Brazil: Is government economic activism misdirected?

In response to lost investment and growth, government policies to stimulate the economy have fallen short of success—perhaps because the policies themselves are part of the problem.

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Interview
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Economy, politics, and policy issues
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A new study from Barclay’s Bank argues that the government’s attempts to revive the economy have created uncertainty that has itself now become part of the country’s economic problems and may be a reason why fixed investments have been sinking. Cláudio Accioli interviews one of the study authors and a number of other experts, including the current Secretary of Economic Policy and one of his predecessors, who express a broad range of opinions.

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GDP growth in the first quarter is expected to be about 1.0% quarter-on-quarter. However, we believe that because a significant portion of this growth resulted from transitory factors, there are considerable doubts that growth can be sustained over the coming quarters. For instance, industrial production has shown itself to be highly volatile. A little skepticism is still in order.
ECONOMY

Ratings of two government-owned banks downgraded
Moody’s lowered ratings for BNDES (the development bank) and Caixa Economica Federal (a mortgage lender) by two notches to Baa2, in line with the sovereign rating, citing significant growth of assets and loans and leaner capital ratios. (March 25)

Current account deficit much higher
Brazil’s current account deficit in February was US$6.6 billion, far above the US$1.7 billion deficit in February 2012. This year as imports surged to a record high for the month there was a larger-than-expected trade deficit in February of US$1.276 billion. (March 25)

Worst first quarter for Stock Exchange in 18 years
The Bovespa index accumulated a loss of 7.55% from January to March this year, falling to 56,352 points, the worst result in 18 years—and also the worst performance among the 18 major stock indexes of America, Asia, and Europe. (March 28)

Industrial production falls
Industrial production fell 2.5% in February compared to January. The contraction, which virtually nullifies the 2.6% expansion in January, affected more than half the sectors surveyed. The biggest drop was in durable goods, especially vehicles, which were down 9.1%. (April 2)

Fewer new jobs in February
In February 123,446 formal jobs were created in Brazil, a drop of 18% compared with February 2012, according to the Ministry of Labor. This was the worst result since February 2009. (March 20)

Consumer confidence down in March
In March the Consumer Confidence Index of the Getulio Vargas Foundation fell for the sixth consecutive month, dropping from March by 2%. Although Brazilian consumers today are not satisfied with the current situation, they are neutral (neither optimistic nor pessimistic) about the foreseeable future. (March 25)

Confidence in construction and commerce also down
The Construction Confidence Index of the Getulio Vargas Foundation (FGV) again fell, by 7.9% quarter-on-quarter in the quarter ended in March, continuing the slowdown since 2012. Similarly, the FGV Commerce Confidence Index declined for the third time in a row, by 2.3% in the quarter ended in March compared to the same period last year. Activity at the end of the quarter was moderate to strong but expectations for coming months are less optimistic. (April 3)

Inflation edges up again in March
Inflation crept up by 0.47% to 6.59% year-on-year in March, breaching the top of the central bank’s target range (2.5% to 6.5%). Food inflation more than doubled (13.48% year-on-year), contributing about half of total inflation. (April 10)

Retail sales drop suddenly in February
In February retail sales in Brazil unexpectedly fell 0.4% from January, the first drop in nearly a decade. Solid retail demand had been one of the few bright spots in a sluggish Brazilian economy, as record-low unemployment and interest rates kept families spending. (April 11)

INTERNATIONAL

US$100 billion BRICS reserve fund agreed
The BRICS will pool US$100 billion of central bank reserves to guard against economic crises, bolstering their calls to reform global financial institutions with a new mechanism of their own. The fund “would also contribute to strengthening the global financial safety net and complement existing international arrangements,” South Africa’s President Jacob Zuma said. (March 27)

POLITICS

Campos running for president in 2014
In recent weeks the governor of Pernambuco state, Eduardo Campos (Brazilian Socialist Party, PSB), has held talks with several parties and business sectors. At a luncheon sponsored by the Institute for Retail Development, he asserted that Brazil needs a clearer foreign trade policy and that the federal government should prioritize sectors of the economy that have comparative advantage. He also listed his own social, educational and health services achievements as governor. (March 15)
US$30 billion direct currency swap between China and Brazil

Brazil and China agreed to swap up to US$30 billion in Brazilian reais and Chinese renminbis over the next three years, part of China’s push to make the renminbi a conduit of global trade. In signing the agreement, their finance ministers and central bankers said the pact might then be renewed. (March 26)

Primary budget deficit of R$3 billion in February

In February Brazil’s government posted a consolidated primary budget deficit of R$3.0 billion (US$1.5 billion) in February, the central bank said, reducing the 12-month primary budget surplus to 2.16% of GDP in February from 2.46% in January. The primary budget balance represents the excess of revenue over expenditures excluding interest payments. The monthly deficit is an abrupt turnaround from January’s R$30.3 billion surplus; it is primarily due to large federal transfers to state and municipal governments in February. (March 28)

Tax cut for vehicle purchases extended

The Brazilian government has extended the reduction of the industrial product tax on vehicle sales through December in an effort to boost the domestic economy and contain inflation. (April 1)

Tax cut to stimulate capital goods purchases

Elimination of the financial operations tax on infrastructure and economic development financing will help open up credit for capital goods, Finance Minister Guido Mantega said. (April 2)

Industry and service payroll taxes cut

President Dilma Rousseff has signed a bill to lower payroll taxes in the industry and service sectors to stimulate the economy and encourage companies to hire more workers. It relieves certain companies from paying 20% payroll taxes. However, businessespeople have criticized cuts of payroll taxes for some sectors. (April 4)

Monetary policy committee raises interest rates

The monetary committee ended an easing cycle that had lasted nearly two years by raising the central bank’s policy lending rate by 25 basis points, to 7.50%, in response to a surge in inflation. Six members of the committee voted to raise the policy rate higher than expected and two members voted to keep it unchanged. In the accompanying statement, the monetary committee said that in its judgment the high level and the resilience of inflation required a response. It also noted that domestic and especially external uncertainties call for caution in managing monetary policy. (April 17)
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Should the administration reconsider its policies?

President Rousseff is extremely self-confident and energetic: Once she commits to a direction, she stays committed. She sincerely believes in government-led rather than private-sector-led growth. In contrast, she lacks the pragmatism of her predecessors Lula and Fernando Henrique Cardoso.

It is obvious that recovery remains shaky with key indicators uneven: Industrial output shrank more than expected in February, suggesting a long-expected rebound in the industry has yet to take place, and the stock exchange index fell 7.55% in the first quarter of 2013, its worst performance in 18 years. The IBRE Economic Outlook raises doubts about whether even the minimal recovery so far is sustainable. Should the president reconsider her administration policies?

Rousseff has remained immensely popular half way through her term in office. Unemployment was low and real wages continued to rise. Now Brazilians are holding on what they have rather than spending it. Not a promising sign for the economy.

Everyone has an explanation about what the basic problem is with the Brazilian economy: a difficult business environment both globally and domestically, the Brazil cost, the inventory adjustment cycle, lagged positive effects of loose monetary policy. The newest is discussed in the cover story: activist short-term government policies to revive investment and growth have created uncertainty.

The cover story analyzes a new Barclays Bank study that found fixed investment in Brazil began dropping when the government began to intensify protectionist measures and favor some sectors over others with tax and other breaks.

In the featured interview, Domingo Cavallo, former Minister of Economy of Argentina, comments, "Brazil has not moved fast enough on microeconomic reforms or on the fiscal, tax, and regulatory reforms that are essential to increase productivity. The good thing is that Brazil has maintained the direction of reforms made so far. The bad, or not so good, is that it has never made reforms fast enough."

At this point, government activism itself may have become part of the problem. Business confidence indicators are already down. If the economy continues to perform poorly and they worsen, unemployment could turn up abruptly, and incomes could turn down. Brazil certainly doesn’t need more economic indicators going in the wrong direction.

When all aspects of the economy seem to be headed the wrong way, reconsidering policies is not only sensible, it is the right thing to do. The president is a straightforward and sensible person who puts the interests of the country first. She should reconsider some of her administration policies.

When all aspects of the economy seem to be headed the wrong way, reconsidering policies is not only sensible, it is the right thing to do. The president is a straightforward and sensible person who puts the interests of the country first. She should reconsider some of her administration policies. She has already moved a little in that direction by changing some of policies, notably by improving to some extent the attractiveness of infrastructure concessions for the private sector. However, much more remains to be done to mobilize private savings and investment.

In discussing the run-up to the elections in 2014, our political columnist said that even if economic winds might have seemed to favor Rousseff to a large extent, "It is easy to spot dark clouds on the horizon." We can feel the favorable winds dropping and see the dark clouds massing. Why can’t the administration?
Elections 2014: Characters in search of a plot

João Augusto de Castro Neves, Washington D.C.

BRAZIL’S NEXT PRESIDENTIAL election is still a year and a half away, but it seems that campaign season is already in full swing. Much recent media attention has been given to potential candidates, shifting coalitions, and President Dilma Rousseff’s reelection chances. In fact, even the president’s decision to replace four ministers in March was perceived by many as a strategic move on the electoral chessboard. The newly anointed cabinet members openly acknowledged that the main reason for their appointment was Rousseff’s need to strengthen the ruling coalition and pave the way for her reelection. As usual, policy gave way to politics.

With approval ratings near 80%, Rousseff is the odds-on favorite in next year’s election. Low unemployment and rising wages sustain her popularity despite two years of lackluster economic growth (2.7% in 2011 and 0.9% in 2012). While economic activity is recovering more slowly than anticipated, GDP growth this year will most likely be this administration’s best so far (at least 3%). This momentum should help consolidate Rousseff’s advantage, even if her approval ratings decline a bit in coming months. If the government can keep mounting inflationary pressures from getting out of control, the balance will tilt in her favor even further.

Despite the incumbent’s clear advantage, however, the 2014 race may be the most interesting presidential election in a decade, at least when it comes to the number of likely well-known candidates. In addition to Rousseff, at least three other hopefuls are lined up to do battle: Senator Aécio Neves, former Senator Marina Silva, and Governor Eduardo Campos. While Neves is from the country’s second most populous state (Minas Gerais) and enjoys
the support of Brazil’s main opposition party, the Social Democrats (PSDB), in the 2010 elections Silva performed impressively as the Green Party candidate, grabbing 20% of the votes in the first round. Moreover, it is quite possible that former presidential candidate José Serra (PSDB) will leave his party to run again.

Yet the true novelty in 2014 will be Governor Campos. As the main leader of the socialist party (PSB), his presidential bid would represent the first real challenge emerging from within the ruling coalition. Furthermore, as the governor of an important northeastern state (Pernambuco), his candidacy might also constitute a threat to the dominance of the Workers Party (PT) in an important regional stronghold. Equally interesting is that his yet untested name and image as a leader from a younger generation may also pose a threat to the opposition. Since his political profile overlaps somewhat with that of Neves, the two may end up competing for the same votes.

While many intriguing candidates are beginning to appear on the electoral stage, most of them still need to craft a clear campaign message. This is not a trivial task when confronting a popular government. PSDB’s three consecutive defeats serve as proof that being in the opposition is not necessarily the same thing as offering itself as a credible alternative to voters. The party’s frequent silence and the lack of consistent views with respect to many of the country’s pressing issues underscore the challenge. As for candidates whose parties were (Silva) or still are (Campos) members of the ruling coalition, conveying a credible alternative message to voters without appearing incoherent may prove even more difficult.

Certainly there is still time for the tide to turn. The campaign is only just beginning, and candidates may be testing the waters before voicing specific policy preferences. And even if economic winds appear to favor Rousseff to a large extent, it is easy to spot dark clouds on the horizon that deserve the close attention of any presidential hopeful. Excessive state intervention in key sectors of the economy, growing inflationary pressures, and a proclivity toward protectionism are just a few examples of topics that candidates will have to explore.

So far, however, the lack of any real debate on issues is not diminishing the media’s early obsession with next year’s election. Maybe after all it is just an indication that, in Brazilian politics, the cast of characters is always more important than the actual story.
In response to lost investment and growth, government policies to stimulate the economy have fallen short of success—perhaps because the policies themselves are part of the problem.

Cláudio Accioli, Rio de Janeiro

When President Dilma Rousseff took office on January 1, 2011, she certainly did not imagine it would be so hard to sustain the economic growth achieved during her predecessor’s administration, which was averaging about 4% a year. After all, Brazil had traversed the international crisis less traumatically than most of its peers, with only a slight decline of 0.6% in GDP in 2009 and an impressive 7.5% recovery in 2010. There was reason then to believe in better days. Reality has proved different.
Despite government action to boost consumption and economic activity—cuts in interest rates to historic lows and tax breaks for certain industries—Brazil’s growth rates have been disappointing, mainly because investments have been sinking. They closed 2012 with a drop of 4%.

There is no shortage of attempts to explain the anemic economy, for example, the Brazil cost, the difficult business environment, the inventory adjustment cycle, the lagged positive effects of loose monetary policy. The newest hypothesis to gain credence, however, is that government’s policy activism to revive investment and growth has created uncertainty. The policy has become part of the problem.

In May 2012, the IBRE Letter warned against the government being tempted to micromanage the economy. It distinguished between systemic measures, such as reducing the benchmark interest rate, which can benefit the whole economy, and actions intended to benefit specific sectors, such as exchange rate interventions, control of fuel prices, changing taxes on credit and financial flows, credit subsidies, barriers (tariff and nontariff) to foreign trade, and sectoral tax exemptions.

As the IBRE Letter said a year ago, each discretionary benefit given to one sector generates side effects. Often the next discretionary measure has to attempt to correct damage done by the previous one. When the government sends confusing signals to the market, businesspeople become more defensive, and less inclined to invest. If this hypothesis is true, the medicine may be aggravating the disease. Micromanaging the economy and showing favoritism to this or that sector intensifies the loss of competitiveness and profitability of the economy as a whole.

REALITY CHECK

Marcelo Salomon, chief economist for Latin America at Barclays Bank, not only agrees with the hypothesis but has the numbers to validate it. In a recent Barclays study, Salomon and economist Guilherme Loureiro identified a structural break in Brazil’s fixed investment growth as a major cause of the poor performance of the Brazilian economy. They found that fixed investments began dropping when the government began to intensify protectionist measures and incentives to industry in early 2012.

“Based on the evolution of investment growth in Brazil since 2003, we did two simulations for [fixed investment] in 2012, based on a simple regression model . . . . The simulations suggest that without the uncertainty, actual investment would have grown more than 6% in 2012, reaching almost 20% of GDP,” says Salomon. The exercise also shows that in 2012 uncertainty reduced economic growth.

Each discretionary benefit given to one sector generates side effects. Often the next discretionary measure has to attempt to correct damage done by the previous one.

by 2.1 percentage points (US$45 billion), which means that Brazil’s GDP could have grown 3% rather than its meager 0.9%.

The Barclays study compares Brazil’s investment growth with that of Argentina, Chile, Colombia, Mexico, and Peru, weighted by GDP. It found that fixed investment in Brazil recovered from the 2009 crisis faster than in other countries in the region, probably because of the favorable outlook: at the time for economic growth in 2010. But then investments in Brazil took a sharp downward turn, underperforming the rest of the region.

According to Salomon, the poor performance of the Brazilian economy cannot be attributed to the international crisis alone. “While part of the blame has fallen on the global scenario,” he says, “other Latin American economies, which suffer from the same uncertainties, are experiencing much higher and more stable growth . . . We believe that the problem is the structural break in fixed investments caused by government interventionism.”

According to the Barclays study, in recent years, Brazil has adopted over 20 measures to stimulate economic activity and two score capital controls. “The heavy emphasis on short-term growth has limited the government’s ability to tackle structural problems. The lack of a consistent long-term strategy to address infrastructure deficiencies and stimulate private investment is also taking a toll on productivity and growth,” the study says.

SENSE OF URGENCY
The government seems pressed for time to recover lost ground. IBRE economist Silvia Matos says, “It was expected that investment would react
When the government sends confusing signals to the market, businesspeople become more defensive, and less inclined to invest.

standable, although not the most appropriate option, that the government is trying to find short-term solutions to persistent problems: “The government has sought through ad hoc measures to reduce the costs of some services or improve conditions for investment. The problem is that sometimes what we imagine as protection or encouragement to one sector of the economy ends up burdening some other productive sector, where it becomes a disincentive to new investments.”

“The great risk of micromanagement is the loss of efficiency in the economy. A problem is addressed, often inefficiently, in the measures to stimulate activity, especially the significant cut in the benchmark interest rate. But there was no clear [investment recovery]. Given this adverse scenario, the government started looking at the economy with a magnifying glass and taking local measures. The question is how to do it without killing investor animal spirits.”

Similarly, Marcos Lisboa, executive director of the Institute of Education and Research (Insper) and Secretary of Economic Policy in the first Lula administration, distinguishes between the problems to be faced and the government strategy for solving them. As he explains, “On the one hand, Brazil has become a country where it is increasingly difficult to invest and produce. It is difficult to import goods, construct a building or a dam, because the authorization processes are complex, often with overlapping agencies. This leads to uneven behavior, penalizing sectors that are more dependent on fixed investment, such as industry, while those less dependent [on fixed capital], such as services and commerce, keep growing and hiring large numbers of workers. This is the structural side of the story. The other side concerns the way to tackle this situation.”

Lisboa thinks it is under-
Measures to stimulate growth

Dec. 3 The Central Bank introduces macro-prudential measures to safeguard the financial system. It raises bank reserve requirements, increases capital requirements for household credit operations with more than 24 months of maturity, and increases the minimum deposit guaranteed by the Guaranty Fund for Credits (FGC).

Dec. 16 The government grants incentives to foster infrastructure project investments, including tax incentives for long-term corporate bonds to finance infrastructure projects, and the creation of a fund to stimulate liquidity of those bonds in the secondary market. The National Bank for Economic and Social Development (BNDES) is allowed to issue bonds to reduce its dependence on National Treasury funding.

Apr. 7 To contain domestic household credit expansion, the Central Bank doubles the Tax on Financial Transactions (IOF) levied on household credit to 3.0%.

Sep. 16 The government raises the Tax on Industrial Products (IPI) on imported vehicles that do not meet the new requirements of domestic content.

Nov. 14 The Central Bank eliminates some of the increases in capital requirements for new consumer loans.

Dec. 1 The government lowers the IOF tax on household credit from 3.0% to 2.5% and reduced the IPI tax on home appliances.

Apr. 3 The government announces: A reduction from 20% to 0% of the social security contribution on payroll for 15 sectors of the economy; a new BNDES capitalization totaling R$45 billion, or 1.0% GDP, more resources for the export financing program; a higher PIS/Cofins social contribution tax on imports, and public sector purchase rule prioritizing domestic goods and services.

May 4 Government changes saving account interest rate rules to give room for the Central Bank to cut its policy rates below 8.5%.

May 21 To stimulate growth, the Central Bank reduces bank reserve requirements to free resources to finance auto loans, the government cuts taxes on new autos and lowers the IOF on car loans, and the BNDES establishes a credit line for investments.

Jun. 27 The government allocates R$8.4 billion (US$4.2 billion) to accelerate the government purchase of goods, favoring domestic industry.

Aug. 15 The government announces the first part of a broad infrastructure investment program to attract private sector investments in toll roads and railroads.

Aug. 29 The government extends the IPI tax cut on vehicles until the end of 2012.

Sep. 4 The government announces an import tariff hike on a list of 100 products.

Sep. 7 The government announces a cut in energy prices for both industrial and consumption segments for next year.

Sep. 17 The Central Bank cuts bank reserve requirements to boost inter-bank liquidity.

Dec 7 The government announces new rules for port concessions in Brazil.

Dec. 19 The government extends the IPI tax cut on vehicles, appliances and furniture until June 2013. This tax cut will be gradually phased out thereafter. It extends the payroll tax cut to all retail sectors after April 2013.

Dec. 20 The government announces the third part of a broad infrastructure investment program, including the privatization of Rio de Janeiro Galeão and Minas Gerais Cofins airports. The announcement also includes subsidies to stimulate regional aviation and new concession rules.

Jan. 15 The government requests that the cities of São Paulo and Rio de Janeiro postpone the hike of bus fares to avoid a higher IPCA inflation reading in January, which could fuel inflationary expectations for the year.

Jan. 24 The government reduces energy prices by 18% for households and 32% for industry.

Mar. 11 The government reduces tax on basic food and toiletries.

Mar. 30 The government extends the IPI tax exemption on cars to the end of the year.

Apr. 2 The government eliminates the IOF levied on loans for infrastructure projects related to concessions to the private sector. 6% IOF on foreign investment in government bonds is maintained.

Apr. 5 Government extends the elimination of payroll taxes to more sectors of the economy.
A recent Barclay’s study found that fixed investments began dropping when the government began to intensify protectionist measures and incentives to industry in early 2012.

The Brazilian Economy

and later creates other problems, “adds Samuel Pessôa, IBRE/FGV associate researcher.

“The discussion about interventionism and micromanagement does not seem to be a careful assessment of what actually is happening with economic conditions in Brazil and what we are implementing,” says Marcio Holland, Secretary of Economic Policy of the Ministry of Finance. He underlines the context of Brazilian economic policy: an adverse global scenario still surrounded by uncertainties.

Another explanation for the private sector’s lack of appetite, Holland says, is the sudden change in expectations about economic growth in the transition from 2010 to 2011. “The fall in investment last year is much more associated with clear business logic than the perception of government activism. From the second half of 2011, there was an increase in inventories and lower capacity utilization. It was a natural process of accommodation of an economy that grew at 7.5% in 2010, fell to 2.7% in 2011, and signaled even smaller numbers ahead, although at the time no one foresaw 0.9%. In this environment, entrepreneurs do not invest. This is probably one of the most important variables to explain investment performance in Brazil in 2012,” Holland says.

NEW FRAMEWORK

Holland maintains that the country now has a new macroeconomic framework formed by a tripod that is different from what was the mainstay of Brazilian economic policy in recent decades. He emphasizes that “We reduced the interest rate to finance production, we managed the exchange rate to ensure external stability and competitiveness of domestic industry, and we implemented fiscal consolidation, which made it possible to reduce and improve the public debt profile, in addition to monetary easing. These changes are permanent and affect the productivity and competitiveness of the economy very positively. We are also taking important steps in tax reform, with changes in the VAT and social contributions and reduction of payroll taxes. These measures will take a little longer to impact investment, since they were adopted recently. But definitely, it is not micromanagement.”

Disagreements aside, most experts recognize that the government’s efforts have merits, especially when it comes to measures of more prolonged effect. Former Minister of Finance Delfim Netto says it is “overkill” to believe that government activism could be an obstacle to resumption of investment. “President Rousseff has made some interventions that are structural and will produce results in the long term, correcting problems that have
## Capital Control Measures

### 2008
- **Mar. 12**  The government introduces 1.5% IOF tax on all investments fixed income (investment) by foreign investors.

### 2009
- **Oct. 20**  The government raises from zero to 2% the IOF on all fixed income and equity investments by foreign investors.
- **Oct. 4**  The government raises from 2% to 4% the IOF tax on all fixed income investments by foreign investors.
- **Oct. 18**  The government increases from 4% to 6% the IOF tax on all fixed income investments by foreign investors, and raises from 0.38% to 6% the BM&F commodity exchange margins for foreign investors.

### 2010
- **Mar. 12**  The government introduces 1.5% IOF tax on all investments fixed income (investment) by foreign investors.
- **Oct. 22**  The government eliminates the IOF tax on all investments fixed income (investment) made by foreign investors.

### 2011
- **Jan. 6**  Cash reserve requirement on short spot US dollar positions of more than US$3 billion was raised to 60%.
- **Mar. 25**  3.8% IOF tax levied on all international credit card transactions.
- **Mar. 28**  6% IOF tax levied on all short-term external borrowing operations (less than one year).
- **Apr. 6**  The government extends the 6% IOF tax on all short-term external borrowing operations with a duration of less than two years.
- **Jul. 8**  The government extends the 60% reserve requirement on short spot U.S. dollar positions to positions larger than US$1 billion.
- **Jul. 27**  The government establishes 1% IOF tax on onshore U.S. dollar derivatives transactions that increase the short US dollar position by more than US$10 million in one day.
- **Sep. 16**  The government introduces a new bill with a more comprehensive structure but in line with the measures of July 27.

### 2012
- **Dec. 1**  IOF tax on foreign equity investments is reduced from 2% to 0%, and on long-term private debt instrument debentures is reduced from 6% to 0%.
- **Mar. 1**  The government extends the 6% IOF tax to all external borrowing operations maturing in less than 3 years (from 2 years).
- **Mar. 2**  All export financing of more than 360 days becomes subject to the 6% IOF.
- **Mar. 7**  The Central Bank increases the pace of easing and slashes its policy rate by 75 bps.
- **Mar. 12**  The government extends the 6% IOF tax to all external borrowing operations maturing in less than 5 years (from 3 years).
- **Mar. 16**  The government eliminates the IOF tax on local derivatives markets for exporters hedging their flows.
- **Jun. 14**  The government relaxes the 6% IOF tax on all external-borrowing operations maturing in less than 2 years (from 5 years).
- **Dec. 5**  The government relaxes the 6% IOF tax on all external-borrowing operations maturing in less than 1 years (from 2 years).
- **Dec. 18**  The government increases the threshold to US$3 billion from US$1 billion of short spot US dollar positions that are exempt from reserve requirements.

### 2013
- **Jan. 31**  The government reduces from 6% to 0% the IOF levied on foreign investors who invest in real estate funds in Brazil.
accompanied us for a lifetime. For example, the reduction of interest rates, the payroll tax relief, mainly for export industries, and interventions in ports and energy. These are difficult policies with management problems and some noise in the short term, but they point in the right direction. When the measures for the ports have matured, we will have the solution to a problem that was there for 30 years without anybody doing anything,” he says.

However, he is not all compliments. Netto criticizes interventions whose effects are not permanent: “I do not think it is effective to combat inflation with ad hoc measures . . . . This is clearly a structural issue, linked to wage increases beyond the growth in labor productivity. Ad hoc policies of delaying price adjustments for short-term results, rather than mitigation, stimulate inflationary expectations, and the losses end up being greater than the gains.”

The example of inflation, which remains near the upper limit of the government’s inflation target (2.5% to 6.5%), has been emblematic of what happens when the government adopts ad hoc policies. IBRE’s Matos says, “The government cuts interest rates, expands credit from state-owned banks to stimulate private consumption, but supply does not follow and inflation rises. To try to work around the problem, it controls some prices but that affects the performance of state-owned oil company Petrobras and the alternative energy sector.

The study shows that in 2012 uncertainty reduced economic growth by 2.1 percentage points (US$45 billion), which means that Brazil’s GDP could have grown 3% rather than its meager 0.9%.

The intention is good, but you need to pay attention to all the gears.”

In defense of government policies, Holland says that Brazilian inflation has been within the target range determined by the National Monetary Council (CMN) since 2004, and that the food supply shocks that have occurred in recent years, both domestically and abroad, cannot be neglected. “Shocks severely affected the prices of agricultural commodities,” he says, which pushed inflation up. In addition, Brazil has low unemployment and the average income of workers has increased. “In this context, it is natural that Brazilian inflation would be higher than the world average. In any case, I do not think it is correct to say there is inflation management in Brazil. The government is implementing reforms and tax measures.”

Another sensitive area is fiscal policy, in particular measures the government has taken to meet its primary surplus target—what some have called creative accounting. According to the Barclays study, the “accounting tricks” used to meet the primary fiscal surplus goal in 2012 cast doubts on the government’s commitment to fiscal stability. Holland maintains that Brazil is in 12th place.
“While part of the blame has fallen on the global scenario, other Latin American economies, which suffer from the same uncertainties, are experiencing much higher and more stable growth. . . . We believe that the problem is the structural break in fixed investments caused by government interventionism.”

Marcelo Salomon

in the ranking of 100 countries in terms of greater budget and fiscal transparency. “Look at the crisis in Europe and the U.S. debate about the fiscal situation. Brazil is far from that,” he points out. “The debt-to-GDP ratio has been falling consistently, which means that we are generating a primary surplus that is even larger than necessary. . . . Brazil has surpassed any predictions of insolvency risk.”

WHAT NEXT?
Regardless of right and wrong or good intentions, to what extent might the government’s activism since early 2011 interfere in the decisions of private investors? For the analysts at Barclays, Brazilian policymakers seem to be in wait-and-see mode, recognizing that growth was worse than expected, but thinking it is now likely to recover. “Better business and consumer sentiment, lagged effects of monetary easing, credit, recovery and an expansive fiscal policy all support a better investment environment,” the study says, but it warns, “The uncertainty issue is critical and could more than offset these positive factors.” The study sees the possibility that a stagflation scenario could emerge if the government continues its activism, which would reduce investor confidence. Fixed investments would continue to trend down, pulling real GDP growth lower. The negative confidence shock could also depreciate the exchange rate, fueling inflation expectations and keeping it close to the 6.5% upper limit of the official target. This scenario could occur later this year as the 2014 election cycle begins.

“The attempt to control inflation by means of price administration, without the use of traditional instruments of monetary policy, demonstrates the inconsistency of the government’s policies,” says IBRE’s Pessôa. Salomon adds: “The first thing to be done is for the government to show that it has a medium- and long-term program to increase productivity. We are not talking about providing incentives or benefits to A or B sectors but about a plan that leads the private sector to believe that the government will actually work to reduce the tax burden, improve public spending, increase productivity, and invest in human capital.”

Lisboa of Insper also believes that government actions that are perceived by private agents as aimed at the short
term, though justifiable, can indeed produce undesirable side effects on private decisions to invest: “Energy, for example, took advantage of the renewal of the concession contracts to obtain an ad hoc reduction in electricity rates, but this did not affect the structural conditions of energy supply in Brazil. We know it will continue to be difficult to build hydroelectric plants in Brazil, and this ends up adding not only costs but also uncertainty to investment.”

Lisboa is concerned that the Brazilian economy lacks systematic analysis that can accurately measure the effectiveness of economic policy. “The National Bank for Economic and Social Development (BNDES), for example, has allocated a significant amount of resources to specific sectors at below-market interest rates. What is the outcome of this investment? How productive has BNDES been?” he asks. He is troubled that there are no mechanisms for measuring how cost-effective policies are. “Several sectors benefit from protectionist measures that imply higher production costs that society should pay, but we do not bother to check if the money was worth it. Such monitoring would also help us learn what kind of protection worked or did not, what kind of subsidized loans generated good results or what did not. That way, we could better assess the impact of public policies and participate more actively in the discussion of allocation of public resources.”

“The fall in investment last year is much more associated with clear business logic than the perception of government activism.”

Marcio Holland

Without the uncertainty, investment would have grown more than 6% in 2012.

Sources: IBGE and Barclays.
Argentina: The current inflationary crisis

**Domingo Cavallo**  
Former Minister of Economy of Argentina

The Brazilian Economy—As a consultant, have you advised the European countries most affected by the economic crisis? What are you recommending?

Domingo Cavallo—I did not advise any governments directly but I have expressed my opinions. I argued that they need to preserve the integrity of the euro, because no country should rebuild its national currency because that would mean destroying the contractual basis of the economy, and would reinstate inflation and uncertainty. We suffered from that in Argentina, and we are still suffering. I suggested cutting payroll taxes and replacing them with the value added tax (VAT) or any other that does not discourage hiring. Spain has announced that it will reduce payroll taxes a little in 2014 but only very timidly. I think this policy should be pursued much more vigorously not only in Spain but also in other countries suffering from high unemployment.

Keeping the euro is important. In Argentina, when the economy stabilized, we allowed the dollar to be used like the Argentinian peso as currency for transactions and contracts, and there was a lot of financial intermediation in dollars. When the government that took power in 2002 decided to abandon the peso-dollar parity, the consequences were very serious. The problem today in Argentina in the energy sector has to do with that, because at that time energy prices were fixed in dollars and in relation to investment.
and energy production costs. When prices were converted into pesos and then controlled, the costs increased because of the exchange rate devaluation but prices were not increased. Then all investment in the energy sector froze and demand for energy increased tremendously because prices were controlled. Now we have a huge energy deficit. It is a serious situation for a country which until 2001 was exporting electricity, gas, and oil.

Has any European country reduced payroll taxes, making it up with a higher VAT? Ironically, even before the crisis, Germany had adopted such a policy on a small scale. It’s almost a natural idea for countries that care about the competitiveness of their economies. This idea should be adopted to address the crisis, especially the unemployment in Spain, Portugal, Ireland, Greece, and Italy.

Is it possible to measure the impact of this policy in Germany?
Germany has never lost competitiveness—instead it has been winning it—but I think not so much because of this tax measure but because of a rise in productivity and a very prudent wage policy that did not increase unit labor costs. Other countries that had more generous wage policies were unable to increase productivity and efficiency by investing as Germany did.

Do you see any similarities between the economic imbalances that can now be seen in European countries and what happened in Argentina when you were minister?

“The best system in effect today is Peru’s. There you can use the nuevo sol or the dollar, and this gives the country a big advantage: it has very low inflation, and enough exchange rate flexibility that the value of the nuevo sol adapts to external shocks.” The origin of productivity imbalances is completely different. In Argentina, our loss of competitiveness was caused by deteriorating terms of trade. Between 1998 and 2002 export prices in Argentina went down because the dollar was a strong currency …. In 1994 China unified its exchange rates and depreciated the yuan. Then the Mexican peso was devalued in 1997 and so were almost all the Asian currencies. In 1998 the Russian ruble was devalued, and in 1999 the Brazilian real. And during 1999, 2000, 2001, the euro recorded a slow devaluation. This implied an overvaluation of the Argentine peso. However, Argentina’s competitiveness, coming from productivity and the quality of investment, registered an impressive increase. From 1990 to 2000 Argentine’s exports grew almost twice as much as Brazil’s.

Has the dollar-peso parity stimulated the quest for increased productivity?
In the 1990s there was a lot of investment, and above all it was efficient. Investments were oriented to increase productivity, which greatly improved transportation infrastructure, especially ports; industry was equipped with modern machines and advanced technology was adopted. Every automobile factory that now is producing at full capacity was installed in Argentina at that time. Agricultural productivity also increased impressively. The loss of competitiveness due to appreciation of the dollar should have reversed itself, and it happened starting in March 2002 with the fall in the value of
the currency. It was not necessary to devalue as Argentina did. Even with the devaluation of the peso, had they not converted contracts in dollars to pesos, the crisis might have been relatively short. In Greece, the situation is different. There were increases in salaries and in public and private spending. The quality of life improved but it was based on the indebtedness of households, businesses, and government, as well as on a transfer of funds from Europe. There was no increase in productivity. After several years, they realized that their labor cost was much higher than in Germany. The same happened to a lesser extent in Spain and Italy. They began to have access to cheap debt. With this they expanded infrastructure, with some very good projects but also exaggerated luxuries. That kind of excessive indebtedness did not happen in Argentina. At the time of the crisis in 2001, public debt was lower even than in Brazil, less than 50% of GDP. The indebtedness of households and companies was not so high either.

Some experts argue that adoption of a currency board is only successful in a small country with a procyclical dynamic, which was not the case in Argentina. Do you agree with this view?

What Argentina had was a bi-monetary system [in which the US dollar circulated as legal tender alongside the Argentine peso]. Actually for an economy with international exchanges as diverse as Argentina’s, we should have had a system with three or four currencies, allowing intermediations in euros or dollars. I think the best system in effect today is Peru’s. There you can use the nuevo sol or the dollar, and this gives the country a big advantage: it has very low inflation, and enough exchange rate flexibility that the value of the nuevo sol adapts to external shocks . . . . The substitution between U.S. dollars and nuevos soles is quite large and, for example, when there is a global excess liquidity of dollars, it does not lead to an extreme appreciation of the nuevo sol. In contrast, in a country that only has a national currency, excess liquidity of dollars and high interest rates in dollars cause the national currency to appreciate excessively, which brings about loss of external competitiveness. I believe that the more appropriate monetary system for open emerging economies is one in which national currencies coexist with foreign currencies that may also be used as legal tender, because that way there is full convertibility of the currency without the downside of a currency board.

Even with its macroeconomic management condemned, Argentina has continued to grow in the Nestor and Cristina Kirchner administrations—average growth was 7% over the last five years. How is that?

Very simple. First, when they came to power Argentina had a lot of investment and production capacity, and had greatly increased productivity. What was missing in 2001 and 2002 was foreign demand because of the appreciation of the dollar and the

“The appropriate monetary system for open emerging economies is one in which national currencies coexist with foreign currencies that may also be used as legal tender, because that way there is full convertibility of the currency without the downside of a currency board.”
world recession. Even so, Argentina’s exports continued to grow faster than Brazil’s. When the exchange rate depreciated, soybean prices and exports soared. This was an extraordinary benefit for Argentina, which allowed the government to charge high taxes on exports, something Brazil and other countries did not do. Also, the devaluation greatly reduced wages so that the government could give nominal wage increases, and control energy and transportation prices. But all this has paralyzed investments. Today Argentina is finding it harder to grow because it has many bottlenecks in key sectors of the economy. The Kirchner administration took advantage of the capability already installed and turned to a protectionist industrial policy, increasing import restrictions. There was some investment in this new phase of import substitution, but now industry as a whole is not competitive in terms of prices and quality products; the old problems of import substitution policies of the 1970s and 1980s have reemerged. Another important factor was inflation: in the beginning it supported the construction industry because people prefer to buy land and houses rather than save. But there were no new investments in gas, electricity, transport, oil .... Although the economy has grown; it lost a huge opportunity to grow on a sustainable basis with stability. Had fiscal and monetary management not been disruptive since the Duhalde administration, Argentina’s economy today would have been a lot like that of Canada or Australia.

What would you do currently to contain inflation in Argentina?

“**The Argentine government is a mix of characters that act disconnected and are not professionally prepared for the responsibility they have.**”

Today, a minister could not resolve the situation. Neither could the central bank governor. That will only happen with a president that inspires confidence, credibility. Kirchner can no longer correct the course of the economy. Nobody believes her, inside or outside Argentina. Today there is no economic team; there is no central bank governor. The Argentine government is a mix of characters that act disconnected and are not professionally prepared for the responsibility they have.

What should the economic team of a new government do?

At once, I would remove all the barriers the government has imposed on the foreign exchange market and foreign trade, and seek full integration of Argentina with the world, seeking a negotiated solution to recover foreign and domestic creditworthiness. It is essential that Argentina no longer lies about inflation and commits to having price indices calculated by an independent institution. With a program of liberalization of the Argentine economy and a president willing to give full autonomy to the Central Bank and to advocate for keeping inflation low and for inflation targeting—in that context it is possible to lower inflation. But before or during this process, there will be a recession. The government that seeks such a stabilization policy will have to have political support. That’s because suppressing inflation, the need for a large devaluation, and the recovery of utilities prices will require a tight monetary policy that will at first necessarily cause a recession.

Recession and inflationary explosion may happen before a new government takes over.
because of the Duhalde and Kirchner policies of the last 10 years, which had also been realized between 1972 and 1975, when Perón returned to Argentina. At that time, prices were controlled, the exchange rate was fixed, public spending was increased to stimulate the economy, and it was financed with large deficits. In June 1975, there was a package which included devaluation of the peso by 150% and doubling of prices for utilities, transportation, and fuels. The unions went on a general strike and demanded nominal wage increases that were of the same magnitude as the devaluation and increase in utility prices, and inflation rose from 30% a year—similar to today—to 150% a year . . . .

Today, in Latin America Argentina is not the only country tolerating inflation. What should be the fate of Venezuela, for example? Among the countries where there are nationalist, isolationist, very populist, very interventionist policies, some have monetary and fiscal prudence imposed by their monetary regimes. That is the case of Ecuador and Bolivia. These countries are able to maintain a better international image than those that have more tolerance for inflation . . . . [In Argentina and Venezuela] inflationary disorder is great and will have to be reversed—but it will be difficult to reverse if these two nations do not radically change the way their economies are organized.

Today, in Brazil, there is real concern about inflation, low growth, and external competitiveness. Where has Brazil failed? Brazil has not moved fast enough on microeconomic reforms including fiscal, tax, and regulatory reforms that are essential to increase productivity. The good thing is that Brazil has maintained the direction of reforms made so far. The bad, or not so good, is that it has never made reforms fast enough. Brazil looks like Colombia, which chooses to reform gradually. But Colombians have an economy that has not accumulated all the inefficiencies and distortions that Brazil has accumulated . . . . The tax system in Brazil is very costly for businesses, and tax evasion and informality prevent companies from accessing credit to invest and modernize. The best way to encourage companies to be creative and grow is to simplify the regulations and tax system . . . . One thing I have never understood is why the real interest rate—the rate for borrowers—is so high in Brazil. For me that is strange, given the number of banks in the country. When there is competition in the financial system, interest rate spreads should decrease.

Mercosur could contribute to the strengthening of our regional economies, at least on a commercial level. How do you see the future of Mercosur? I think Mercosur functioned only for five years, from 1994 to 1999—when Brazil had managed to stabilize its economy with the Real Plan and Argentina had its convertibility plan working. During that period, Europe looked at Mercosur as something admirable, it
wanted to negotiate free trade agreements, and in Brazil and in Argentina there was talk of a deal with the U.S. But Mercosur began to run into difficulties after the Brazilian real was devalued because obviously this meant a negative blow to Argentina. Still, there was a climate of dialogue and understanding until the 2001 crisis, when Argentina began to impose trade barriers. That was the end for Mercosur. When President Lula took office there was still an unprecedented opportunity to reverse this situation. The currencies of both countries were devalued and if at that time the Argentine government and central bank had imitated Brazil’s monetary policy, both currencies would have appreciated at the same pace and created a healthy climate of monetary integration between Brazil and Argentina. Instead, Argentina insisted on containing the appreciation of the peso, bought a lot of reserves, raised barriers to trade, and when inflation increased and there was capital outflow, imposed exchange controls. Today in practice Mercosur does not exist, especially with the incorporation of Venezuela, which is an invitation to finish it. What we have to think about in the next year or maybe in the next decade is to improve what remains of Mercosur as a good free trade area. I find it unthinkable that the bloc could become a customs union.

“Had fiscal and monetary management not been disruptive since the Duhalde administration, Argentina’s economy today would have been a lot like that of Canada or Australia.”

The Brazilian economy and macroeconomic scenarios

The Brazilian Institute of Economics (IBRE) Economic Outlook provides statistics, projections and analysis of the Brazilian economy:

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The crisis affected all countries in all sectors of the economy, to a greater or lesser degree. However, tourism has been performing remarkably well, even in the current difficult international situation. Tourism in Brazil grew 6% in 2012, according to data from the World Travel and Tourism Council—well above GDP growth. And the tourism forecast for 2013 is 5% growth, double the forecast for GDP. The World Tourism Organization is predicting that this sector will not be affected by the crisis in 2013. I say more: Tourism is a tool against the crisis that can help us to grow steadily and sustainably, with social inclusion and environmental preservation.

How do we attract tourists from European countries? How does Brazilian tourism grow when other economies are declining?

Our strategy must be to find new partners. Spending abroad by our traditional visitors has remained stagnant: Last year, Spain spent abroad only 3% more than in 2011, France 7%,
and Italy, our third largest source of visitors, fell 2% in spending abroad. In contrast, China’s spending abroad grew 42% and Russia’s grew 31%. Russians spend US$183 a day in Latin America, while Argentines, our main visitors from the region, spend US$54 a day in Brazil. We need to attract tourists from the BRICS countries, Malaysia, and Canada. We have included tourism on the agenda of the bilateral commission for cooperation between Brazil and Russia, headed by Vice President Michel Temer. Direct flights and facilitated connections between Brazil and Russia are on the agenda. We have also agreed on a memorandum of understanding for tourism cooperation among the BRICS countries to stimulate travel between member countries.

**How will the big events in this and coming years further promote Brazilian tourism?**

The major impact of these events for tourism is the improvement of infrastructure. In Brazil critical points are airports, roads, and public transport within cities, which are receiving billions in investments. The positive balance of the World Cup and the Olympics will not be felt immediately, although we expect 600,000 tourists and an increase of US$4.7 billion in tourist revenue for the 2014 World Cup. The work of the Ministry of Tourism will really begin with the final whistle of the last game, managing the legacy of the World Cup.

Preparation for the big event is our opportunity to dissolve major constraints. More recognition of Brazil as a world-class tourist destination will be seen in subsequent years.

**What are the expectations for attracting tourists and revenues for future years?**

Our major goal, set out in the National Tourism Plan, is to transform Brazil so that it has the world’s third highest tourism-related GDP by 2022. Today, we are the sixth. This will require annual growth of over 7%—challenging, but certainly feasible, given everything we are doing.

**How will the government’s planned investments in ports, airports, and highways benefit the industry?**

The benefit is total: Brazil ranks 129th in the world in land transport infrastructure, according to the World Economic Forum . . . . Better roads, ports, and airports mean lower transportation prices. That is one aspect. The other is to open opportunities to visit places that have tourism potential but are not currently accessible. The Ministry of Tourism participated actively in selecting priority airports for the first phase of the federal government program to encourage regional aviation.

**Regarding tourism services, what challenges still need to be addressed?**

The main one is the shortage of skilled labor,
which is a challenge not only for tourism but for the whole Brazilian economy. The Ministry of Tourism and the Ministry of Education are investing US$195 million to train 240,000 people under the National Program for Access to Technical Education (Pronatec) for the World Cup in 2014. The Ministry of Tourism also is partnering with Austria and Belgium for training courses at the college level for students of tourism in Brazil. The other challenges are infrastructure, prices, and taxation.

How does the number of foreigners visiting Brazil compare with the number of Brazilians traveling abroad?

It is unfavorable for us. Brazil is a country that spends more abroad than many others, which is a sign of the vitality of our economy but produces a permanent deficit in our balance of payments. Today, the deficit is about US$15 billion. The number of foreigners who come to Brazil has varied very little in recent years, hovering around 5 million. In 2012, we did a little better at 5.7 million.

There is much talk of the Brazil cost and how it ultimately affects tourism.

We included the sectors of hospitality, aviation, and road passenger transport in the Greater Brazil Plan last year. All these sectors were exempted from payroll taxes and started paying a flat rate of 2% on gross sales. For the hospitality industry alone, this represents annual savings of over US$100 million. In addition, the federal government lowered electricity rates, which has had significant impact on the entire economy, particularly hotels. We are still studying further tax exemptions for pubs, restaurants, and theme parks. Last year, the government set up a system for foreign trade in services and intangibles … the idea is to return [to tourists] part of the taxes on services purchased here.

How is inflation affecting the sector?

Inflation is bad for everyone. But the major concern for the tourist industry is the exchange rate..

“Our major goal, set out in the National Tourism Plan, is to transform Brazil so that we have the world’s third highest tourism-related GDP by 2022. Today, we are the sixth.”

“Russians spend US$183 a day in Latin America, while Argentines, our main visitors from the region, spend US$54 a day in Brazil. We need to attract tourists from the BRICS countries, Malaysia, and Canada.”
GDP GROWTH IN THE FIRST QUARTER is expected to be about 1.0% quarter-on-quarter. However, we believe that because a significant portion of this growth resulted from transitory factors, there are considerable doubts that growth can be sustained over the coming quarters.

The economic outlook has changed little in the past month. But some signs have become clearer, making it possible to better distinguish between what is transient and what is more likely to last out the year. What has become obvious is that consumer price inflation is rising in the short term, though there is hope that by mid-year it should begin to decline. A permanent problem may be the continuation of an expansionary fiscal policy in a situation where anti-inflationary monetary measures should be getting more support from fiscal policy. These are the most worrying aspects of recent developments.

Some factors suggest that part of the economic recovery in the first quarter resulted from events that are transient. First, agriculture is likely to perform well. Second, there was significant growth in the production of capital goods due to the resumption of production of trucks and buses, which had contracted by more than 36% in 2012. Consequently, industry and fixed investment will be looking better in the first quarter of 2013. With both agriculture and industry performing better, we estimate GDP growth in the first quarter will be about 1%. That means that the 12-month GDP growth will be up to 1.2% for the year ending March 2013.

But there are doubts about whether the growth is sustainable. Industrial production has shown itself to be extremely volatile; in February it sank 2.5% in seasonally adjusted terms over the previous month, nullifying the gain it had recorded in January.

One question is whether, once truck production is back to normal, capital goods production will grow enough to justify significant increases in fixed capital investment. Also, can industry maintain higher growth in the months ahead even without strong growth in capital goods?

Meanwhile, the performance of commerce, which had been quite satisfactory so far, has slowed as real incomes have been eroded by rising consumer inflation and a loss of near-term confidence in the services sector, after the resumption of growth in the third quarter of 2012 was frustrated.

A little skepticism is still in order on the economy’s strength as recovery remains shaky with key indicators showing uneven growth.
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