As Rio de Janeiro state diversifies beyond oil and gas, how can it tap its full potential?
Economy, politics, and policy issues
A publication of the Brazilian Institute of Economics. The views expressed in the articles are those of the authors and do not necessarily represent those of the IBRE. Reproduction of the content is permitted with editors’ authorization. Letters, manuscripts and subscriptions: Send to thebrazilianeconomy.editors@gmail.com.

Chief Editor
Vagner Laerte Ardeo

Managing Editor
Claudio Roberto Gomes Conceição

Senior Editor
Anne Grant

Production Editor
Louise Ronci

Editors
Bertholdo de Castro
Claudio Accioli
Solange Monteiro

Art Editors
Ana Elisa Galvão
Marcelo Utrine
Sonia Goulart

Contributing Editors
Kalinka Iaquinto – Economy
João Augusto de Castro Neves – Politics and Foreign Policy
Thais Thimoteo – Economy

IBRE Economic Outlook (monthly)
Coordinators:
Regis Bonelli
Silvia Matos
Team:
Aloísio Campelo
André Braz
Armando Castela Pinheiro
Carlos Pereira
Gabriel Barros
Lia Valls Pereira
Rodrigo Leandro de Moura
Salomão Quadros

Regional Economic Climate (quarterly)
Lia Valls Pereira

The Getulio Vargas Foundation is a private, nonpartisan, non-profit institution established in 1944, and is devoted to research and teaching of social sciences as well as to environmental protection and sustainable development.

Executive Board
President: Carlos Ivan Simonsen Leal
Vice-Presidents: Francisco Oswaldo Neves Dornelles, Marcos Cintra Cavalcanti de Albuquerque, and Sergio Franklin Quintella.

IBRE – Brazilian Institute of Economics
The institute was established in 1951 and works as the “Think Tank” of the Getulio Vargas Foundation. It is responsible for calculation of the most used price indices and business and consumer surveys of the Brazilian economy.

Director: Luiz Guilherme Schymura de Oliveira
Vice-Director: Vagner Laerte Ardeo

Directorate of Institutional Clients:
Rodrigo de Moura Teixeira

Directorate of Public Goods:
Vagner Laerte Ardeo

Directorate of Economic Studies:
Márcio Lago Couto

Directorate of Planning and Management:
Vasco Medina Coeli

Directorate of Communication and Events:
Claudio Roberto Gomes Conceição

Comptroller:
Célia Reis de Oliveira

Address
Rua Barão de Itambi, 60
Botafogo – CEP 22231-000
Rio de Janeiro – RJ – Brazil
Phone: 55(21)3799-6840
Email: ibre@fgv.br
Web site: http://portalibre.fgv.br/
THE BRAZILIAN ECONOMY

NEWS BRIEFS
4 Unemployment down, wages up … industry more confident … 4G problems threaten World Cup … electric power crisis on the horizon … 2012 inflation above target, within range … new political party planned … government loosens gas prices … fiscal discipline may be slackening … budget surplus target missed.

POLITICS
8 Roussef’s next step
Since the president’s economic policy priority has been to lower interest rates to more civilized levels, the challenge now will be to keep rates low despite growing inflationary pressures—and of course to get the economy going again. João Augusto de Castro Neves analyzes how that might be done, and what might get in the way.

COVER STORIES
10 Rio: An economy in transition
Both Rio de Janeiro state and its capital have put their finances in order, and the state plans to invest as much as US$100 billion between 2012 and 2014, stimulated by deep sea oil exploration and the coming international athletic events. Solange Monteiro talks to contributors of a new book on the state to find out how far the state has come, its family grant model, and the new promise of security in Rio city. She also discusses why the speed at which investments are being announced and the deadlines set for some sports venues have raised concerns.

22 How high can public education go?
Rio de Janeiro state is working hard to change its high level of educational inequality and its low supply of skilled labor. Thais Thimoteo talks with the state Secretary of Education and others about the new priorities: a minimum curriculum for all subjects from sixth to ninth grade, periodic assessments of students, tutoring students who have to repeat grades, awards to the best teams of teachers, teacher training, and, notably, substituting professional directors for political appointees.

INTERVIEW
26 “Rio is on the right track”
Eduardo Paes, mayor of the state capital, Rio de Janeiro city, gives IBRE staff his opinions about the current and proposed distribution of oil royalties, how the city spends the oil royalties it currently receives, its relationship with the oil and gas industry, its numerous initiatives to diversify the economy—especially its intent to become the national center for reinsurance—and its continuing commitment to building an economy centered on services.

INTERNATIONAL TRADE
31 Brazilian services in world trade
The issue of productivity in services, which constitute 67% of Brazil’s GDP, is very important for the performance of Brazilian exports. Lia Valls Pereira explains why it is essential to identify bottlenecks in a variety of service sectors that prevent an increase in Brazil’s share in world service exports – beyond the obvious shortage of qualified and educated labor.

IBRE ECONOMIC OUTLOOK
33 2013: More constraints than certainties on the horizon
More than in recent years, when economic uncertainties mainly related to the external scenario, 2013 starts with concerns about domestic factors that threaten the stability and performance of the economy in both the short and the medium term. Nevertheless, there are some promising aspects.
ECONOMY

Unemployment at a new low
Even with a weakened economy, the unemployment rate fell to 4.9% in November, the lowest for the month in the last 10 years, according to the government statistics agency, IBGE. Average 2012 unemployment through November was 5.6%, against 6.1% in 2011. Low unemployment and a shortage of skilled labor have raised wages: Workers’ average income adjusted for inflation rose in November by 0.8%, to US$900, which was 5.3% above November 2011. (December 21)

Industrial output again down in November
Output at factories fell in November by a seasonally adjusted 0.6% as auto production slowed despite substantial tax breaks and record-low interest rates, IBGE reported. IBGE also revised October industry growth down from the previously reported 0.9% to just 0.1%. (January 4)

Mobile phone problems threatens 2014 World Cup
Lack of national regulations for installation of antennas, delay in issuing licenses, and a dearth of investments are some of the problems threatening the launch of the fourth generation of mobile phone communications standards (4G). The goal is to complete the 4G network by December in all cities that will host the World Cup. The task has proved much more difficult than business and government imagined. (January 6)

Electric power crisis threatens
One of Brazil's most severe droughts has depleted reserves of hydropower from north to south. Reservoirs are sinking close to the level that, in 2001, led to power rationing and blackouts. In the past 12 months, the price of a megawatt hour has skyrocketed by 4,194%. Shares of electric power companies have been falling, and industries that buy energy on the open market have been moving toward rationing. (January 9)

Trade surplus fell 35% in 2012
After an unexpected trade deficit in November 2012, Brazil posted a US$2.3 billion surplus in December, the Ministry of Foreign Trade reports, for a surplus for the year of US$19.4 billion. This was 35% less than in 2011. Since export volume was unchanged from last year, the primary problem was lower prices. (January 3)

Inflation for 2012 above the target
The official consumer price index closed 2012 at 5.84%, compared with a 6.5% advance in 2011, IBGE said—above the government’s mid-point inflation target of 4.5% but within the target range (2.5% – 6.5%). While Brazil’s economy is expected to grow about 3.0% in 2013, continued inflationary pressures could limit the central bank’s ability to use interest rates to boost activity should the economy slow again. Public transportation and fuel prices are expected to rise this year, and a weaker Brazilian real pushes up the cost of commodities imports, such as crude oil and wheat. However, some relief is expected in 2013 as the expected large grain and oilseed harvest should help ease food prices. (January 10)

POLITICS

No presidential comment on politician convictions
So far as the Supreme Court conviction of top aides of former President Lula on charges of diverting public funds to buy political support for his coalition government is concerned, President Rousseff said, “I do not comment on decisions of another branch. That would not be contributing to the governance of this country.” Regarding members of the Workers Party support for former President Lula to run for the presidential election in 2014, Rousseff said she will not anticipate the end of her term by discussing the upcoming elections. (December 27)

New political party planned
With an eye on the 2014 presidential election, former senator and presidential candidate Marina Silva is drumming up support for creation of a new party. The future party has support from dissidents in the three main parties, PSOL, PT, and PSDB. A partner in the venture is former senator and current councilor for Maceió city Heloisa Helena (PSOL: Socialism and Freedom Party). To create a new party, Silva must collect signatures from at least 0.5% of voters and attract financial resources to access radio and TV. Brazil currently has 27 political parties officially registered. (January 10)
**Fiscal discipline may be eased**

The Brazilian government is willing to relax its fiscal discipline to prioritize economic growth in 2013, Treasury Secretary Arno Augustin told Reuters. Augustin said Brazil does not need to meet its closely watched primary budget surplus target exactly to keep finances in good standing because the economy has matured. His comments suggest that the Brazilian government is moving away from the strict fiscal management rules that are credited with ushering in macroeconomic stability after decades of crises. Augustin also hinted that the government might even drop the primary surplus target in favor of an overall balanced-budget goal; however, he made it clear that no decision has yet been made. (January 9)

**Budget surplus target missed**

The government has missed its 2012 primary budget surplus target of R$139.8 billion (US$68.6 billion). Authorities were forced to tap the sovereign wealth fund and state companies issued dividends early to meet a reduced primary goal. The primary budget surplus—revenues minus expenditures excluding interest payments on public debt—is a closely watched measure of a country’s ability to repay its obligations. (January 5)

**Gasoline prices to rise**

Brazil’s government will certainly raise gasoline prices in 2013, Finance Minister Guido Mantega said, in a move that could stem losses at state-owned oil company Petrobras but add to inflationary risks. Government attempts to keep gasoline prices below global levels to help control inflation have cramped Petrobras revenues and investments. (December 19)

**R$42.5 billion budget released by executive order**

Since Congress failed to approve the 2013 budget, Minister of Planning Miriam Belchior has announced that the government will publish an executive order early in 2013 to make available R$42.5 billion (US$21 billion) in order to ensure public capital works investments. The aim is to stimulate economic growth and prevent interruption of infrastructure works and social programs. (December 27)
IBRE HAS ALL THE NUMBERS THAT YOU NEED FOR YOUR BUSINESS TO THRIVE

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.

ONLINE DATABASES

- **FGVData** – Follow the movement of prices covering all segments of the market throughout your supply chain.
- **FGV Confidence** – Have access to key sector indicators of economic activity in Brazil through monthly Surveys of Consumer and Industry.
- **Inflation Monitor** – Anticipate short-term inflation changes.
- **Research and Management of Reference Prices** – Learn the average market price of a product and better assess your costs.
- **Custom Price Indices** – Have specific price indices for your business, calculated in accordance with your cost structure.
- **IBRE Economic Outlook** – IBRE’s monthly report on the Brazilian economy and macro scenarios.
- **Sector Analysis and Projections** – Obtain detailed studies and future scenarios for the main sectors of the economy.
- **Costs and Parametric Formulas** – Find the most appropriate price index to adjust your contracts.
- **Domestic inflation** – Follow the evolution of domestic costs of your company and compare with market costs.
- **Retail Metrics** – Learn how your customers react to price changes by studies of the demand for your products.

For more information about our services please visit our site (www.fgv.br / IBRE) or contact by phone (55-21) 3799-6799
The early renewal of concessions in the electric power sector sacrificed the buildup of an institutional framework that would foster competition, the foundation of a healthy capitalism. Indeed, the government had the option of letting the concessions expire and then auctioning new ones, letting the market set the prices. A major advantage of such competition would be to reveal how much fat there actually is in current electricity prices. It is even possible that new bids for electric power concessions could lead to even larger cuts in the cost of energy than the ones decided by the government, although they would take longer to take effect.

Competition in a sector as complex as infrastructure also requires development of such institutions as auctions, which today has become one of the most sophisticated branches of economic research. Each auction for infrastructure services is an opportunity to test new and better ways to improve society’s welfare.

In the case of electric power concessions, auctions to set prices and competitive infrastructure services would be perfectly viable and would signal that the government is willing to support a competitive and efficient capitalist regime. It was unfortunate that the government opted for the quick short-term gain rather than building the institutions Brazil needs for competitiveness over the long term.
Rousseff’s next step

João Augusto de Castro Neves, Washington D.C.

IT APPEARS IN HINDSIGHT that one of the administration’s main economic policy objectives in President Dilma Rousseff’s first two years in office was to aggressively lower Brazil’s perennially high interest rates. But driving the benchmark rate to its lowest level ever came at a price: In addition to arousing speculation about political interference with the central bank’s operational autonomy, the government’s focus on monetary easing as a means to spur economic activity has not been very effective. Average GDP growth during Rousseff’s term so far has been the worst since President Fernando Collor’s tenure in the early 1990s.

The decision to lower interest rates only makes sense if it is not an end in itself but the beginning of a process to tackle the elements that constitute what is too well-known as the “Brazil cost.”

Given the current scenario of economic uncertainty, Rousseff’s challenge for 2013 is twofold. Since her economic policy priority was to lower interest rates to more civilized levels, the challenge now will be to keep rates low despite growing inflationary pressures. Macroprudential measures—such as credit restraint—will most likely be the government’s first choice of action to contain prices, but recent history suggests that such measures alone might not be enough to keep inflation at bay.

The recent debate about a looming energy crisis may further complicate matters. If keeping domestic fuel prices artificially low—which severely depressed Petrobras’s investment capacity—was not hard enough, this year there will now be pressure from the need, in order to reduce the risk of energy rationing, to relieve a scarcity in hydroelectric energy by resorting to more expensive thermoelectric energy. The irony here is that the combination of low growth and scarce energy was the main reason for the downfall of the opposition PSDB a decade ago.

The president’s other challenge is obvious: get the economy up and running.

castroneves@eurasiagroup.net
again. Since lower interest rates and sector-specific stimulus measures have not been enough to spark investment, however, an appropriate administration response to that challenge is not obvious. If on the one hand the government seems to have acknowledged the need to resort to the private sector, as is the case with transport infrastructure, on the other its proclivity for intervening in the economy, as was the case with banks and the power sector, raises concerns about regulatory risks. So far, most foreign investors are looking to Brazil despite government policy, not because of it.

Granting the Rousseff administration the benefit of the doubt, it is possible that, notwithstanding the chatter, a sequential strategy is in place for the long term. Certainly, the decision to lower interest rates only makes sense if it is not an end in itself but the beginning of a process to tackle the elements that constitute what is too well-known as the “Brazil cost.” Recent overtures in the transport sector highlight concern with another component of the Brazil cost: poor logistics. And the Science Without Borders program only marginally addresses yet another element: the lack of skilled labor. Still, although all are limited or in need of fine-tuning, the fact that these policies exist at all is at least a sign that the government realizes what Brazil’s main challenges are.

So what would be the ideal next step in a long-term strategy for the rest of Rousseff’s term? The short answer: tax reform—specifically, reform that lowers the country’s increasingly high tax burden and simplifies the tax code, which would reduce compliance costs for businesses. The roadmap is obvious. In addition to further lowering payroll taxes to industrial sectors, merger and reduction of federal levies (PIS-Cofins) is being considered. More arduous would be harmonizing the state-based value-added tax of all 27 states. But even here a conjunction of factors seem to favor reform, among them the need for states to revalidate existing tax incentives, favorable conditions for renegotiating state debt with the federal government, and Rousseff’s high political capital.

That last factor, incidentally, is crucial not just for congressional support. Since any substantial tax reform would ultimately entail loss of revenue for the central government, it would inevitably translate into a substantially lower fiscal primary target (it is currently 3.1%). The government’s task, therefore, would be to credibly convey the idea that it is not abandoning yet another leg of the macroeconomic tripod. A lower primary target should not fuel more government spending but would certainly lead to a lower tax burden that would allow the private sector to invest more.

For a government that waves to the private sector with one hand while holding a rock in the other, this is not a trivial task.
SOMEONE LOOKING AT THE ECONOMY OF RIO DE JANEIRO at the beginning of this century could hardly have imagined where the state—especially its capital—would be today. Since 2000, per capita income has more than doubled. Violence has been reduced, primarily by the Pacifying Police Units (UPPs) currently installed in 28 city slums, and public education has gained a new management model. Both municipal and state administrations have put their finances in order, and the state plans to invest as much as US$100 billion between 2012 and 2014, according to the Federation of Industries of the State of Rio de Janeiro (Firjan).

The discovery of deep sea oil in 2007 was of course a factor, but the choice of Rio de Janeiro to host the 2014 World Cup and the 2016 Olympics has also been a major driving force. “With this, we could move off the drawing board essential transport projects for the city, such as the rapid transit buses (BRT) and the extension of the metrorail,” said Cristiano Prado, Firjan manager of Industrial Competitiveness and Investment. “Other works, such as the beltway connecting the Port of Itaguai to major highways, will open up other regions of the state, stimulating employment and income,” he said. “Not to mention the Açu port complex in São João da Barra, and other investments in shipbuilding and automobiles, the Petrochemical Complex of Rio de Janeiro (Comperj) in Itaboraí, and the multinational research centers that will be working in research and development on Fundão Island.”

Rio Business, the municipal trade promotion agency, has taken advantage of the visibility from the sporting events to attract businesses. “We had intense activity in London last year to promote Brazil,” says Antonio Carlos Dias, its commercial director. “There were about 800 contacts—sports businesses, materials,
marketing companies, energy, chemical and pharmaceutical, information technology...” To Carlos Dias, the city today has a more inclusive dynamic, thanks to the expanded mass transportation network that is creating a new economic axis: “Besides projects like the Maravilha Port, this involves 5 million square meters of office space that many abroad still do not know about.”

The speed at which investments are being announced and the deadlines set for some sports venues, however, have raised concerns. Despite the advances in recent years that helped set off the public-works marathon, Rio still needs stronger institutions if it is to avoid its missteps of the past and ensure sustainable growth.

At the same time the diversification of services, which is the hallmark of the city’s economy, can bring a new perspective to the city where 70% of the state population lives. Economist Fabio Giambiagi, National Bank for Economic and Social Development (BNDES), identifies some of the problems: “There are still many shortcomings, such as public works poorly designed and carried out and serious problems in the health sector. And municipal administrations are precarious. There needs to be a reduction in the administrative discontinuities that arise with changes in municipal government.”

A new book, *Rio de Janeiro, a State in Transition*, edited by Armando Castelar and Fernando Veloso of the Brazilian Institute of Economics (IBRE), brings together 17 articles in which economists talk about economic development in the state. As early as 1940 it was more urbanized than the national average, which pushed early consolidation of a service economy. The book outlines factors that may determine its future success: how it manages coming oil wealth, what needs to be done to expand the formal economy, and the need for environmentally sustainable designs for urban redevelopment that will preserve the image of the city.

**MIXED BLESSING: OIL WEALTH**

Since the state is responsible for about 80% of Brazil’s oil production, it is impossible to dissociate the state’s economy from the oil and gas sector. IBRE researcher Lia Valls notes that, thanks to oil, Rio de Janeiro state jumped from ninth to third place among exporting states between 2000 and 2008. However, there are contradictory aspects as well. Aloisio Campelo, assistant manager of the IBRE Business Cycle unit, points out that the low-volatility profile so far of the oil industry—which feeds industries such as shipbuilding—has helped Rio de Janeiro state recover faster from economic downturns than the national average, but the expansion of oil production...
and exports may change this scenario, leaving Rio de Janeiro more vulnerable to recessions, external shocks, and changes in monetary and fiscal policies.

Although the oil business is capital-intensive, labor productivity in Rio de Janeiro has risen. “This is not limited to exploration. Certain services that come together with oil activity, like finance, have also shown improvement,” says IBRE’s Mauricio Canêdo. However, there may be a problem related to how oil royalties might affect the state’s fiscal policy. Economists Samuel Pessôa and Fernando de Holanda Barbosa Filho see considerable risk unless the state puts in place strategies to address oil revenue volatility; they suggest creation of a fund that generates savings and regulates the flow of oil revenue, because that revenue is so dependent on volatility in international oil prices and the productivity of each field, which is nonrenewable. Brazilian oil production doubled between 1997 and 2010, raising royalties from US$212 million to US$11 billion, but wells in the Campos Basin are already giving signs of decline and the cost of extracting deep sea oil will be higher. There is also the risk that changes in the distribution of royalties may reduce the share of Rio de Janeiro state.

The oil-sharing model—which now depends on whether President Rousseff signs Article 3 of the bill passed in Congress, which among other things decreases the amount of royalties from current contracts—generates controversy everywhere. In Macaé and Campos
Goytacazes counties to the north, nobody wants to admit the possibility of change, presumably because “we have 52 projects in the Sustainable Development Plan … about US$90 billion in coming years,” says Getúlio Almeida, president of Commercial and Industrial Fields. The list of projects includes promoting regional culture, monitoring environmental data, metrorail and regional light rail projects, and educational projects that aim to have 50% of the economically active population attending or having completed technical education or higher by 2035. Almeida points out that, “If the rules for distributing royalties change and Rio de Janeiro state loses this money, we will not have any of that.”

In Três Rios County in the mid-south, which does not benefit from royalties, there is a different mood. To support the local economy, the city has an aggressive policy of tax incentives to attract companies like Nestlé and bus manufacturer Neobus that has helped to triple its budget in three years. The mayor, Vinicius Farah, condemns the way oil revenues are shared: “This is perhaps the greatest injustice we suffer. Only five non-oil producing counties do not participate in the distribution, and we are one of them. We have managed to do so much, and we could do even more if we were included.”

What worries Sergio Besserman, president, Technical Chamber of Sustainable Development and Metropolitan Governance of Rio de Janeiro, is the threat of breaking contracts, which he thinks could alienate investments at a key point for Rio de Janeiro state. Regardless of what happens with the revenue-sharing law, Besserman and other economists consider it important to broaden the debate to cover how the money is spent. So far royalties have had limited effects on economic activity. In the IBRE book, Joana Monteiro, research fellow, Center for International Development, Harvard University, points out that between 1997 and 2010 the royalty revenues of counties in Rio de Janeiro rose 34%, up from R$97 million to

The speed at which investments are being announced and the deadlines set for some sports venues, however, have raised concerns.
R$3.3 billion, but the money was used to pay for a swelling municipal administration rather than public services like education, health, and infrastructure.

Economist Alcimar das Chagas Ribeiro, Northern Rio de Janeiro State University, notes that average public investment in the north and northeast of Rio de Janeiro state is low: “In São João da Barra County, which has 30,000 inhabitants and a budget of R$ 400 million, investment last year was about 1.6% of current revenues, in Macaé County it was about 7% due to works infrastructure. [But] Campos County in the last three years has invested 18% to 19% of current revenue” (although he cautions that quantity is not necessarily quality).

After 35 years of royalties, Ribeiro points out, the counties that benefited are still poor, and he does not expect this to change soon. “One of the compensations of the Port of Açu complex is that laborers will be trained in technical courses like mechanical and electrical. But Campos and São João da Barra counties are ranked very low in the Basic Education Development Index of Rio,” he says. “When the port complex starts operations the demand for more qualified manpower will be higher. How do you educate workers to be engineers? … This dependence on exogenous investments does not resolve the situation in a sustainable manner. What could solve it are local investments and businesses that could better distribute wealth.”
IBRE’s Canêdo emphasizes that the great challenge for Rio de Janeiro state is to take advantage of its oil wealth in ways other than royalties. “We can develop oil-related industry and services regardless of whether we have oil in Brazil,” he says, citing the example of Norway. “Although Norwegian oil production is falling, GDP is rising because today Norway sells equipment and services to other countries—without relying on government transfers or protectionism.”

Besserman goes further, suggesting that Rio de Janeiro needs to build a low-carbon economy. “Relative prices in the

**Rio’s state and city family grant model**

**Kalinka Iaquinto**

THE COMBINATION OF STATE and municipal projects with the federal Family Grant (Bolsa Família) assistance program is a prominent Rio de Janeiro state policy to improve the income of the poor and the education of underprivileged children. The state government in 2009 launched Better Income (Renda Melhor) as part of the Plan to Eradicate Extreme Poverty; it gives financial assistance to families who are in the federal family grant program. Since December 2010 the municipal government has also had a family grant program (Família Carioca) that guarantees a monthly income supplement to families on the federal program. The benefit amount depends on income and number of family members.

Marcelo Neri, president, Institute for Applied Economic Research (IPEA), calls these initiatives social federalism: “The data from the Unified Register and the Family Grant show that municipal governments have operated in a coordinated manner, with complementing actions but also innovations.” He adds, “This is a two-way street. Just as states and municipalities are beginning to use the Family Grant model to design their programs, the ability to differentiate the programs according to the needs and possibilities of each place adds an interesting aspect. We are reaching those who are really poor.”

According to Neri, the programs reach about 94% of eligible families, totaling 540,000 people in the capital and more than a million in Rio de Janeiro state. Because the program is large-scale yet relatively inexpensive, there is an immediate reduction of poverty. Neri also sees other positive effects: increasing school attendance, parental involvement in the school activities of their children, and better grades, especially in science and mathematics. “To the extent that these variables improve, estimated household income increases and consequently reduces the assistance that individuals need. Eventually individuals will exit the program and become full citizens.”
global market economy tend to suffer unpredictable changes. There is a cost to emitting greenhouse gases and, once there is a global agreement, prices will adjust fast,” he said, suggesting that this could radically change the return on investment in deep sea oil. “The deep sea oil ought to be a path to another type of economy, more knowledge-oriented.”

SPEEDY CHANGES
In Rio de Janeiro city, where the direct impact of oil is lower, Fabio Giambiagi, BNDES, suggests that the recipe for GDP growth requires a combination of education and technology. “We must use the resources from oil to invest more in science and technology—like what Petrobras is doing with its initiatives on Fundão Island, which are attracting new businesses,” he says. “Increased investment in education, with management changes to avoid spending more without higher return, is consistent with initiatives in education that both the state and county are implementing in Rio de Janeiro city.”

The expansion of oil production and exports may leave Rio de Janeiro more vulnerable to recessions, external shocks, and changes in monetary and fiscal policies.
“We are a city of services, and services are knowledge . . . We have to invest in knowledge and culture,” Besserman adds, arguing that one of the main legacies of activities related to the Olympic Games, could be a change in the city’s work culture: “We do not have a culture of excellence in Rio because the reality of a competitive market is recent. Our tradition is more of bureaucracy, even though we are creative when undertaking business.”

Among the numerous projects converging on that goal are some for those most in need of income and incentives for education: slum dwellers. Rio de Janeiro pioneered integration of state and municipal activities to supplement federal assistance programs that pay poor families a monthly allowance conditioned on their children attending schools and parents participating in school activities. Also, efforts are being made to map and improve access to services and urban infrastructure.

“We have a mayor focused on pragmatic goals and management, the sport events have a date, and we have a society quick to seize opportunities, which are all positive factors,” Besserman says. “But we have to perform. We cannot content ourselves with improving student grades; we must have the best grades . . . . In Brazil in general we value knowledge very little: the poor because they were excluded for centuries, and the elite because they did not need to compete.”

Between 1997 and 2010 the royalty revenues of counties in Rio de Janeiro revenues rose 34%, … but the money was used to pay for a swelling municipal administration rather than public services like education, health, and infrastructure.

Service sector dominates Rio de Janeiro city economy
(Employees by economic activity, % of total worker)

<table>
<thead>
<tr>
<th>Economic Activity</th>
<th>BRAZIL</th>
<th>RIO CITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commerce</td>
<td>19</td>
<td>16.8</td>
</tr>
<tr>
<td>Public administration</td>
<td>52.8</td>
<td>68.3</td>
</tr>
<tr>
<td>Agriculture and fisheries</td>
<td>3.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Industry</td>
<td>19.2</td>
<td>9.8</td>
</tr>
<tr>
<td>Construction</td>
<td>5.7</td>
<td>4.9</td>
</tr>
</tbody>
</table>

Sources: Rio Negócios and Ministry of Labor.
The effort has helped increase the revenue of business services located in slum communities. “Before, crime was a barrier, people had feared to visit slums. Now people feel free to do so,” says Sérgio Guimarães Ferreira, chief information officer, Municipal Planning Institute Pereira Passos (IPP). “The UPP policy was instrumental in promoting Rio as an integrated city,” he says.

Inclusion

Vinícius Assumpção, Special Secretary for Outreach Economic Development, agrees: “There is a breaking down of barriers, and that is the great victory
of peace. Rio is being reinvigorated economically, and especially culturally, because we are able to understand that the slum is a product of the city, part of being an inhabitant of Rio.” Another positive factor is that the pacification created market opportunities in slum communities that did not exist before it generated incentives for resident latent entrepreneurs to take advantage of what the UPPs were doing.

Former fisherman and musician David Vieira Bispo, a resident in the Chapéu Mangueira slum community in Leme, had taken the name of the community to other regions of the country and even abroad. About two and a half years ago, he decided to open a pub with his name. “We were the first pub in the slum community to compete for prizes of gastronomy,” he says proudly—the appetizers won prizes. “Today, I recognize myself as an entrepreneur. David’s Pub creates jobs. The slum is no longer the ugly duckling of the city. People feel that this is an area society has reclaimed.”

Another Chapéu Mangueira resident, Regina Tchelly, worked as a maid and cook for a year and now invests in her own project, Buffet Organic. With the guidance of the Brazilian Service of Support for Micro and Small Enterprises (Sebrae), she seeks to innovate in food preparation. She currently operates the business from her home, but “My plan is to have my own space for Buffet Organic to be able to produce more and better meet the growing demand. I also want to work with prisons to hire ex-convicts to work for Buffet Organic.”

Resistance

Although there are many cases of successful businesses in slums, not all seek to formalize their activities. According to a census by the State Chief of Staff Ministry in the Rocinha, Complexo do Alemão, and Manguinhos slum communities, between 2008 and 2009, there were 14,057 ventures in these localities, but only 1,083 were formal. Moreover, 45% in Rocinha, and 35% in the Alemão Complex saw no reason to legalize their businesses.

The partnership between municipal government and Sebrae has helped to increase formalization to some extent. “We now have in pacified slum communities 30,000 enterprises. Of these, only 3,500 are formalized. It is a low number, but we understand that formalization will result gradually from a process of cultural change,” said Carla Teixeira, project coordinator of entrepreneurship, Sebrae-RJ, in pacified slum communities.
“The slum is an extremely informal environment. And the formality of a business has to do with the formality of a territory,” said Teixeira, pointing out that, until recently, slums now under UPPs used to obtain utility services illegally by tapping into electricity and water services. “The more we formalize these territories, the more important business legalization will be.”

IPP’s Sérgio Ferreira agrees. He believes the role of the government and its partners is essential to have a formal setting. He also believes trade between businesses in the slum communities and between slums and other cities should encourage formalization: “The entrepreneur who begins to attract more demanding suppliers, requesting invoices, for example, will realize the importance of adhering to formality.”

A year ago, federal and municipal governments instituted the program Rio Solidarity Economy (Rio Ecosol) in Complexo do Alemão, Manguinhos, Cidade de Deus, and Santa Marta. “We seek to know the whole slum community’s social productive network and, from this, support their productive growth,” explains secretary Vinícius Assumpção. The program survey found that in the Cidade de Deus community 58% of enterprises were not on the National Register of Legal Entities (CNPJ); nor were 82% in Complexo do Alemão 90% in Manguinhos, and 73% in Santa Marta. “We realized that in these communities everyone wants to be an entrepreneur. So we partnered with Sebrae to formalize a number of enterprises,” says Assumpção. He adds: “Our goal is to pass basic concepts of community, show a new form of production for sustainable businesses. We know that instilling these concepts is difficult, especially in locations with little information, so we created networks.” The networks are groups of local merchants who, for example, unite to purchase raw materials or sell their products collectively.

**Formality and security**

The importance of broadening the formalization of these slum communities is not only to promote the economy, but also contribute to the advancement of security. “In this sense, the pacification program has been very successful. But
to solve other problems new actions are needed,” says Sebrae’s Carla Teixeira. According to IPPs Sérgio Ferreira, along with ensuring security the government and its partners need to reduce the costs of legalizing informal businesses. He adds that city hall now has the UPP Social program to articulate policies and municipal services in order to consolidate the progress made so far.

**How more peaceful slums affect real estate**

_Kalinka Iaquinto_

SETTING UP POLICE PACIFICATION Units (UPP) in 28 slums of Rio de Janeiro has had a positive effect on the city’s real estate market. A study by Benjamin Mandell, economist, Federal Reserve Bank of New York, and Claudio Frischtak, president, Inter.B International Business Consulting, shows that property prices have risen, especially near the police units. “We believe that the UPPs contributed about 15% of the average growth in property prices since 2008. Of course, other things, such as the fall in interest rates, increased credit and incomes, and institutional changes, were also important — but the UPPs proved crucial,” Mandell says.

Installation of the UPPs helped to reduce property price differentials in the city, the study found. And the UPPs have been well-received by the population. “When we look at the effects of UPPs on housing prices over time, we observed a slight upward trend. This may be an indicator that the security policy has gained greater credibility,” Mandell says.

The downside of rising property prices and the growth of local economies could be that residents are crowded out. “There is much alarm that speculation will reach the point that the cost of living becomes unbearable,” says Sonia Fleury, professor, Brazilian School of Public and Business Administration of FGV.
RIO DE JANEIRO STATE IS STRIVING TO CHANGE its high level of educational inequality and low supply of skilled labor. Although the main focus is the quality of education in public universities and graduate courses, primary and secondary education also leaves much to be desired. “This disparity creates a shortage of skilled workers in Rio de Janeiro,” says Rodrigo Leandro de Moura, IBRE researcher. Prospects of a large increase in oil production, the upcoming World Cup in 2014 and the Olympics in 2016, and expansion of investments in the state will increase employment opportunities. But what can be a winning situation can also become a challenge, especially when it comes to public education, which must overcome numerous difficulties to become “first-world education,” according to plans drawn up by the State Secretary of Education through 2024.

Meeting that goal will be hard: Although it has improved since 2009, in 2011 Rio de Janeiro’s Basic Education Development Index (Ideb) was far below the standard
The political influence on schools has ended. We replaced 850 people, including directors and assistant directors. There is much reluctance and vested interests, but we will not retreat one millimeter.

Wilson Risolia

Nevertheless, there has been progress. In just one year, public schools in Rio de Janeiro rose from 26th place among the 27 states of the federation to 15th in 2011. However, Wilson Risolia, Secretary of Education, State of Rio de Janeiro since 2010, plans to go much higher. “In the perspective of 11 years, our goal is to achieve a Finnish Ideb index of above 7 points,” he says. According to Schwartzman, when Risolia came in, he found a system addicted to poor habits and behaviors, a completely disorganized and chaotic educational program, poorly planned schools, political appointments to leadership positions, and precarious governance. “The secretary did not even know how many teachers the school system had. In fact, nobody was much concerned about dealing with the problems of education in Rio de Janeiro state and Brazil, which are also quite complicated. But that has changed.”

The State Secretary of Education has defined a plan to reach the desired results. Among the priorities are to put in place a minimum curriculum for all subjects from sixth to ninth grade, periodic assessments...
of students, tutoring students who have to repeat grades, awards to the best teams of teachers, teacher training, and finally, substituting professional directors for political appointees.

“The political influence on schools has ended. We replaced 850 people, including directors and assistant directors. There is much reluctance and many vested interests, but we will not retreat one millimeter,” Risolia says. Having school managers committed to improving student learning and not just focused on their own careers is important, Naércio Menezes, professor, Institute of Education and Research (Insper), argues, but he also points out that it requires constant vigilance: “A successful policy should not change if the education secretary leaves. For good results in education, technical management is essential, based on numbers and reviews that identify deficiencies.”

However, there is no point in having first-world management if the schools do not have motivated students. Today, young people are discouraged from learning: According to an Inep survey in 2010, Rio de Janeiro state has a high school dropout rate of 13%, compared to 7% in the South East and 10% for Brazil as a whole. The source of the problem is the first years of basic education. Menezes explains that “We have to start focusing on the early school years. A common problem of our schools is that the curriculum is too general and far too many subjects; and our legislators continue to add more subjects. The student has to learn things that are often of little interest. Some students want more practical lessons with professional content, others want a more theoretical approach to prepare for college. We see this in many other countries, not just here.”

Schwartzman agrees with him: “We have a single model of school organization and upon it the government created the National Secondary Education Examination (Enem), which requires that everyone learn everything to pass the test and go to college. This type of format and pressure upon a youth who had poor education in the public school and often does not have much prospect of going into higher education due to family financial conditions causes many to leave school.”

Professionalization

For those who can move on and continue studying, there is good news: Rio de Janeiro state’s expected economic success in coming years. According to a 2011
Many entering the labor market are almost illiterate: They can read but do not understand what they read and lack logical reasoning.
The Brazilian Economy—Two important issues could reshape the Brazilian federative pact: the distribution of oil royalties and revision of the criteria for distributing the States and Municipalities Sharing Fund. Is there a risk that alliances of states with similar interests in these matters could block discussions on other federalism topics? How should the municipality of Rio de Janeiro position itself in this discussion?

Eduardo Paes—Rio de Janeiro has already positioned itself. We are in favor of enforcing contracts, not changing the rules in the middle of the game. Rio just wants to protect its royalties, and those of Rio de Janeiro state. This has been Governor Sérgio Cabral’s position and we support it. Rio city will not lose much if the law of sharing royalties is changed; we don’t collect much in royalties at the municipality level. However, without these transfers the 2014 World Cup and the 2016 Olympics are threatened, and the state could not afford to pay its employees, for example.

How can the city of Rio de Janeiro benefit from the growth of the oil industry? What has been done to attract oil companies? Rio has an advantage over other cities in Brazil in the oil and gas industry. First, the city is the decision-making center and head-
quarters of large oil and gas corporations and programs—the Brazilian oil company (Petrobras), National Agency of Petroleum (ANP), National Organization of the Petroleum Industry (Onip), the Brazilian Petroleum, Gas and Biofuels Institute (IBP), and Program for Mobilization of the National Oil and Natural Gas (Promin); and 63% of global companies for exploration and production of petroleum and gas. The largest research center of the sector in Latin America—Research Center Leopoldo Américo Miguez de Mello (Cenpes)—is located in Rio.

Second, in the last two years Rio has attracted 11 oil research centers, which will invest around US$1.5 billion . . .

Third, Rio was invited to join the select list of international cities in the World Energy Cities Partnership, and in the city are 16 engineering programs ranked between six and seven by the Coordination of Improvement of Higher Education Personnel—the largest number in Brazil. Finally, I would like to highlight that Rio de Janeiro state is responsible for 80% of production and oil reserves in the country.

Rio is the energy capital of Brazil. We have markets, industry, logistics, and largest concentration of offices, services and research centers of the oil and gas industry.

The proceeds from royalties have been used to pay for current expenditures. As for revising the oil royalty distribution criteria: “We are in favor of enforcing contracts, not changing the rules in the middle of the game.”

Shouldn’t the city use these funds to reduce the housing deficit, slums, and lack of basic sanitation?

The Draft Budget Law of 2013 estimated royalty revenues of R$222 million, which will be used mainly by the Municipal Urban Cleaning Company, for waste management and treatment of solid waste, and the Department of the Environment, for activities such as management and recovery of green areas, quality of water resources, prevention of environmental damage, conservation of parks and landscaped areas, maintenance of sewer sanitary systems, and drainage of rivers and channels . . . . Royalties end, because oil exploration is not endless, and a city cannot give up its own revenues.

If there is a loss of oil resources, even a partial one, what could Rio do to offset the loss?

The city’s loss of revenues will be much less than the loss to Rio de Janeiro state. There will be no loss of existing contracts, but Rio will not receive funds from the new deep sea oil. The city’s economy has great diversity to generate revenue, such as information and communication technology like call centers, data centers, technology research and development, real estate and infrastructure, financial services like insurance and reinsurance, venture capital, and private equity and assets. There is also a sound creative
We are attracting new high-standard international universities that are creating new courses to build our human talent base. The International Institute for Management Development and Columbia University have already opened offices in Rio and initiated strategic discussions on urban innovation, the creative economy, and other services. To encourage this, city hall has capitalized a fund for investment in new technology companies and the state government has set up research funding agencies. They comprise a comprehensive powerful base on which to stimulate and foster R&D. They are expected to invest US$1.6 billion over the next two years to create R&D centers in different sectors. In addition, the city, through its Rio Business agency, helps develop strategic and focused courses in collaboration with corporations and local universities.

The city’s economy is based on services. What activities have the greatest potential for growth in coming years?

In addition to services for the oil and gas industry, hospitality is creating 15,000 new rooms in 84 new hotels, investments of R$2.8 billion and 11,000 direct jobs and 33,000 indirect jobs; IT, media, audiovisual, construction, infrastructure, financial services, all with great growth potential. The steel and shipbuilding industries are still expanding because of the oil and gas developments; we also have 12% of the Brazilian pharmaceutical industry, as well as sports, culture, media, entertainment, and tourism.

The quality of teaching in Rio has improved, but it still is a long way from the level of developed countries. What lessons can be drawn and what is planned in terms of education policies?

The most important lesson to be drawn from this improvement in education is that it is right to focus on children’s learning, not just on buildings or events. Consistently, a municipal curriculum was created, organized by bimonthly marking periods, with appropriate material to work with students. It was also correct to invest in teachers’ training, and so the School of Teacher Education was established, supported by courses always based on the curriculum. The emphasis on literacy, with
production, including our own book literacy, involving parents in the process, was the secret of the success of our strategy of educating everyone in the first year and thus reducing functional illiteracy in the higher grades . . . The Schools of Tomorrow were established to ensure that in uncontested or newly pacified areas the child could learn, reduced truancy and learning disabilities compared to other schools in the system. The quality of municipal schools will be maintained because we will persist in pursuing a strategy that was adopted in early 2011: turning all schools progressively full time. No developed country has only four and a half hours of classes a day . . .

**What is the city plan to become a center of reinsurance?**

The Rio Business Agency, the property consultancy Jones Lang LaSalle, and the National Federation of Business and Reinsurance have partnered to carry out the project to make Rio a national center for reinsurance. We are inspired by the model of London and the idea is to concentrate all players involved in reinsurance in the same place. Our objectives are clear: to bring greater operational ease and agility to everyday processes and solutions . . . In the first quarter of this year, we will announce the location of the National Center of Reinsurance.

**“The main challenges this administration faced at the beginning in developing new businesses in the city were linked to infrastructure, health and education, which is where we focused our efforts.”**

Besides tourism, which other sectors have potential competitive advantages in exports of services in Rio?

We see as strategic to the city not only oil and gas but also technology, health, industry, media, and financial services, among others. The main challenges this administration faced at the beginning in developing new businesses in the city were linked to infrastructure, health, and education, which is where we focused our efforts. The Marvel Port project, the largest public-private partnership in Brazil with investments of US$4.5 billion, is upgrading 70 km of urban roads and adding 700 km of new networks of urban infrastructure. This area will be our new and modern shopping and business center. We also invested US$2.2 billion in education, US$2.8 billion in health and social development, US$7.3 billion in housing and urbanization, US$8.5 billion for mass transit, US$1.9 billion investment in the environment . . . More than 80 new hotels will be built by 2015, representing investments of US$1.5 billion . . . We are on track for investments.

The city of Rio innovated in proposing policies and global targets for poverty reduction, such as the Rio Family program, which was influential in the design of
national policies. What are the next steps in fighting poverty and fostering social development?
We targeted the poorest families in Rio and after a year of the Rio Family program, we had raised 46% of them above the poverty line; 8% of the population is being served by the Rio Family program with more incentive to educate their children. The project uses the same registry of poor families as the federal Family Grant program in Rio and is an income supplement to the federal program . . . Last year we increased the number of families served and doubled the benefits for people with disabilities and youths in pacified communities. This year, we are also to requiring parents to have their children attend at least 90% of classes, participate in at least one bimonthly school meeting, and take children for mandatory health care in municipal clinics . . . There are 134,000 households and about 540,000 people enrolled in the Rio Family program . . . It is slowly changing the social reality of our city.

“The quality of municipal schools will be maintained because we will persist in pursuing a strategy that was adopted in early 2011: turning all schools progressively full time. No developed country has only four and a half hours of classes a day. “.
THE IMPORTANCE OF THE SERVICE SECTOR (67% of GDP) to increasing potential Brazilian output has been highlighted. The sector’s growth has been driven mainly by the incorporation of new workers. With the fall in the growth of the economically active population, the dynamism of the service sector will depend crucially on higher productivity.

The issue of productivity in services is also very important for the performance of Brazilian exports. Low-quality domestic services in logistics and technical assistance reduce the competitiveness of Brazilian products. Also, a lack of well-structured marketing (participation in fairs and exhibitions, for example) inhibits the entrance of domestic products in world trade.

According to the World Trade Organization (WTO), Brazil’s share of services exports in global trade was 0.9% in 2011, which puts the country in 31st place on the list of top exporters—second only to South Africa for the worst performance among the BRICS. China is in 4th place (4.4% share), India in 8th (3.3%), and Russia in 22nd (1.3%). However, it is encouraging that since 2005 Brazil has moved up from 35th place. What has improved?

In 2011, globally services exports were categorized as transport (21%), travel (26%), and other business services (54%).

It is essential to identify bottlenecks that prevent an increase in Brazil’s share in world service exports – beyond the obvious shortage of qualified and educated labor.
Brazil’s services exports were transport (15%), travel (17%), and other services (68%). In the lists of top exporters in each group, Brazil appears only in the last, but in 13th place, having increased its export share from 0.6% in 2005 to 1.1% in 2011.

Indicators
According to the central bank, in 2011 Brazil recorded services balance deficits in rental equipment (the largest deficit, US$16.7 billion), insurance, computing and information, royalties and license fees, and personal services, cultural, and leisure activities. Brazil recorded surpluses in business services, professional and technical services (the largest surplus, US$20.7 billion), financial services, communications, and construction. The share of business services in total exports rose from 38% to 48% between 2005 and 2011. Though the largest contributor to that item, engineering projects, fell from 21% to 19% between 2005 and 2011, it recorded average annual growth of 14%.

Brazil’s increased share in other commercial services exports suggests an improvement in competitiveness. In this case, we can highlight the engineering and architecture, project development, and professional services segments. Niche markets are important and should continue to be explored. However, we are still far from India’s successful strategy in the computer industry and information technology, which increased its share in service exports from 1.2% in 2000 to 3.3% in 2011.

Without advocating a policy of “strategic” sectors for export of services, it is essential to identify bottlenecks that prevent an increase in Brazil’s share in world service exports – beyond the obvious shortage of qualified and educated labor. Trade, services, and logistics are priority productive sectors in the Greater Brazil Plan launched by the government in 2011. If it is crucial to increase the productivity of services to ensure Brazil’s economic growth, it will also be welcome if this increase were reflected in an increased share of Brazilian services in world trade.
2013: More constraints than certainties on the horizon

AFTER THE SEASON OF CELEBRATIONS, the turn of the year was marked by announcement of a series of disappointing results for the Brazilian economy in 2012 and the emergence of new risk factors, among which the possibility of electric power supply outages stands out. More than in recent years, when the uncertainties were mainly related to the external scenario, 2013 starts with concerns about domestic factors that threaten the stability and performance of the economy in both the short and the medium term. Nevertheless, there are some promising aspects.

The inflation rate as measured by the IPCA rose 5.84% last year and remained persistently above the mid-point target (4.5%) and close to the upper bound of the target range (2.5%–6.5%). It was very resistant to a slowdown, despite low GDP growth.

Although for the entire year inflation ran above target, fiscal policy was expansionary. The budget primary balance target was met only through accounting tricks and by ignoring Acceleration Growth Program (PAC) expenditures. In addition to failing to meet the fiscal target, the transparency and the trustworthiness of public accounts was thus compromised.

Continued feeble economic activity reflects continued contraction of gross investment. We estimate that gross investment fell 1.3% in the final quarter of last year, the sixth consecutive quarterly decline, and between 4% and 5% in 2012 as a whole. The worst of the bad news is industry’s poor performance at the end of 2012, accompanied by a slowdown in retail sales.

We estimate GDP growth in the last quarter of 2012 at only 0.6%, and for the year as a whole at just 0.9%, despite countless government stimulus packages, particularly for industry. Continued disappointing growth for several quarters generates negative expectations.

Nevertheless, the outlook for 2013 does have some positive aspects: low unemployment rates and the higher new minimum wage will help to keep real incomes and consumption rising in the short term; new concessions in infrastructure will have a positive impact on investment; a more competitive exchange rate will help industry exports; interest rates should stay low; and there seem to be no extreme risks to world growth.

But yet again, 2013 will be a year of great challenges for the Brazilian economy.

**Brazil’s gross investment has declined for six consecutive quarters.**
(Percent change over the previous quarter and 12-month moving average, seasonally adjusted)

Sources: IBGE, Funcex, and IBRE.