of Sanitation, demonstrates the extent of damage to both the public and the private sector. The federal National Health System would save an annual average of R$42 million from a reduced number of intestinal infections if all municipalities had sanitation services. The private sector in turn spends R$547 million a year on wages paid for hours not worked to employees absent due to gastrointestinal infections.

The study also shows that lack of sanitation has other economic costs. “An area with tourist potential but without the necessary sanitation infrastructure will have no financial return. The same applies to residential developments,” says Edney Dias,

With more education and purchasing power, Brazilians are beginning to realize how important it is to have clean tap water and good sanitation.
The private sector spends R$547 million a year on wages paid for hours not worked to employees absent due to gastrointestinal infections. consultant to the Brazilian Institute of Economics (IBRE) and contributor to the study.

Since 2007, the Ministry of Cities (MIC), through the Growth Acceleration Program (PAC), has made efforts to relieve the problem by lending resources to states and municipalities to invest in sanitation. PAC 1 (2007–2010) allocated R$40 billion and PAC 2 (2011–2014) another R$45 billion. But the results so far have been meager. According to the MIC, only 9% of the projects funded by PAC 1 were carried out, so that only R$3 billion was spent. "Today we offer about R$15 billion a year for sanitation projects but cannot even spend R$8 billion. Considering that the aim of MIC is to universalize services by 2030 and that the federal government intends to allocate R$420 billion for the sector over the same period, we are not even at half the spending needed to achieve the sanitation goal," Carlos says.

Yuri Giustina, MIC infrastructure specialist, attributes the slow progress to a lack of planning and management, especially by the municipalities, which are among the largest managers of resources for sanitation. He points out that "In selecting projects, problems began to appear in relation to quality, often outdated or poorly designed plans without environmental permits, and the inadequate execution capacity of bidders." This experience led to more rigorous project selection in PAC 2: "Now, we verify the suitability of all projects. If selected, their viability is then evaluated by the government savings bank, Caixa Econômica, as agent of the ministry."

Election

However, all efforts to improve the quality of life are of no avail if society does not understand the importance of sanitary conditions. "Brazilians live reasonably well with open sewers," Carlos says. "The citizen demands asphalt, security, transportation, before sanitation." Yet, it is possible to see signs that with more education and purchasing power, Brazilians are beginning to realize how important it is to have clean tap water and sanitation. "The population is already concerned [about sanitation], so local governments are acting. But what happens is that a city often outsources sanitation services to companies and shifts the blame to them for eventual failures. However, the government is responsible for administering the service," Giustina says. Carlos adds that "Gone are the days when sanitation yielded no votes. We have to take the opportunity we have in an election year and discuss the sanitation agenda outside the offices. Only when people ask for improvements will the authorities mobilize more arduously."

"An area with tourist potential but without the necessary sanitation infrastructure will see no financial return."

Edney Dias
The Brazilian Economy—How do you assess the current government’s industrial policies in terms of the environment?

Rubens Ricupero—Development of Brazil in the last 30 years has gone through several phases, in each of which there was a predominant problem. In 1994, when I was finance minister, the problem was hyperinflation. The second phase was the expansion of global demand as the middle classes grew. These two problems did not disappear but we are moving into a third phase, where the emphasis should be on long-neglected issues: competitiveness, productivity, and efficiency. It is in this phase that the environmental implications of policies become an issue.

What should be prioritized?
In 15, 20, 30 years, the world economy will increasingly rely on products and services based on low-carbon-emission technology. A good case is China, which for a long time practiced predatory development of natural resources but today is investing heavily in clean and renewable energy. Investing in the green economy is key for Brazil to achieve competitiveness, productivity and efficiency, says former ambassador Rubens Ricupero, now director of the Faculty of Economics at the Armando Alvarens Penteado Foundation (FAAP). Previously minister of finance and the environment in the Itamar Franco administration and secretary-general of the United Nations Conference on Trade and Development (UNCTAD), Ricupero affirms that Brazil has five environmental strengths: the world’s largest rainforest, the largest reserve of fresh water, remarkable biodiversity, clean and renewable energy (40% of the total), and a globally unique program of biomass fuel (ethanol) that can power millions of vehicles.
wind and solar energy, where gradually it is becoming a major equipment manufacturer . . .

Another curious fact is that in the past companies with high stock market capitalization were those that had giant industrial facilities. Today, Microsoft and Apple have intangible assets that require minimal power. These days Brazil cannot be anchored in an industry like vehicles, which are almost the symbol of the industrial revolution.

**What is the best route to competitiveness?**

Brazil cannot indefinitely postpone addressing bottlenecks that continuously raise the cost of producing everything. If that were true, some might advise that we take refuge in agribusiness, or in iron ore. Production costs increase for all sectors, [but] in the case of manufacturing, which is inefficient, there is no margin, so any increase in production costs undercuts competitiveness . . . If nothing is done to curb rising costs, [eventually] no Brazilian product will be able to compete, except perhaps for oil. In the case of commodities, Brazil does have a competitive advantage, and the erosion of competitiveness caused by higher cost there is slower, but still steady.

Also, for years, tax revenue has been greater than the growth of the economy . . . Brazil is proud to produce a high proportion of clean and renewable energy—but the tax burden on electricity is huge.

**Would more economic use of natural resources offer a way out?**

Brazil is a kind of environmental power because it has five advantages: the world’s largest rainforest, the largest reserve of fresh water, remarkable biodiversity, clean and renewable energy (40% of the total), and a globally unique program of biomass fuel (ethanol) that can power millions of vehicles. No other country has this combination of advantages.

Why is Brazil so efficient in producing and exporting food? We have water and sun. This huge advantage explains how we went from a country that was only significant in two or three agricultural products to take a leading position in 15.

**How do we make the transition to a green economy?**

Last year, the United Nations Program for Environment (UNEP) published a report assessing the cost of this transition as 2% of global GDP (US$1,300 billion) . . . Brazil has both natural forests that could be managed and also the potential to plant more forests. [But] China in one year is planting more than Brazil has planted in 20. As yet Brazil has not had

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*In 15, 20, or 30 years, the world economy will increasingly rely on products and services based on low-carbon-emission technology.*
a rational long-term forest policy. We made mistakes in the 1970s, for instance, when areas of Minas Gerais state were destroyed because forests were planted in unsuitable places . . . And though Brazil has formulated advanced genetics for eucalyptus reforestation, unlike South Africa, we use relatively little eucalyptus for furniture manufacturing.

**Brazil cannot indefinitely postpone addressing bottlenecks that raise the cost of producing everything.**

Can the Rio+20 conference help us to further the transition?
We are working in this direction. The group of which I am part argues that Brazil should take this opportunity and produce a report like the UNEP did [on transitioning to the green economy] . . . It is sad to see measures, to increase taxes for imported cars and financing for selling more cars, that have no environmental counterpart. They are emergency measures that may even exacerbate the problem. Whenever the economy slows, the government has only one solution: increase car sales. This is done without requiring, as is done in other countries, that cars be less polluting and more fuel-efficient.

What is the government’s position on the environment?
The person in government who is environmentally sensitive is Izabella Teixeira, (the Environment Minister), but she is isolated. Unfortunately, environmental awareness is not among the great merits of our president. I think she recognizes this fact, but she has given more emphasis to social and economic policies.

Should we take more account of what environmentalists and scientists are saying?
The attitude of most governments is denial. Anyone can download the latest 2007 report of the Intergovernmental Panel on Climate Change. If you do, you will find that the situation is bad. Even though there is unanimity among scientists, the silence [of governments] is absolute. It is disturbing to learn that the most likely scenario for the Amazon was an average temperature increase of 8°C in 2008.

With economies failing, will economic concerns override environmental concerns?
This is the trend, although Europeans have been resisting it bravely, despite their being most affected by the economic crisis . . . . So far they have a much more progressive policy than ours. In the case of developing countries, some islands will be flooded, many coastal areas will have serious problems, and African food production will be affected tremendously.
How are other countries addressing energy production?
In most countries efforts to mitigate the generation of greenhouse gases are related to measures for low-carbon emissions. In Brazil there is a curious case of dissociation. The Brazilian effort [to reduce greenhouse gases] is appreciable—the country committed to ambitious goals in Copenhagen—but most efforts go to reducing deforestation in the Amazon. That does not build a green economy, it just avoids burning the forest.

The most effective path to a green economy is simply to reduce energy waste. During the electrical blackout crisis, Brazil showed that it can greatly reduce energy consumption. If we can reduce waste, many of the power plants being built in the Amazon would not be necessary.

Brazil had a very important role in developing ethanol for fuel—a large green economy project. But Brazil has rested on its ethanol laurels. Ethanol was the flagship of Lula’s diplomacy, but today, because of deep-sea oil, we do not talk about it. In the long run, if we do not invest and others discover technologies to use cellulose and other sources, Brazil may lose this advantage.

**Whenever the economy slows, the government has only one solution: increase car sales.**

What environment policy is needed?
One of the goals of Rio+20 should be to set goals, much like the Millennium Development Goals [for poverty reduction]. Probably we will not be able to put numbers on them, but we can establish targets, for example, to increase the share of clean and renewable energy. The conference should set these goals and assess the viability of financial resources (through the World Bank, funds, technical cooperation) to help countries reach them.

What would be the best way to measure progress?
One of the major problems of [Rio + 20] is that there is much disagreement on the choice of indicators to assess progress in environmental matters. Usually national accounts never compute what is being permanently destroyed. Today countries are designing an accounting framework to compute environmental liabilities. That would be the best way.

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China in one year is planting more forests than Brazil has planted in 20.
How should the State Participation Fund be shared?

Congress has until the end of the year to set new criteria for how the states will share in the Participation Fund. Because the options suggested so far antagonize interests, Congress is far from consensus.

It is not difficult to understand why Congress has not yet formalized the review of the State Participation Fund (FPE) the Supreme Court mandated last February. The states of Goias, Mato Grosso, Mato Grosso do Sul, and Rio Grande do Sul had filed a suit charging that the current allocation is unconstitutional, and the court ruled that the shares of the 27 states in FPE resources do not meet the constitutional principle of promoting social and economic balance between states and therefore compromised the federative pact.

What should be a theoretical debate about redistributive principles has been contaminated by state financial agendas. The R$50 billion in the FPE consists of 21.5% of what the federal government collects in income tax (IR) and excise tax (IPI). In the fight for shares, however, the states’ demands do not add up realistically.

Several draft supplementary laws on the matter are pending in Congress, and on March 16 the Senate created a special committee to review not only new FPE share criteria but also the federative pact and the tax system more generally. Notably absent from the discussions is the Rousseff administration. Without effective coordination, and with elections scheduled for October, it is unlikely that the dispute over FPE shares can be resolved by January 2013, the deadline the Supreme Court set.

EQUALIZATION

When the constitutional reform of 1965 established the FPE, its resources were to be shared on dynamic distribution criteria, geared to reflect socioeconomic changes between states over time. The original formula to share the resources, which then consisted of just 10% of federal IR and IPI tax collection, allocated resources based on state area, population, and an inverse of state per capita income. Some limits were imposed to protect less populated and developed states, but the important point
was that the allocation would always vary to accomplish the desired equalization.

For the states, the 1965 constitution made two major changes: it introduced both the ICM (a state value-added tax) and the FPE. They were intended to complement each other—the FPE sought to compensate for inequality in ICM collections, which at the time were much more concentrated in the southeastern states, explains economist Fernando Rezende of the Brazilian School of Public and Business Administration, Getulio Vargas Foundation.

José Roberto Afonso, a Unicamp economist specializing in public finance and a consultant to the Senate, adds that the system obeyed the logic of transferring income from richer to poorer states and municipalities in order to reduce disparities between regions.

A PERMANENT TEMPORARY FIX
With few changes, the 1965 FPE criteria remained valid until 1988, when a new constitution was approved. The 1988 constitution expanded the amount of funds in the FPE to 21.5% of IR and IPI collections. It also mandated that a law defining new criteria for sharing resources be voted on within one year. However, since there was no consensus on new sharing parameters, Congress, based on a study of the National Board of Finance Policy (Confaz), in December 1989 created a table with fixed coefficients for the 27 states; it was established that 85% of FPE resources would be allocated to the North, Northeast and Midwest, and 15% to the South and Southeast—São Paulo received a meager 1% and Rio de Janeiro just 1.5%.

Unicamp economist Sergio Prado points out that the states and Congress never revisited the sharing criteria, so there was an agreement that in effect replaced what should be a mechanism to promote equality among states for a system of fixed ratios for sharing taxes. “It was to be reviewed in two years,” he says, “but it has remained in place.”

No discussion of tax reform in Brazil since 1988 has addressed the federal equity issue, yet in the last 20 years, the profile of the population has changed radically in economic, demographic, and social terms. Rezende points out that “Regions that were poorly developed, like the Midwest, have gained tremendously from the growth of agriculture. However, because the sharing coefficients remained static, there has been a huge disparity in fund transfers among states.”

Afonso notes that in 1985, according to the Brazilian Institute of Geography and Statistics, only the South and Southeast

No discussion of tax reform in Brazil since 1988 has addressed the federal equity issue, yet in the last 20 years, the profile of the population has changed radically.
When the constitutional reform of 1965 established the FPE, the sharing of resources was based on dynamic distribution criteria, geared to reflect socioeconomic changes among states over time.

regions; the states of São Paulo, Rio de Janeiro, Rio Grande do Sul, Santa Catarina, and Amazonas; and the Federal District had GDP per capita above the national level. By 2007, income per capita in the Midwest was also above the national average, while in the Northeast it was far below.

SHARING OPTIONS
Most bills that the House and Senate are considering propose that FPE resources be shared according to such parameters as income per capita, gross domestic product (GDP), Human Development Index (HDI) status, population numbers, land area, and more specific indicators, such as share of houses with access to safe water and sewerage.

The resources at stake are significant. According to Afonso, the net amount of the FPE is equivalent to 1.4% of GDP, 13% of state tax revenues, and 22% of ICM.

There are two obvious alternatives for addressing income equalization: go back to the original model, which prevailed in the tax code, or create a new mechanism that could incorporate into the system of income equalization parametric criteria such as those used by federations like Germany, Australia, and Canada. “The parametric model has been the tradition in Brazil, but it does not take into account how much revenue each state itself takes in. It simply applies the parameters and distributes resources. If the state is poor, for example, it receives more. Equalization of revenue, which is unknown in Brazil, takes into account a state’s direct tax collection and shares resources according to state per capita expenditure. This is a more modern system, which deserves our attention because it reflects the states’ funding capacity,” Prado says.

Whatever the sharing formula, experts warn that there will be difficulties in moving toward a concrete solution for the problem. Changes in the distribution of the FPE could reduce state resources by up to 15% or 20%, which could be catastrophic.

WHOLISTIC CHANGE?
FPE reform offers a good opportunity for discussion of other federation issues, in particular the tax exemption war between the states, the sharing of oil royalties, and the restructuring of state debts. However, in the opinion of Afonso, although there is a consensus among planners and policy makers on the desirability of analyzing the issues together, the federal government has no sympathy for the idea. “The Executive argues for a case-by-case assessment,” he
FPE reform offers a good opportunity for discussion of other federation issues, in particular the tax exemption war between states, the sharing of oil royalties, and the restructuring of state debts.

Realizing that its decision has consequences for state budgets, and because it is a case of partial omission—there is a law, but it does not meet constitutional standards—the Supreme Court in declaring unconstitutional the criteria for distribution of the FPE also held that the current law should still apply for the next two financial years until a new sharing formula is issued. Given the lack of consensus on the issue, however, this may not be enough time. Small states like Rondônia, Roraima, Acre, and Alagoas cannot survive without FPE resources. This problem needs to be resolved before January 2013; otherwise the Supreme Court will have a substantial ‘hot potato’ on its hands. The hope, according to Afonso, is that the federal government will come forward to arbitrate the issue, even if only in its own self-interest.
Not long ago Mexico was the largest economy in Latin America, celebrating a return to full democracy after 71 years of Institutional Revolutionary Party (PRI) governance, and opening up the economy through the North American Free Trade Agreement (NAFTA), which increased trade with the United States and Canada from US$50 billion in 1994 to US$700 billion in 2011.

However, when China joined the World Trade Organization in 2001, Mexico lost U.S. markets and investment. Meanwhile, Brazil has benefited from high demand and prices for its commodities and the growth of its middle class has stimulated domestic demand. As a result, in 2011, Brazil reached twice the Mexican GDP, becoming the sixth largest economy in the world. It has also gained international influence by forming partnerships with other large emerging markets, the BRICS (Brazil, Russia, India, China, and South Africa).

But fortunes may be changing again. Today Brazil faces uncertainties about Chinese purchasing strength and its domestic economy is faltering. Meanwhile Mexico’s economic outlook is improving. Last year, Mexico’s GDP grew 3.9% compared to Brazil’s 2.7%. This year the Mexican economy is again expected to grow more (3.43%) than the Brazilian (3.22%). “The recovery of the U.S. economy and higher international oil prices are favorable factors for Mexico,” says Lia Valls, coordinator, Center for the Study of the External Sector, Brazilian Institute of Economics (IBRE).

Manuel Molano, director general, Mexican Institute for Competitiveness (Imco), adds, “There’s always a growth rebound after a major recession.” He notes that Mexico’s GDP fell by 6.2% of GDP in 2009 after the financial crisis in the United States, the destination for 80% of Mexico’s exports. Contributing to today’s rebound, says economist Renato Baumann, University of Brasilia, is that “Mexico has sought to expand its markets and now has 14 commercial treaties, a commendable effort.” But, he notes,
further growth will still depend on the performance of the U.S. economy.

**Changes**

To confront Chinese competition, Mexico had to make changes in its production base; the results have been positive. “The loss of labor-intensive maquiladora industries to China made us look for sectors with higher added value,” Imco’s Molano observes. The result was the creation of extended supply chains, as in the car parts chain that today supplies the auto industry, which in 2011 exported 2.1 million vehicles. “We gained market share with world-class products, not protectionism or local content rules,” Molano says, underlining the difference between Mexican and Brazilian industrial strategies. (Recently the Brazilian government put pressure on Mexico to limit its car exports to protect the ailing Brazilian car industry.)

**Today Brazil faces uncertainties about Chinese purchasing strength and its domestic economy is faltering while Mexico’s economic outlook is improving.**
To confront Chinese competition, Mexico had to make changes in its production base; the results have been positive.

Mexico is moving fast to expand other sectors of the economy, Molano goes on: “While Mexico’s oil sector recorded a 6% increase between 1993 and 2011, its manufacturing sector grew 58%.” However, this was not enough to get Mexico’s trade balance back in the black.

Even though the winds are changing, Mexicans are aware that their economic growth rate is still far from ideal. Any open economy is vulnerable to external shocks—Mexico’s international trade is about 60% of GDP—but that is not the main concern. Molano diagnoses the problem as “an incomplete transition to a market economy.” He believes the lack of political power of the National Action Party (PAN) administrations has prevented major reforms. “Today,” he says, “most modern industries have to pay toll to the old establishment, such as maintaining large public and private monopolies and property rights practices, among others, that stifle the economy and increase production costs.”

Even after speeding up the volume of its trade with the rest of the world for more than 30 years, Mexico still has the same share of global GDP. Hector Aguilar Camin, Mexican journalist, writer, and historian, asserts that the main challenge for the next president, to be elected in July, will be to escape what he calls the middle-income trap. In the prologue of his book, *Future for All*, which he presented to the presidential candidates in April, he wrote:

“Countries that have fallen into that trap have wages too high to be competitive in basic manufacturing associated with cheap labor, but at the same time they do not have the technological capabilities, human capital, and institutions necessary to produce more sophisticated products and compete with more advanced countries. That is, [they are] unable to
move from growth driven by commodities to one stimulated by competitiveness and productivity.”

Problems
José Gerardo Traslosberos Hernandez, Mexico’s consul general in São Paulo, believes that some of the weaknesses that affect Mexican competitiveness are also common in Brazil. Poor infrastructure, lack of skilled labor, a shortage of engineers, and the high price of electricity are among the issues that both countries have to address. But there are also contrasts. One is tax revenues, which in Mexico are among the lowest in the region. Not only do tax revenues there not even reach 20% of GDP, they are also heavily dependent on the tax payments of the state oil company, Pemex. Tax reform would improve fiscal management and would be an effective tool against corruption: Today, with low tax revenue and guaranteed federal transfers, local governments are not accountable and are not motivated to spend efficiently.

Businesses would also like to see more flexible labor laws and more access to credit. Both could help to reduce the informal economy, which exceeds 30% of GDP, and help mitigate such long-term problems as drug trafficking and the accompanying violence: In 2010 the 25,000 homicides in Mexico were double the number in 2003. “Studies estimate that drug trafficking carries an economic loss for the country of 3% to 10% of GDP,” says Alejandro Fonseca, professor, Egade Business School in Monterrey. Eight years ago Monterrey city was considered safe and was a pole of attraction for business; today it is recording an exodus of entrepreneurs. “The security issue is still really sensitive,” says Marcelo Ciasca, CEO for Latin America of Stefannini, a Brazilian information technology company. Ciasca, who has been working in Mexico City for eight years, nevertheless recognizes Mexico’s enormous business potential, noting that “Over the past three years, our company has grown at annual rates of 50%.”

Imco’s Molano believes it will be crucial that the next president put in place a consistent reform agenda. “Before 1970 we had already experienced a period [of high growth like] the BRICS, with growth rates that reached 9%, but we did not know how to spend the accumulated wealth: we invested poorly, and did not liberalize [the economy] as we should have.” He would like to see Mexico take the route Korea took: increase total factor productivity, savings rates, and investment—and, of course, open the economy. “Today Korea is richer and has a trade balance of 98% of GDP,” he points out. “In other words, openness helps the economy, and protectionism condemns it.”
The state-owned oil company, Petroleos Mexicanos (Pemex), must deal with a true dilemma: having to ensure a large part of federal government revenue yet not having the autonomy to make the investments it needs to stay competitive with the world’s leading oil producers. For years, Pemex numbers have been heading downhill: proven reserves fell 50% in the last decade, and daily production declined from 3.4 million barrels of oil in 2004 to 2.5 million in 2012. Although past administrations have made efforts to stabilize production, reversing this situation depends on deeper reforms, such as allowing private capital to invest in oil exploration.

That would require changes in the Constitution, and therefore building political consensus beforehand. Today, with a large part of Pemex revenues going to pay taxes and royalties, which constitute 35% of federal revenues, and restrictions on private involvement in the oil sector, there is little room for investment. For instance, Pemex lacks sufficient money and technology to explore prospects for deep-water oil in the Gulf of Mexico.

“We cannot imagine any meaningful reform without a massive crisis or a popular enough president to form a coalition and raise public awareness,” says Carlos Elizondo, professor of political science, University of Oxford, England, and Mexico’s former ambassador to the Organization for Economic Cooperation and Development (OECD). He explains that a constitutional change needs the approval of two-thirds in both houses, plus one half plus one of the states’ chambers.

To further complicate matters, there is little popular support for reforms.

“The majority of Mexicans are misinformed. Although they defend competition if it will give them better services, such as gas stations, they still see Pemex as a symbol against foreign imperialism that must be preserved,” says Gilles Serra, professor of political economy, Center for Research and Economic Policy. “It may be that this change would only gain support if there were a shock, such as a sharp drop in production, an accident that would put in doubt Pemex’s ability to control it, or a major corruption scandal.”
With 35% of Pemex revenues going to pay taxes and royalties and with restrictions on private involvement in the oil sector, there is little room for investment.

**Promise**

The first signals from Enrique Peña Nieto, PRI (Institutional Revolutionary Party) candidate for president, who has been heading the polls, suggest a willingness to liberalize. In April at the World Economic Forum, Peña Nieto said that Mexico should depoliticize the decision to attract private capital for the oil sector, citing the Brazilian oil company, Petrobras, as a model. Analysts, however, say that such a statement is far from reflecting a search for a true model of privatization; Elizondo comments that, “Peña Nieto may be defending competition in sectors such as gas, petrochemicals, and distribution, but never exploration and production of oil itself.”

There is some precedent for that opinion. In his 2008 reform bill, President Felipe Calderon of the PAN (National Action Party) proposed to open the refining sector and pipelines to private competition but was defeated in Congress; the PRI was then in opposition. “Now,” Gilles says, “Peña Nieto will need more than desire; he will need to negotiate majorities and, above all, have a firm grip on the nationalist wing of his own party, which is influential among service providers and the Pemex workers’ union.” The Pemex union is strenuous in its defense of worker rights. Pemex ended 2011 with a labor liability of U$56 billion, mostly related to pensions for workers. Reforming Pemex “would be a radical change,” Elizondo says, noting that it would require two other factors: an administration that collects more revenue and has more discipline in spending, to reduce the tax burden on Pemex, and a regulatory framework that will prevent monopolies and ensure a balance of power for new participants in the market.

“*We cannot imagine any meaningful reform without a massive crisis or a popular enough president to form a coalition and raise public awareness.*”

*Carlos Elizondo*
Despite a good recovery from the crisis of 2008, why is growth in Mexico still relatively low?

Brazil and Mexico share similar challenges: Mexico needs to make the labor market more flexible and make it easier to start a business. We must improve the infrastructure of ports, roads, and public transport systems and train more skilled workers—in Mexico, as in Brazil, education spending needs to be more effective.

In the last decade, the emerging BRICS countries have gained geopolitical and economic influence. Has Mexico been harmed by not being part of this group?

Mexico is a country with 112 million inhabitants, with per capita income similar to that of Brazil. It has a growing middle class, increasing purchasing power. . . . Whether it is among the BRICS or not is just a matter of definition. For there are also large differences within the BRICS. Brazil’s growth is well below that of China and India, for instance. The fact is that, like Mexico, they are large markets and that will encourage growth in demand. Just as important is the fact that Mexico started a trend after the Cold War ended by negotiating an agreement with the United States that also changed the geopolitics.

In the beginning, NAFTA was related to the expansion of the maquiladoras in Mexico. These are no longer an issue. Traditional maquilas are ceasing to exist. These plants were established on the Mexican side of the border, imported component parts, used only Mexican labor, and exported finished products to the United States. From my point of view, that had benefits because it generated jobs. Over time, the difference between industries that only sell abroad and those that sell to the domestic market tended to disappear. We integrated production chains in a context of openness, and today Mexico produces more parts and components—such as for autos and electronics—which generate much more value and are important Mexican exports.

Has the review of the automotive agreement between the two countries affected Mexican willingness to have closer ties with Brazil?

Mexico practices an open regionalism. We are interested that Brazil thinks Mexican cars enrich its market, because they are good, and their consumers can benefit. The presence of Mexican cars may encourage the Brazilian industry to develop more competitive cars. And it does not stop there. We have huge complementarity, for example, in aerospace. We would like to have an Embraer plant, because we have parts, engineering service, and quality design. There are also opportunities in other areas, such as capital goods, agricultural machinery, sugar production, and in particular biofuels and biotechnology, in which Brazil has made remarkable strides.
Argentina: On the slippery slope to full nationalization?

Marcia Carmo, Buenos Aires

Has late Argentine first lady Eva Duarte de Peron been resurrected for President Cristina Kirchner’s administration? Evita, who died 60 years ago, embodied the populist polices of Peronism that previous President Nestor Kirchner and his wife, the current president, have been reviving since 2003. These policies favor a larger government presence in the economy.

A picture of the late Evita was the backdrop for the president’s announcement that her government was intervening in Repsol-YPF, in which the majority shareholder was Spanish company Repsol, and was advancing a bill to expropriate 51% of its shares, leaving Repsol with only a 6% share in YPF. Repsol risks getting nothing for the expropriation: Deputy Minister of the Economy Axel Kicillof said it will be charged with environmental liabilities.

“We are the only country in Latin America and one of the few in the world that does not manage its own natural resources,” Kirchner said, claiming that the expropriation will help reverse this situation. She blamed Repsol for falls in oil production and for Argentina becoming an importer of fuel. “For the first time in 17 years, since the privatization of YPF in 1998, in 2011 we became importers of oil and gas,” she said. Last year the
Although foreigners heavily criticized Argentina for the Repsol expropriation, it was hugely popular among Argentines. The country had to import US$9.3 billion in fuel. “If we continued like that, Argentina would become a unviable country,” she said. She considered Repsol-YPF to be the major cause of these hardships—even though it represents only 30% of gas and oil production.

Kirchner suggested that the Brazilian state oil company, Petrobras, was now her model: “In Brazil, the government owns 51% of Petrobras shares. We choose to do the same [with Repsol-YPF].”

Even as Kirchner was announcing the intervention, Minister of Planning Julio de Vido and Deputy Minister of the Economy Axel Kicillof occupied the Repsol-YPF building and gave 16 executive directors 15 minutes to leave, which outraged Spanish diplomats. Kicillof, 41, has emerged as the government strong man. Now the “new YPF” is looking for new foreign partners.

Popular support
Although foreigners heavily criticized Argentina for the Repsol expropriation it was hugely popular among Argentines. Opinion polls showed that over 50% of the population supported it. However, Mariel Fornoni of Management & Fit warned that “Argentines support the expropriation, but not blindly. There is much speculation about how the company will be managed. It is clearly understood that Minister De Vido is responsible for the energy crisis and therefore cannot head the oil company.”

Political analysts Rosendo Fraga, New Majority Studies Center, and Graciela Romer, Romer and Associates consultancy, said that YPF is a symbol of Argentina’s nationalism. The Repsol nationalization reversed the president’s recent fall in popularity, Romer said. Fornoni noted that “With the measure, she recovered 17 points of support lost between last December and early April.”

A popularity roller coaster
Several factors had contributed to the president’s fall in popularity: the February train wreck that killed 51, rising inflation, the perception that the economy may be slowing after nearly nine years of growth, and allegations of corruption against the vice president, former Economy Minister Amado Boudou, who has been accused of influence peddling in choosing the company that prints paper money. “In Argentina, when earnings start to get short, when the party is no longer for all, accusations of corruption then attract the attention of voters and naturally affect the popularity of the authorities,” Fornoni said.

When a measure has popular support, Congress will pass it easily. The expropriation bill was approved by a large
majority in the Senate and the Chamber of Deputies (207 for, 32 against). It also raised a cry for more nationalizations. Opposition representative Fernando Solanas urged, “We cannot be limited to 30% of the oil sector, the Repsol-YPF market share. The government must have control of 100% of this market that is strategic for any country.” Though the governing coalition applauded his statement, it raised concerns among foreign investors.

Nor did the nationalization bandwagon stop there: “After the oil, we have to nationalize electricity companies,” claimed unions that support the government. Among embassies and foreign companies, the most common questions are thus: “Will the government move to other sectors? What could be next?”

Distrust
In a survey by Sel Consultant, Buenos Aires, 70% of the corporate executives questioned believe that the Repsol-YPF expropriation will “worsen the business environment”—previously 58% had considered the investment climate to be stable. Results of a study by Abeceb consultancy in early May, however, found that in the first quarter the business climate was already marked by “uncertainty” due to import restrictions, exchange controls, inflation, and a change in the central bank charter (see page 37).

A few days after the Repsol nationalization, the Argentine press published statements by Murilo Ferreira, president of Brazilian company Vale, suggesting that the company might review its investments in the province of Mendoza due to political uncertainty and inflation. Days later, a government spokesperson said that Vale had reassured authorities in Mendoza that it would continue to explore for potassium there: “It’s okay. If plans are not changed, Vale plans to invest over US$5 billion in the mining project, and this could turn Argentina into one of the largest potassium producers in the world.”

Declining investment
Last year, according to the Economic Commission for Latin America and the Caribbean (ECLAC), the region received a record US$153 billion in foreign direct investment (FDI). In 2011, Brazil led with US$66.7 billion in FDI (43.8% of the total), nearly 10 times more than Argentina’s US$7.2 billion. “It is hard to construct the model of social inclusion dreamed by the government, with this low investment,” said former Energy Secretary Alieto Guadagni.

What is heard from economists and businesspeople critical of the government is that Argentina is being “excluded” from the investment map. Many, however, avoid public criticism of the government. “We invited 15 economists and experts to talk about the economy and the energy situation...
Among embassies and foreign companies, the most common questions are: “Will the government move to other sectors? What could be next?”

in the country, but only 3 came,” Senator Norma Morandini noted. In Argentina under Kirchner, there are no ministerial meetings or presidential press interviews. Few ministers speak to journalists; the planning minister is among those who do not.

Gas reserves
Repsol has speculated that the expropriation may have occurred because the government “kept an eye” on gas reserves and unconventional oil in Vaca Muerta region, in the rocky ground in Neuquén province in Patagonia. Experts say there are no reliable figures that can confirm that Argentina could have the third largest reserves of unconventional gas in the world, as the U.S. Department of Energy has claimed. According to advisors to the Neuquén government, fear of an ecological disaster will require billions of dollars in extra care. The question now is whether the expropriation of Repsol-YPF and the Argentine nationalization roller coaster could discourage further exploration of this gas field.

After the expropriation of Repsol, “It will not be easy to instill confidence in new investors,” said economist Orlando Ferreres, Ferreres and Associates consultants. “Argentina has been characterized as a country that breaks rules. It invaded the Falklands island in 1982 (during the military regime), defaulted on public and private debt in 2001, restructured its debt at a discount of 75%, and is now expropriating oil companies,” wrote Eduardo van der Kooy, political analyst for the Clarin newspaper.

President’s ambivalence
In 1992, Christina Kirchner and her husband, then governor of the province of Santa Cruz, called for privatization of YPF. In 2011, as president she praised Repsol investment and productivity in the country. In 2012, she expropriated Repsol. In practice, there is now a disconnect between what the government is doing, falling investment, and business fears. Soon after the expropriation law was passed, on May 3, television station TN (Todo Noticias) promoted a debate on whether it would be possible to amend the constitution to pave the way for the president to have a third term. TN asked: “Cristina Kirchner eternally in power?”

From economists and businesspeople critical of the government what is heard is that Argentina is being “excluded” from the investment map.
Controversial moves by President Kirchner

- **Nationalization of pension and retirement funds:** The government justified the move by arguing that private enterprises were mismanaging pension funds. Today, the nationalization has broad popular support.

- **Control of imports:** New requirements for imports entered into force in February: Importers must submit to the Federal Administration of Public Revenues (AFIP) a complex sworn statement on purchases from abroad. The system has increased red tape and slowed the pace of imports; Brazil exported 23% less to Argentina in April than it did in April 2011. Economists estimate that this control will increasingly affect Argentine industry, which depends heavily on imports of components and machinery.

- **Amending the central bank charter:** The government in March approved a change that increased the amount of international reserves that can be used to pay government financial obligations. Those reserves have now been transferred to the Treasury. It also mandated that central bank international reserves not fall below US$47 billion. In 2011 they were US$52 billion.

- **Control of dollars:** The government has set new limits for purchasing dollars and sending money abroad that AFIP is enforcing. Traditionally, Argentines save in dollars. Both the middle class and businesses consider the measure to be unfriendly. At first, the measure caused the dollar to rise in the parallel exchange market. In exchange houses and banks, the price follows the government’s decisions; in early May, they quoted the dollar at about 4.40 pesos. However, in shopping malls, some shops accept U.S. dollars at the rate of 5 pesos per dollar.

- **Media concerns:** The opposition accuses the Argentine government of not being transparent in managing public resources, particularly what it spends on advertising. Concern has increased about the concentration of media in the hands of companies sympathetic to the government, according to the UCR party, after the April announcement of the sale of the group that owns radio Diez, the most popular station in the country, to C5N TV, which is second in cable television audience share and owned by a businessman that reportedly supports the government. The government and the press have been contending about this since at least 2009 when a new law for the sector was approved.

- **Inflation:** Fearing government fines, private consulting firms no longer publish their own estimates of inflation. However, the parliamentary opposition is doing so. It estimates inflation to be almost double the official rate, which Indec (National Institute of Statistics and Prices) claims is about 10%. With the lack of reliable price statistics, prices have been increased more often, especially for food.
The bankruptcy of Mercosur

Lia Valls Pereira

The rise of protectionism and Argentina’s nationalization of the YPF oil company illustrates how bankrupt the Mercosur project has become. Brazil can only lose by being identified as belonging to the same group as Argentina. It is being harmed from an economic point of view, and recent events are being used to strengthen the position of sectors that do not consider regional integration to be relevant.

On April 16, 2012, the Argentine government announced the expropriation of 51% of the shares in oil company YPF held by the Spanish company Repsol, which was YPF’s main shareholder. The justification claimed was that a lack of investment had brought about a trade energy deficit that started in 2010. (Critics of nationalization instead blame the government’s policy since 2003 of controlling oil prices, which inhibited YPF’s plans to expand production.) Another view sees the expropriation as a nationalist strategy to ensure the development of Argentina’s strategic reserves, one that parallels increasing protectionist measures since 2008.

The nationalist bias of Argentine politics seems to stem from both political and economic assessments. Some nationalist

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symbols (the Falkland/Malvinas Islands and the YPF nationalization) are politically popular with some sectors of society. The economic issue relates to constraints on the country’s stable development.

**Growth**

After defaulting on its external debt and seeing GDP fall by 10%, Argentina in 2003 entered a period of high economic growth that coincided with the election of President Nestor Kirchner. The winds stayed favorable due to high commodity prices, despite the shock of the global crisis of 2008–09. However, underlying restrictions on sustained growth in Argentina came to the forefront after the crisis as President Cristina Kirchner reaped the legacy of the 2002 default and Argentina found it difficult to obtain financing in international capital markets.

In 2011, uncertainties again dominated the international scene. World trade had grown by 14% in 2010 but fell to 5% in 2011, and the World Trade Organization (WTO) expects growth of only 3% in 2012. At the same time, Argentina started recording deficits in the oil and current account balance of payments. A tax imposed on soybean exports later had to be lifted; private pension funds were nationalized; and central bank international reserves were used to finance government. Meanwhile, the Kirchner administration sought to address the current account deficits with protectionist measures that have been widely criticized.

At the March 30 meeting of the Council for Trade in Goods of the World Trade Organization (WTO), the United States submitted a statement, with which at least 11 countries and the European Union concurred officially, that expressed concern about Argentina’s protectionist trade practices. According to the WTO, among countries that did not sign the declaration but did express support were Mexico, China, Colombia, Peru, Singapore, and Malaysia. Thus the countries unhappy with Argentine practices account for almost 50% of Argentine exports. Argentina’s principal trade partner, Brazil (market for 20% of Argentine exports), remained silent.

**Exports**

In 2011 Argentina was the third largest market for Brazilian exports (8.9%), after China (16.5%) and the United States (12%). In early 2012, new Argentine rules for imports steeply suppressed Brazil’s exports to Argentina. Though total Brazilian exports increased by 7.5% in the first quarter of 2012 year-on-year, exports to Argentina fell by 4.4%; exports of Brazilian manufactured goods fell 2.4%. Argentina buys 20% to 25% of Brazilian manufacturing exports. Reports of Brazilian trucks stuck at the Argentine border waiting for release of their loads have become frequent. (Though about 50% of trade between Argentina and Brazil is automotive-related, that trade is still protected from these measures.)

In addition to the possible losses to exporters, the irritation caused by Argentinean protectionism further worsens the fragile discipline of Mercosur. Speaking to the World Economic Forum on Latin America in April in Puerto Villarta, Mexico, The president of Spain, Mariano Rayo, has said that the Argentine decision to nationalize the YPF is damaging to all Latin America.
We do not believe that Brazil’s image has been contaminated by the Argentine government’s policy choices. However, they have damaged small and medium-sized Brazilian companies.

the president of Spain, Mariano Rayo, said the Argentine decision to nationalize YPF is damaging to all Latin America. The decision creates a precedent that investors fear could be repeated elsewhere in the region, at a time when recovery of the world economy is still uncertain. As a result, we should expect less European investment. Countries in the region should understand that Europeans need regional leaders to work to curb protectionist actions of their neighbors. If the European Union supports Spain, Brazil could promote debate in Mercosur on how to minimize conflict. After all, strengthening Mercosur requires that the whole region be economically stable. The problem here is that for some time national interests have outweighed the Mercosur union.

Caution
What is the impact for Brazil? The Brazilian oil company, Petrobras, has announced that its investments in Argentina’s energy sector will continue to be guided by criteria that ensure continuing profitability. Brazilian companies established in or intending to invest in Argentina are on hold, but Argentina is an important step toward internationalization of Brazilian companies.

So far as trade relations go, agreement between Mercosur and the European Union seems ever more distant. Those who advocate a Brazilian trade agenda of agreements independent of Argentina see recent events as arguments in defense of their positions. Argentina’s protectionist measures also stimulate demands that Brazil retaliate.

We do not believe that Brazil’s image has been contaminated by the policy choices of the Argentine government. However, they have damaged small and medium-sized Brazilian companies that in general have more difficulties in overcoming bureaucratic hurdles and diverting their production to other markets.

Recent events in the region, not only Argentina’s protectionism but also nationalization of foreign companies in Bolivia as well as Argentina, retard the consolidation of Mercosur, which was intended to raise the region’s competitiveness and improve its people’s welfare. This has happened before. Mercosur negotiations stopped in the late 1990s and did not resume until 2003. Since then, as the largest economy in Mercosur, Brazil has been active in promoting investments in the region and pays most of the joint project costs. This new Brazilian attitude, however, has been accompanied by a relaxation and virtual abandonment of any discipline Mercosur created over the years. Countries’ claims have been accommodated by making exceptions to the common external tariff (customs union, if any, is not likely before 2018) and free intra-regional trade. Recent events only reinforce this trend.

In addition to the possible losses to exporters, the irritation caused by Argentina’s bureaucratic protectionism further worsens the fragile discipline of Mercosur.
To what can we attribute the relatively tranquility of the Brazilian economy through the global crisis?

Compared to Europe, especially the euro zone, which was most affected, Brazil has not experienced the excessive and euphoric private sector borrowing that happened in some European countries. . . . After decades of inflation that were extremely harmful to the economy, the Brazilian banking system has learned to be cautious. Also, the Central Bank of Brazil has a long tradition of regulating and supervising financial institutions properly, for instance, applying leverage rules more severe than those of other countries. When the crisis came, since about 20% of financial institution funds were from external financing, we caught some of the effects of the credit crunch that occurred elsewhere. However, since we did not have the same problems as other economies, the fiscal stimulus has not excessively increased public debt. Above all, the space for monetary easing was enormous due to the high interest rates. The results were clear in 2010, when the economy experienced fantastic growth, 7.5%, well above its potential. As always, such a jump raised concerns about inflation, leading to reversal of the stimulus measures and the consequent slowdown in economic activity we can see today. We are now in a new phase of monetary easing, but the effects of the previous phase still predominate.

José Júlio Senna
Managing Partner at MCM Associated Consultants and former director of the Central Bank

“One savings with fixed interest rate was an anomaly”

Claudio Accioli, Rio de Janeiro
Brazil's GDP grew 2.7% in 2011, and IBRE studies suggest that growth potential is in the range of 3.5%. How can we improve these numbers?

The main problem is that today the Brazilian economy has very modest growth potential due in large measure to low savings and investment. To correct the savings problem, public sector spending needs to be cut; indeed the public sector does not save anything . . . . As a result, investment as a whole oscillates at less than 20% of GDP because there is not enough savings. Our infrastructure bottlenecks result from lack of public sector investment. High taxation and stifling bureaucracy also suppress economic growth. Finally, low productivity is mainly due to the poor quality of human capital. The last census of the Institute of Geography and Statistics shows that the share of population with access to primary education had gone up considerably, but the quality of education leaves much to be desired.

Industry has been one of the sectors most affected by low economic growth. Is there a risk of deindustrialization?

As an economy develops, it is natural that the share of industry in total GDP declines. But I believe an important part of the recent fall is related to two factors: loss of competitiveness, due to factors such as those already mentioned, and an inadequate system of incentives. I am very concerned about the industrial policy recently adopted by the government. The measures promote the idea that only those who enjoy a good relationship with the central authorities have a chance to benefit by getting tax cuts or subsidized credit from government-owned banks. It is a policy of picking winners that transmits skewed signals to the economy.

Moreover, it is clear to everyone that lower interest rates stimulate economic activity, so why restrict the benefits to only 10 or 15 sectors? The program also suggests that subsidized loans may increase the investment capacity of Brazil, but again investment requires savings. A recent study by the International Monetary Fund concluded that if Brazil had domestic savings similar to that of Chile and Mexico, about 22% of GDP, its real interest rate would be 2 percentage points lower.

What do you think of the government’s effort to bring interest rates down?

Let's look at what happened with interest rates: From 2005 to 2008, the average real central bank policy rate was 9.40% and average inflation was 4.80%, close to the government target of 4.5%. The target was met even when interest rates were high. Between 2009 and 2011, the real interest rate fell to 4.60% and average inflation rose to 5.80% . . . . Inflation rose, but it did not explode. It is easy to understand the government rationale: If we can reduce the real interest rate by more than half and inflation rises only moderately, it is worth paying the
price. It’s an acceptable trade-off to have a little more inflation in exchange for more robust economic activity, higher employment, and lower interest payments on public debt—not to mention the political gains. Government is attempting to take the opportunity of the global crisis to bring about a significant reduction in interest rates, paying a relatively modest price, according to the official understanding. But the inflationary risk of this strategy seems obvious.

What real interest rate level would result in a monetary policy that is neither expansionary nor contractionary (a neutral real interest rate) for the Brazilian economy? It is a slippery concept, because it is not an observable variable, but there are reasons to believe that the neutral real interest rate in Brazil has actually fallen because inflation volatility is lower, the central bank has more credibility, and especially in 2007 the country was transformed into a net international creditor. It is not known, however, how much space the real interest rate has to continue falling. Many economists worry about future inflation, given the aggressiveness with which this policy of lowering the real interest rate has been conducted. It must be recognized, however, that several factors are helping to keep inflation relatively low. . . . The prices of imported goods have been favorably stable, which has generally helped to contain inflation. Thus it appears from all indicators that we will have a long period of low interest rates.

What do you think of the changes in the remuneration rules for savings accounts? The fixed real interest rate for savings was an anomaly. It was one of those distortions created to fight another distortion in a very particular moment in Brazil’s history when inflation was very high. The present government has understood this for some time. The recent back and forth on the issue reflects the authorities’ uncertainty about the political cost of tackling the problem. President Rousseff is very popular in part because the public identifies her as the mastermind behind the low interest rate policy. So the government must have thought that if there is a political cost to changing the remuneration of savings accounts, there may also be a political gain if people understand that the change can enable even lower interest rates [on loans]. I think the adoption of flexible remuneration linked to variations in the central bank policy rate was a correct solution to the problem.

Our infrastructure bottlenecks result from lack of public sector investment. High taxation and stifling bureaucracy also suppress economic growth.
Low fixed capital investment and weak business confidence are slowing prospects for continuing economic recovery in the second quarter of 2012. However, it is expected that the strength of consumer demand and recent measures to stimulate industry will gradually improve economic activity later in the year.

IBRE has lowered its estimate for first-quarter GDP growth from 0.6% to 0.4%, measured by the moving average Economic Activity Indicator (EAI). Despite some acceleration of the 3-month moving average in April, the 12-month change in the EAI through April fell to 1.9% from 2.1% in March. For the second quarter, IBRE’s preliminary growth forecast is 1.2%.

Investment in fixed capital (machinery and equipment) did badly in March. In that month IBRE’s Monthly Indicator of Investment (MII) posted another fall compared with the previous month. In fact, all components of investment fell in the first quarter, leading to a significant decline of 2.5% compared with the previous quarter. The only reason first quarter growth was not even worse was growth in household and government consumption.

In April, IBRE surveys found business confidence generally, and industry confidence in particular, to be weak. However, business expectations are more favorable over six months, which suggests a good response to the measures to stimulate the industrial sector that the government recently announced. In contrast to the ebbing confidence of businesses, in April the Consumer Confidence Index rose for the third consecutive month. Thus, consumers’ perception of the economy in general remains favorable, especially in terms of the labor market and lower inflation. This could favorably affect household financial expectations and increase consumer spending on durable goods.

External demand slows

That the global economy is less dynamic is clearly reflected in the slowing of Brazil’s exports: January-April exports increased only 4.5% compared with the same period of last year even though devaluation of the real exchange rate was greater. In the next few months, while the external environment should not have much effect on export performance, a higher trade balance is expected because growth of the Brazilian economy has been sluggish and recent protectionist measures will slow imports, which grew 7.4% in the first quarter.