CURRENCY DEVALUATION, LIMITED EFFECT

A worsening external environment and the negative perception of the economy should keep the Brazilian real undervalued, but the recovery of industry will take much more than a devalued currency.
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Power cut hits
A failure in the electric grid interrupted energy transmission between the North and South East of Brazil on February 4; the power cut affected over 2 million consumer households. A severe drought that has sapped hydroelectric output and increased government spending on energy subsidies means the Treasury may have to pay US$5–8.4 billion this year to secure energy supplies, according to research by Bradesco bank. (February 5)

Demand for consumer credit falls, defaults rise
Consumer demand for credit fell by 2.8% in January over the same period last year, according to Experian SERASA, which says consumers remain cautious about borrowing because of rising interest rates, uncertainty about inflation, and worry about defaults. Meanwhile, for the fourth consecutive month, in January consumer delinquencies went up, by 1.1%. (February 12)

Unemployment goes up to 4.8% in January
Unemployment in Brazil’s six main metropolitan regions was 4.8% in January, said the government statistics agency IBGE, up from 4.3% in December. Job vacancies fell by 0.4% compared to December, mainly because 46,000 formal jobs were eliminated. (February 20)

GDP grew 2.3% in 2013
Consumer spending and investment allowed Brazil’s economy to end 2013 on a positive note. According to government statistics agency IBGE, GDP was up 0.7% quarter-on-quarter in December, and for the year as a whole grew 2.3%. (February 27)

February brings another trade deficit
Brazil posted a trade deficit of US$2.1 billion in February, its second straight monthly shortfall, said the Ministry of Trade. Demand for Brazil’s exports has slackened due to a subdued global economy, and the low productivity of Brazilian manufacturers has made their products less competitive globally. (March 6)

Industry rebounds in January
A jump in capital goods production energized Brazilian industrial output in January, though not enough to make up for the steep plunge in December. Production in Brazil rose 2.9% in January month-on-month, according to IBGE, but was down 2.4% from January 2013. The international economic environment is still unfavorable for Brazilian industry. (March 11)

Auto production jumps, but sales lag
Motor vehicle production in Brazil surged in February after auto workers returned from vacation, though production is still below 2013 levels. Production rose 18.7% in February after having risen 2.9% in January, according to the automakers’ association, Anfavea. However, car sales dropped 17% in February and had fallen 11.7% in January. Part of the decline was likely due to unusually high sales in December, when consumers rushed to take advantage of holiday sales and tax breaks. (March 11)

Inflation up in February
The IPCA (National Consumer Price Index) rose by 0.69% in February, after increasing 0.55% in January, mainly because of tuition hikes in February. For the last 12 months, inflation was 5.68%. (March 12)

WTO: Brazil the most protectionist country
Brazil holds the dubious title of world’s most protectionist country. In 2013 it opened 39 antidumping actions, according to a World Trade Organization (WTO) report. Not far behind were India, with 35 cases, the U.S. with 34, and Argentina with 19. In the past two years the WTO has several times questioned Brazil’s trade policy. Europe is expected, probably with support from Washington, to appeal Brazil’s policy of tax incentives. (February 17)

No EU–Mercosur agreement yet
Statements by President Rousseff and representatives of the European bloc suggest that both sides are committed to working together at a technical meeting scheduled for March, with the main topic to be a free trade agreement between the EU and Mercosur. No concrete progress was made at the February 24 EU-Brazil summit in Brussels. (February 24)
**Politics**

**President Rousseff approval ebbs**
Approval of President Dilma Rousseff fell for the first time in seven months as growth slows and inflation remains above target. Her approval rating dropped from 59% in November to 55% in February, according to a National Transport Confederation poll. However, the survey suggests Rousseff would still win the October election outright with 44% of votes (February 18).

**Business complains about government**
At an official dinner on February 18, representatives of major Brazilian companies complained about their lack of dialogue with the administration; they also criticized government accounting gimmicks and delays in investment in infrastructure. Criticisms along the same line had been raised by the chairman of the Institute for Studies in Industrial Development, Pedro Passos, who told *Estado S. Paulo* newspaper that “business confidence in the government has ended.” (February 8)

**Cardoso criticizes today’s economic policy**
Former President Fernando Henrique Cardoso thinks it’s time for Brazil to undergo another change as major as the Real Plan. “The people feel that it is time to change course,” he said on his way to a ceremony in the Senate honoring the 20th anniversary of the Real Plan. He stressed the importance of meeting inflation targets and honoring the Fiscal Responsibility Law, and though he emphasized that there is no single recipe for good economic management, he said, “At the moment Brazil is in a slightly different rhythm than the rest of the world.” (February 25)

**Economic Policy**

**Concessions to bring in US$34 billion**
Federal concessions granted last year will bring in an estimated US$34 billion for investment in transportation, energy, oil and gas, and ports, according to the Ministry of Finance. The government is betting on a surge in infrastructure investment to boost the economy this year. Due to contractual obligations, most of these investments will take five years to play out. (January 10)

**Government budget cut to restore credibility**
The new government target for the primary budget surplus—revenues after expenditures but before interest payments—is a “conservative” 1.9% of GDP. Brazil failed to achieve its primary budget goals of 3.1% in 2012 and 2.3% in 2013. A realistic and transparent primary surplus is crucial as Rousseff struggles to attract enough investment to revive the economy. (February 21)

**Central Bank raises policy rate once again**
As expected, the Monetary Policy Committee voted unanimously to raise the policy rate by 25 basis points, to 10.75%. Though the increase was smaller than the previous six, each 50 basis points, the Central Bank stated that the hike was part of “a continuing process of adjustment to the policy rate” as inflationary pressures failed to dissipate. (February 27)
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Economic policy in an election year: What can be done?

WITH POLLS FINDING THAT President Roussef has a good chance to be reelected, the administration economic strategy seems to be to stay the course with no dramatic adjustment in policies until after the October election. The government has indeed made some corrections in its policies: the central bank is still hiking interest rates to fight inflation; the government has announced it will reduce subsidized lending by public banks; and the private sector has been called in to help with transportation infrastructure. However, questions about the future remain, preventing a more vigorous recovery of private investment and higher growth.

In the past, postponing policy adjustments was very costly for Brazil in terms of low growth and unemployment. As the late economist and finance minister Mario Henrique Simonsen aptly explained, “Inflation hurts, but the balance of payments kills.” However, Brazil is less vulnerable today than in the past because it has higher international reserves and lower public debt. Nevertheless, a more cautious policy stance should be considered to make the country less vulnerable to external shocks.

As our cover story makes clear, the worsening external environment and the perception that the economy is deteriorating imply that the Brazilian real will continue to devalue, which should be good for the external current account. But devaluation is not helping to reduce the current account deficit because the private sector and the government are consuming too much—so much that foreign investors are unwilling to pour in more money. Also, government policies, especially price controls on petroleum products, are preventing the pass-through of currency devaluation to prices. Adjustment of the current account requires a healthy increase in the price of goods traded internationally, such as oil products, relative to goods traded only in the domestic market, such as services.

The president has been struggling to find the right mix of policies to jump-start growth. She believes that development and social policies should take priority. We do not doubt her sincerity and good intentions. But the balance of risks for Brazil has tilted to the downside because of the unfavorable external outlook.

Though we understand the government’s margin for fiscal maneuvering may be limited this year, further policy measures to help reducing the external current account deficit and contain inflation should still be considered. Among the various measures proposed by economists and analysts interviewed in this edition, the adjustment could be launched with two modest proposals: (1) The government should publish a clear formula to gradually adjust fuel prices to close the gap between domestic and international prices in 2014. (2) The central bank should tighten monetary policy accordingly to ensure that the fuel price adjustment does not heat up inflation.

Though politicians would be understandably reluctant to endorse this proposal in an election year, the suggested measures would clear the way for an orderly external adjustment and to some extent improve confidence, which can be only beneficial for the political process. If the president acts decisively, she may heal the apprehension that afflicts the country, and help the country navigate safely to 2015. This by any measure would be a considerable achievement.

FROM THE EDITORS

March 2014 • The Brazilian Economy
Rousseff’s reelection pitfalls

João Augusto de Castro Neves

A RECENT BATCH OF POLLING data casts little doubt on who is favored to win the presidential election in October. After the abrupt shake-up of the political chessboard brought about by last year’s wave of urban protests, the pieces have settled somewhat. After a plunge in support, President Dilma Rousseff’s approval ratings have since rebounded consistently. While her popularity is unlikely to reach pre-protest levels, it is safe to say that this year’s election is hers to lose.

In the span of a few months, however, a flurry of potentially harmful issues (energy crisis, protests, political bickering, among others) has stormed the political landscape, giving more than a glimpse of hope to those who wish to see a very competitive ballot later this year. For now, the probability of these events escalating into a full-fledged crisis that could seriously undermine Rousseff’s reelection chances seems relatively slim. Nonetheless, in the next few months pundits and politicians alike will scrutinize these issues to exhaustion. The fact that, despite Rousseff’s favorable position, three major political forces will be competing from the outset may make this the most interesting presidential election in recent history. A closer look at each potential risk is therefore a valid exercise.

The primary risk for Rousseff is the economy. Despite some good government intentions, economic activity continues to disappoint. Average growth for Rousseff’s first four years will likely close at the lowest level since the early 1990s. So far, politically a vigorous labor market—unemployment reached historically low levels in January—and inflation somewhat under control—well above the inflation target but still within the central bank’s tolerance band—have neutralized the low-growth environment. Ultimately, these mixed signals from the economy help explain the resilience of the president’s support.

While the labor market is expected to loosen somewhat in the coming months, a sharp downturn is unlikely. Inflation on the other hand, may pose a greater problem.
Despite central bank efforts, rising prices are still testing politically tolerable levels. In addition to continuing pressures to raise administered prices—fuel, electricity, public transportation—the currency may also play a decisive role, depending on both what happens with respect to U.S. monetary policy and the deterioration of Brazil’s external accounts. Notably, high inflation was the main factor behind the slight decline in Rousseff’s approval ratings even before last year’s protests.

Social unrest constitutes another pitfall for Rousseff. The growing demands of a new middle class have scarred the political landscape with demonstrations since last year. Given that the government now faces more acute macroeconomic trade-offs, since it has less fiscal room while the pressure for more public spending is intensifying, a latent discontentment will probably linger and make its way to the headlines. But while protests will remain a source of risk, especially in June and July during the World Cup, and localized violence may erupt, they are unlikely to escalate to the same levels seen last year and lead to political instability. And even if they do, the political impact would probably be somewhat diffuse across party lines.

A third risk stems from a possible energy crisis. Drought and above-average temperatures are pushing Brazil’s power system to the limit. Despite the risk of energy rationing, the likelihood of it being implemented is much lower now than it was during Brazil’s energy crisis in 2001. The decision of the Fernando Henrique Cardoso administration (Brazilian Social Democratic Party, PSDB) to implement a rationing program and its mismanagement of the crisis were among the main causes of the PSDB fall from power. For the remainder of 2014, therefore, Rousseff’s main challenges will be to avoid rationing or blackouts and also prevent electricity prices from rising substantially.

Finally, poor management of the party coalition in power constitutes another risk factor. Rousseff’s lack of political savvy not only undermines the government’s agenda in congress, it also poses a threat to the coalition heading into the election. Frequent squabbles between the two largest parties, the Workers’ Party (PT) and the Brazilian Democratic Movement Party (PMDB), may ultimately lead to divorce, which would subtract precious resources from the president’s reelection campaign. Until now, Rousseff’s popularity has been the glue that has kept the coalition together. If that popularity wanes to a point of significantly lowering her reelection chances, parties are more likely to defect from the coalition and join forces with the opposition.

Even if all look unlikely for now, a combination heightening any of these four risks could seriously undermine Rousseff’s reelection chances. Nevertheless, the caveat here for the PT is that they have the antidote to save their political project in case the worst scenario plays out. His name is Lula, the former and hugely popular president.

Rousseff’s lack of political savvy not only undermines the government’s agenda in congress, it also poses a threat to the coalition heading into the election.
CURRENCY DEVALUATION, LIMITED EFFECT

A worsening external environment and the perception that the economy is deteriorating should keep the Brazilian real undervalued, but the recovery of industry will take much more than a devalued currency.

Solange Monteiro

FOR TWO YEARS, THE BRAZILIAN CURRENCY has been steadily weakening. Last year, the currency dropped 10.5% against the dollar, for a total plunge of 46% since mid-2011. In part, the devaluation of the Brazilian real and several other currencies was due to the tightening of the extraordinarily loose U.S. monetary policy and the resultant lessening of external financing. But the devaluation of the Brazilian real reflects the perception that the economy is deteriorating. In February, the U.S. Federal Reserve positioned Brazil among the countries most vulnerable to changes in U.S. monetary policy, which cemented the international market’s view of the economic outlook for Brazil.

This scenario that today penalizes Brazil, along with Turkey, Indonesia, and South Africa, reflects in part a stampede out of foreign investors ignoring the country’s positive points. Nevertheless, Brazil’s economic fundamentals have
indeed deteriorated, which in an election year intensifies expectations and uncertainties about the Brazilian situation. “Figuring out the course of the exchange rate this year is no easy task,” says Pedro Cavalcanti, professor, Graduate School of Economics of the Getulio Vargas Foundation (EPGE). With rising gross public debt-to-GDP and external debt-to-exports ratios and a deteriorating external current account (3.7% of GDP in 2013), the real is likely to devalue more.

Regis Bonelli, researcher, the Brazilian Institute of Economics (IBRE), points out that the Central Bank’s commitment to controlling inflation will in part slow the pace of devaluation this year, but “Even so, I think the real will be devalued further against the U.S. dollar. Predictability is difficult at this point because the exchange market is mixed-up,” says Bonelli. Nelson Barbosa, IBRE associate researcher, also believes the real will continue to adjust in 2014. He estimates that the exchange rate adjusted by price changes in Brazil and trading partners increased by 20% in 2012 and 2013 and the adjustment is expected to continue.

In this context, the important question is whether a devalued currency benefits Brazilian industry. So far, the numbers do not suggest that: in 2013, manufacturing posted a record trade deficit of US$54 billion—US$12 billion more than in 2012. According to the Brazilian Institute of Geography and Statistics (IBGE), industry output plunged in December 2013 by 3.5%, though it was up slightly for the year as a whole.

Some businesspeople say it takes more predictability to ensure that exchange rate devaluation will have a consistent effect on industry. “Our concern is that the correction that begins to take shape now [in industry] will take time,” says Thomaz Zanotto, head of the Department of International Relations and Foreign Trade, Federation of Industries of São Paulo (Fiesp). José Augusto de Castro, president of the Association of Foreign Trade of Brazil (AEB), explains that “manufacturing exports are not like commodities, for which there are spot sales. They require contracts that have to be met and recalculated when they are renewed.” Other businesspeople admit that a devalued exchange rate alone is not enough to make up for the lost competitiveness of manufactures; becoming competitive again requires structural changes both to reduce the “Brazil cost” and to ensure that the country’s economic fundamentals improve. “Industrial policy based on exchange rate devaluation alone does not work. We need efficiency,” Cavalcanti says.

“It would be acceptable for Brazil to have a large current account deficit if fixed investment was high, the government had a balanced budget, and public debt was not growing. … But that is not the case.”

Silvia Matos
RELATIVE PRICES

José Luís Oreiro, professor at the Institute of Economics of the Federal University of Rio de Janeiro (UFRJ), argues that there is room for further correction of the exchange rate: “I have no doubt that the Brazilian real is overvalued in terms of industry competitiveness as well as the external current account deficit, which is approaching an unsustainable 4% of GDP.”

Silvia Matos, IBRE researcher, stresses the imbalances associated with the current account deficit. “A country with low domestic savings like Brazil is expected to have a higher current account deficit and require external funding,” she explains. In the Brazilian case, however, the expanding external current account deficit is accompanied by low growth, high inflation, and a fiscal deficit: “It would be acceptable for Brazil to have a large current account deficit if fixed investment was high, the government had a balanced budget, and public debt was not growing. Then the country would be on a path of sustainable growth. But that is not the case.”

What is holding up the adjustment of the balance of payments are economic policies that slow the pass-through of currency devaluation to prices. The adjustment of the current account requires a healthy increase in the price of goods traded internationally, such as oil products, relative to goods traded only in the domestic market, such as services. Unless there is a change in relative prices, Brazil will continue to import more than it can afford and export less than it could. Between June 2011 and November 2013, the

Most emerging market countries had their currencies devalued.

(Effective exchange rate adjusted for inflation; above 100 indicates appreciation)

<table>
<thead>
<tr>
<th>Country</th>
<th>Dec 2010</th>
<th>Dec 2012</th>
<th>Jan 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Africa</td>
<td>98.7</td>
<td>96.0</td>
<td>75.6</td>
</tr>
<tr>
<td>Argentina</td>
<td>105.3</td>
<td>88.4</td>
<td>74.2</td>
</tr>
<tr>
<td>Brazil</td>
<td>103.6</td>
<td>90.0</td>
<td>85.4</td>
</tr>
<tr>
<td>China</td>
<td>101.5</td>
<td>110.1</td>
<td>121.2</td>
</tr>
<tr>
<td>Mexico</td>
<td>102.0</td>
<td>99.7</td>
<td>101.4</td>
</tr>
<tr>
<td>Russia</td>
<td>99.8</td>
<td>106.9</td>
<td>103.2</td>
</tr>
<tr>
<td>Turkey</td>
<td>98.1</td>
<td>92.8</td>
<td>80.0</td>
</tr>
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</table>

Source: Bank of International Settlements (BIS).
nominal exchange rate was devalued by 46%, but the prices of goods traded internationally fell by 6% relative to prices of goods traded domestically. Matos says that the main reason is the policy of controlling fuel prices, which prevents the pass-through of devaluation to the prices of gasoline and other petroleum products.

Price controls were largely responsible for the problems of the energy sector in Argentina, Zanotto warns. “Today this is contributing to the worsening of this country’s economic situation,” he says. With wages rising and prices of goods traded internationally not growing much, consumption and imports have been stimulated to a pace the economy can no longer maintain.

**INTEREST RATES AND CURRENCY VALUE**

Continuation of the exchange rate correction is arousing optimism among Brazilian manufacturers who were penalized by its appreciation in 2010 and 2011. Zanotto explains that, in addition to improving the terms of trade for Brazil’s commodities exports, the country’s high interest rate caused an undue appreciation of the Brazilian real against dollar, which attracted foreign capital. “The previous government liked the formula,” he says, “because it created a wealth effect, in which people consumed imported goods for artificially low prices, while helping fight inflation. But that was wearing down the entire domestic production chain.” Carlos Pastoriza, director of the Brazilian Association of Machinery and Equipment (Abimaq), agrees that the effect was significantly more toxic in longer production chains. He says the gradual loss of profit margins and market share resulted in the substitution of imported for local goods. “The vehicle industry, which in the past had 95% of its parts supplied domestically, now has less than 40%. This is what we call silent de-industrialization,” he says.

Guilherme Mercês, manager of Economics and Statistics of the Federation of Industries of Rio de Janeiro (Firjan), is another who argues that a devalued exchange rate cannot compensate for industry’s lack of competitiveness: “There is no ideal exchange rate for industry. A devalued exchange rate can help in the short term insofar as it increases the profitability of exports, but in the long run, devaluation cannot overcome all the problems related to the Brazil cost, which makes our products more expensive than those of our competitors in the international market.”

What is holding up the adjustment of the balance of payments are economic policies that slow the pass-through of currency devaluation to prices.
AEB’s de Castro reinforces the point, noting, “Today I advocate less concern about the exchange rate and more about production costs. The exchange rate varies according to the wishes of the market. But the cost is within a company’s control.”

**STRUCTURAL REFORMS**

There is consensus that, in an election year, little will change. “This year, the outline has already been given by the government and the Central Bank … to prioritize the fight against inflation and monitor exchange rate devaluation,” Zanotto says. José Julio Senna, head of the IBRE Center for Monetary Studies, points out that the best way for Brazil to take advantage of the recovery in developed economies is to improve international perceptions of its own economy: “The best way to protect the economy is to strengthen it, demonstrating that it is less vulnerable to inflation and the current account balance.”

To adjust the exchange rate and the external balance, according to analysts, the next government will have a long list of tasks to resume structural reforms, starting with a more robust public budget and adjustment of controlled prices. “Today inflation limits our room for maneuver, but in 2015 we must correct fuel prices,” Matos says. She also recommends reducing subsidized National Development Bank loans. Cavalcanti argues for pension reform to increase domestic savings.
Speaking for industry, Firjan’s Mercês sees three broad priorities: “We have a heavy and complex tax system. In infrastructure, we have the most expensive energy in the world, and there are deficiencies in telecommunications, such as the low quality of broadband.”

Fiesp’s Zanotto underscores the difficulty Brazil faces from having the highest interest rates in the world, adding, “We have to fight high interest rates that bring about an undue appreciation of the exchange rate.” Although managing interest rates is a classic and effective remedy against inflation, Senna points out that applying it requires skill: “The interest rate alone is not enough; it must be complemented with fiscal adjustment, in the right dosage, in order not to impact public accounts and be counterproductive,” he explains. Cavalcanti adds that attracting foreign capital is important for a country that saves little. As long as there are no reforms to increase domestic savings, he says, “we cannot afford to stop attracting capital.” Matos notes that Brazil is still dependent on imported technology to improve its productivity, and external financing, if well used, would bring positive results to the productive sector.

“We have a heavy and complex tax system. In infrastructure, we have the most expensive energy in the world, and there are deficiencies in telecommunications, such as the low quality of broadband.”

Guilherme Mercês

“The best way to protect the economy is to strengthen it, demonstrating that it is less vulnerable to inflation and the current account balance.”

José Julio Senna
The Brazilian Economy

Interfacing Brazil’s debt with U.S. monetary policy

In February the U.S. Federal Reserve ranked Brazil as the emerging country that is second most vulnerable as U.S. monetary policy normalizes. Do you agree?

Affonso Celso Pastore— I agree. … Nevertheless, Brazil is less vulnerable today than in the past, when it had no reserves and had unsustainable public debt. In 2002–03 when there was a crisis of confidence, the primary surplus was insufficient, gross public debt was 75% of GDP, and it was uncertain whether new President Lula would maintain fiscal discipline. Brazil’s risk premium skyrocketed to 2,500 points, causing capital flight and exchange rate devaluation. … Now Brazil is much less vulnerable—all emerging markets are much less vulnerable today. All have accumulated international reserves and reduced their debt.
Is the government making the necessary policy corrections to reverse this situation and put Brazil back on the path of sustainable growth?

Let’s put it this way: the government diagnosis was that Brazil was not growing because of a lack of demand. It tried to stimulate demand by reducing the primary fiscal surplus and loosening monetary policy. When demand grows above a country’s total production of goods and services (GDP), it increases net imports and the external current account deficit.... So we have a current account deficit of 3.7% of GDP, and we may say that is not large, [but] what is relevant here is whether capital inflows are sufficient to pay for the deficit. ... For the past 12 months, capital inflows into Brazil were slightly below the current account deficit....

What will determine Brazilian currency value going forward is the amount of international capital inflows. ... In my view, the United States will continue to attract capital—capital that is moving away from emerging countries. Brazilian currency found temporary relief at the end of February, but I believe that when the U.S. recovery picks up, the Brazilian currency will be under pressure again. So the outlook is for further currency devaluation, inflation, and low growth.

In an article published last February, former President Lula stated that Brazil is now a global competitor and that international investors have a more objective and less pessimistic view of the country. Do you agree?

He’s living in a world different from the one I’m looking at. The data do not corroborate President Lula’s view. Fixed investment is falling. The recent national account figures confirm that. With the uncertainty that lies ahead, it will not be possible to raise fixed investment. I also think that potential GDP growth is falling.

Was the government wrong to judge that the country was prepared to live with low interest rates?

The government made a huge mistake. ... [At the time the central bank cut interest rates,] what was happening was a temporary global cycle of lower interest rates. Interest rates fell in the United States, Europe, worldwide. Except that in Brazil the rate fell more than it should have. Interest rates started rising again globally, and now Brazil must raise its interest rates. When the central bank began to cut interest rates, we had inflation of 7% a year. Do you think that was a deal well done? This was a very crude, rudimentary monetary policy blunder.

What more could the government do now?

The government has already spent its ammunition. Will it now lower interest rates to boost growth this year and accept inflation above 6.6%? Will it raise interest...
rates to prevent inflation from straying above 6.5% and accept growth below 1.2%? The government usually says it is constrained because it received a cursed legacy, but in this election year it is reaping a very bad harvest that it planted itself. I do not know what the government will do, but it will have to make choices, and not easy ones.

**Even with devalued currency** and a stimulus package, Brazilian industry has shown no signs of recovery. **What went wrong?**

For 2002–08, unit labor cost was constant, and growth in wages was equal to the growth of labor productivity. … Since 2010, however, the unit labor cost has been rising and is now 17% to 18% above its historical average. As unit labor cost rose, profit margins in manufacturing fell. You look at this and ask: how can industry be well? Some people say industry needs a devalued exchange rate. Yet the exchange rate devalued, but the unit labor cost rose even more . . . The government has carried out a policy of income redistribution, raising wages, but labor productivity has remained constant.

**Do you think the president elected this year will see the need to change economic policy in 2015?**

Whoever wins will have to change economic policy. The changes in policy will have costs, but depending on how the changes are done—if they are done correctly—the cost will be temporary and the country will resume growth. If government persists in flawed policies, there will still be costs but without growth. The dilemma is not whether the government will do something but what it will do.

**Industry lost competitiveness because there were no structural reforms. We must tackle the problem as it exists and not seek the easy way out. … Despite the currency devaluation, we still have a unit labor cost that is too high.**

With high interest rates and no structural reforms, how do you see the medium-term outlook for industry?

Industry lost competitiveness because there were no structural reforms. We must tackle the problem as it exists and not seek the easy way out. One can no longer use the argument that the Brazilian real is overvalued, as it was in 2011. A huge exchange rate correction took place. Nevertheless, we still have a unit labor cost that is too high.

**Do you think it will be possible to roll back the stimulus policy based on tax exemptions for some sectors?**

Brazil will have to increase the primary fiscal surplus, and to do that we have to raise taxes or cut spending, or both . . . . The way things are done in this government is that who complains more wins more. The industry lobby can afford a trip to the capital city, Brasilia, to speak directly to President Rousseff . . . It is very possible that with the
industry lobby pressing the government, it will not roll back tax exemptions. So this tax benefit will have to be paid by someone else. One way or another, we have to raise taxes or cut spending, or both.

In Brazil low productivity is a fact. Some economists point out that part of the problem is the government’s disregard for education.

I agree absolutely. To quote Paul Krugman, “productivity is not everything, just almost everything.” Almost all economic growth is productivity. People say we have to increase investment, but if there is no increase in productivity, the country does not grow. And from the point of view of increasing productivity, investment in human capital is not everything but it’s a good chunk of the story. Countries that have managed to break the inertia and grow, like South Korea, succeeded because they invested in education. When you invest in education, you solve two problems: economic growth and income distribution. If you direct investment in education to low-income people, you increase their productivity, their incomes will rise much faster, and you are improving income distribution. Socially, investing in education is extremely profitable. Highly desirable. This is the first part of the story. … It is necessary to create an educational system that eliminates social and economic differences. We have to pay teachers more, but the pay needs to be based on performance.

Whoever wins will have to change economic policy. … If done correctly, the cost will be temporary and the country will resume growth. If government persists in flawed policies, there will still be costs but without growth.
Argentina on the edge

After devaluing the peso and publishing more realistic inflation numbers, the Argentine government still needs clearer fiscal and monetary policies to stabilize the economy.

Solange Monteiro

THE DEVALUATION OF THE ARGENTINE PESO by 23% in January was the harbinger of a difficult year for the Argentine economy—a year of low growth or recession with high inflation. According to analysts, the government will have to show a clear, credible, and consistent path of fiscal and monetary policy in the first quarter if it wants to mitigate the current negativity and position itself well for the presidential elections in 2015. “If the government does not carry out a fiscal adjustment and continues to finance the budget deficit by printing money, it will have considerable difficulty in stabilizing the economy,” said Dante Sica, president of Abeceb consultancy in Buenos Aires.

Lucas Llach, professor at Torcuato Di Tella University in Buenos Aires, points out that “after the devaluation, the parallel dollar continued to have a premium of 50% over the commercial dollar.” Government acceptance of a more realistic inflation number, which the official statistics institute INDEC had been manipulating for seven years, is a positive step as confidence in Cristina Kirchner’s administration is low. Inflation calculated from the new base and monitored by the International Monetary Fund reached 3.7% in January compared to only 0.9% under the old base.

“Going back to international markets, whether to attract foreign direct investment or for financing, demands reliable statistics,” Llach says. Sica says the Kirchner administration has also to change its incorrect diagnosis of the economy’s woes: “The government still argues that inflation is not the result of wrong fiscal and monetary policies but is the result...
of speculative groups and corporations that in order not to lose their share of national income are increasing prices indiscriminately.” Sica estimates that inflation will soar above 30% in 2014.

One of the key factors in whether inflation can be contained will be the wage agreements negotiated between unions and companies. In the midst of uncertainty about the evolution of prices and the government’s stabilization program, it is natural that workers seek guarantees against inflation. “In March the big unions that set wage trends such as those in metal industries, banking, and commerce will be in a better position to negotiate,” says Sica. “Today a wage rise of 25% to 30% is being discussed, but the recession plays into the hands of the government because the unions want to save jobs as much as possible.”

Last February, the country had somewhat of a truce with markets and moderation of expectations as people patiently went through shortages in supermarkets because of price controls established by the government. But a truce has its limits. On the fiscal side, the government will have to reduce the burden of subsidies, especially those for energy consumption. “Since 2001, Argentina has maintained subsidies for gas and electricity rates for nearly 85% of customers in the country. This generates a fiscal deficit of almost 3.5% of GDP,” says Abeceb’s Sica. Lach adds that “Although the subsidies cover company costs, this measure is not enough to attract investments in the oil sector,” says Llach, adding, “The price of oil is regulated by a high tax on oil exports that lowers company profitability.” Llach points out that Argentina exported energy in the 1990s and has since become an energy importer.

To attract additional foreign capital, Argentina needs to address complex international issues by, for instance, negotiating with the member countries of the Paris Club after a 12-year debt moratorium; making progress in discussions with U.S. creditors, whose claims are being heard by the U.S. Supreme Court; and paying compensation for the nationalization of Spanish Repsol, which is central to attracting investments in the oil sector. “If the country can move ahead on these issues, maybe next year Argentina could attract foreign capital.” Sica believes.

According to José Augusto de Castro of the Association of Foreign Trade of Brazil, this year Argentina will reduce its imports by about US$5 billion, of which goods worth US$2.5–3 billion are supplied by Brazil. “Last year, Brazilian exports to Argentina, mostly manufactured goods, totaled US$19 billion. This is a serious situation for Brazil, especially if there is the possibility of late payments,” he says.

“If the government does not carry out a fiscal adjustment and continues to finance the budget deficit by printing money, it will have considerable difficulty in stabilizing the economy.”

Dante Sica
FOR DECADES LOW PRODUCTIVITY has been responsible for the poor performance of Brazil’s gross domestic product (GDP). Today, increasing productivity—which rebounded slightly last year but is still far from stellar— is more urgent if the country wants to achieve more robust economic growth without pressure on wages and inflation, because the labor force is expected to decline as the population ages.

In 2013, unemployment averaged 5.4%, according to the Monthly Employment Survey (PME) of the Brazilian Institute of Geography and Statistics (IBGE). This is the lowest annual result ever. But a recent study by Fernando de Holanda Barbosa Filho, researcher, Brazilian Institute of Economics (IBRE), based on IBGE data for 2002 through 2013 shows that growth in total factor productivity—the measure of the efficiency of all inputs, labor and capital, to GDP—fell to 0.4% for 2011–13 after averaging 1.7% for 2003–10. Growth of labor productivity alone was a milder version of the same pattern, averaging 1.8% in 2011–13, down from 2.2% in 2003–10. “With the same factors of production as before, we are producing fewer goods and services than before,” says Barbosa Filho. “Last year, the weak recovery in total factor productivity of 0.8% was not sufficient to make up for the loss of 0.9% in 2012.”

Alcides Leite, professor of economics at Trevisan Business School, explains that “Brazil has grown in the past decade because there were a large number of unoccupied workers. When these workers were put to work, total production grew. In order to sustain long-term growth, Brazil now needs to make a quantum leap in productivity.”

To do so, in addition to fostering innovation, increasing investment, and improving workers’ skills, there is a need to reduce the weight of less efficient sectors like services and commerce in GDP and boost the productivity of industry and agribusiness—sectors seriously affected by infrastructure and logistics deficiencies. Barbosa Filho warns that resources are being allocated to precisely the least productive sectors: “When the services sector expands, the result is to reduce total productivity.”

Thais Thimoteo
David Kupfer, a member of the Group of Industries and Competitiveness of the Institute of Economics of the Federal University of Rio de Janeiro (UFRJ), has a different view. He believes that economic growth raises productivity rather than the contrary, because the labor market is less elastic than production. “If GDP grows 3%, for example, employment does not grow to the same extent, increasing productivity. In contrast, when the economy shrinks, businesses do not lay off workers immediately, and productivity falls,” he explains. “It is natural that entrepreneurs are more willing to invest when the economy is doing well, which raises productivity,” adds Julio de Almeida Gomes, former Secretary of Economic Policy of the Ministry of Finance and now professor of economics at the University of Campinas (Unicamp).

Kupfer also points out that labor productivity is being affected by high turnover of workers, who have little incentive to stay in a job when the booming labor market presents plenty of job opportunities. He says, “The high turnover of workers is a plague . . . workers quit their jobs more easily because they receive other offers. So companies have no reason to invest in training to improve worker skills and productivity.”

In order not to lose workers, the Brazilian company TOTVS, developer of integrated management systems, trains its professionals regularly. The company believes that investing in people and innovation must be done by any company that intends to be competitive enough to establish itself in the international market. “Obviously we have structural problems that the government needs to address, but if we sit around waiting for them to be solved, we get nowhere. We also have an obligation to invest in our businesses. If I want to differentiate myself, being competitive I need to invest. Nothing is free,” says Alexandre Mafra, TOTVS financial executive vice president. The company now has 26,000 customers and affiliates in Argentina and Mexico in addition to a research lab in Silicon Valley. Mafra explains that especially for information technology, productivity as a result of innovation is essential to business success because software systems become obsolete quickly.

Unicamp’s Gomes believes the most effective way to increase productivity and competitiveness is to expand company operations in overseas markets as TOTVS has done. “Our companies need to be more aggressive regarding exports and internationalization so that they acquire the innovation DNA from their experiences abroad, where competition is fierce,” he emphasizes.

Confidence down
Unfortunately, industry does not have the drive to invest today. With manufacturing nearly stagnant since 2010, business confidence is at its lowest, according to surveys of the

“With the same factors of production as before, we are producing fewer goods and services than before.”

Fernando de Holanda Barbosa Filho
Brazilian Institute of Economics (IBRE) and the National Confederation of Industry (CNI). “In addition to low business confidence, the inability of industry to invest is also coming from competition between our domestic products and those imported, which does not allow industry to raise prices to cover their increased costs,” notes Renato Fonseca, CNI research manager.

Moreover, industry must also compete for workers with the service sector. “Because of the strong growth of the services sector, we are being forced to hire professionals who are poorly educated, and to keep them on the job it is also necessary to provide wage increases and other benefits. All these costs exceed productivity gains,” Fonseca says. A CNI survey shows that increases in wages have outpaced growth in manufacturing productivity. From 2001 to 2012, productivity grew by only 1.1%, while the average pay in dollars for industrial workers rose 169%, which undermines industry’s external competitiveness.

### How to increase productivity?

IBRE researchers Regis Bonelli and Julia Fontes call the problem of productivity in Brazil “the long-run challenge.” According to their estimates for 2012–22, the Brazilian economy will be able to grow 4.4% a year only if productivity increases by 3.4% annually. Sustaining such high productivity growth will require a tremendous effort in terms of research and development of products, investment in education, and improvement of infrastructure.

Here Barbosa Filho points out that government policy may be suppressing productivity growth. Granting tax exemption to companies that are not in good shape economically only postpones their demise. “Policies that support noncompetitive companies do not provide incentives for these companies to make the changes necessary to improve their productivity. In general, recessions eliminate unproductive companies. But if you save them all, you can slow down the
In addition to producing and disseminating the main financial and economic indicators of Brazil, IBRE (Brazilian Institute of Economics) of Getulio Vargas Foundation provides access to its extensive databases through user licenses and consulting services according to the needs of your business.

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There were already enough uncertainties complicating the fiscal scenario: for instance, inflation is still resistant to falling and has not pushed through the target ceiling (6.5%) only because of government price controls; and the external scenario is far from benign, typified by unprecedented trade deficits in January and February. Now recent weeks have seen more dark clouds forming because of lower than expected rainfall and the costs associated with administered electricity prices.

Though it is premature to even mention the idea of energy rationing, the theme is worrying. The delay in the rainy season has led to heavier use of oil- and coal-generated power plants rather than hydropower to meet demand, and the government is expected to cover the higher cost of producing electricity. More money flowing into energy subsidies could compromise the government fiscal effort, triggering predictable reactions about Brazil’s country risk and future interest rates.

One solution would be to pass part of the cost of producing electricity on to electricity prices. But as with the fuel price increases, that would likely push inflation above the target ceiling, which may not be tolerable in an election year. The government thus has a difficult trade-off: Either let electricity tariff adjustments pass through to inflation, or pay the costs of higher electricity prices and increase the fiscal deficit.

We hold to our growth forecast of 1.8% in 2014 but are raising our inflation projection from the previous 5.9% to 6.4%. However, forecasting has become more tentative in recent months, and even lower growth is possible. Currently, our scenarios do not incorporate the possibility of energy rationing, but even without it, the outlook is for only lukewarm economic activity with an expected modest slowdown in GDP growth, mainly because of lower growth in manufacturing.

Brazil’s economic policies since 2008 have failed to promote sustainable economic growth but have instead led to such macroeconomic imbalances as high inflation, low fiscal primary surpluses, and a significant increase in the external current account deficit. The next government will have to take corrective measures to address these if the economy’s growth rate is to improve.

### Brazil: IBRE baseline scenario for 2014

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<td>Budget primary surplus (%)</td>
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<td>International reserves (US$ billion)</td>
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<td>378</td>
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Source: Brazilian Institute of Geography and Statistics, Central Bank of Brazil, IBRE staff projections.

1 Recurring primary surplus defined as budget balance excluding interest payments on public debt, extraordinary revenues from dividends and concessions, and some investments of the Growth Acceleration Program.