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BRAZIL'S POLITICAL CHALLENGE: BUILDING CONSENSUS ON AN ECONOMICALLY SUSTAINABLE STRATEGY

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What I will present today is a brief outlook of the Brazilian economy, mostly a quantitative analysis of what the main challenges and problems are, how the government is dealing with them, and how the economy is faring so far in this turbulent domestic and international scenario. To facilitate the analysis, I organized my talk around four main questions that usually dominate the debate in Brazil but tend to be unknown in the U.S. and the rest of the world. So, the four questions are: why economic growth decelerated, why inflation accelerated, what happened to fiscal policy and what is next for the economy in terms of our expectations for the near future and the next presidential mandate.

First: why economic growth decelerated. There is a lot of talk about a loss of confidence or crisis that has developed in Brazil over the past ten years. But, when you look at the data it is actually very easy to explain why growth decelerated without resorting to metaphysical or political explanations. There was an excessively restrictive macroeconomic policy in place in Brazil in 2011, both on the fiscal side and on the monetary side, with quantitative tightening by the Central Bank.

At that time this policy was used to fight inflation without having to raise the base interest rate too much. So, this was a peculiar Brazilian feature, because we have such a high real interest rate, the Central Bank actually combined prudential measures and quantitative tightening with an increase in its base interest rate. The government also increased its primary surpluses substantially. This was just after the 2010 G20 meeting where the mood of the day was the expansionary fiscal contraction, that is, the idea that a quick fiscal consolidation would actually restore confidence faster, reduce interest rates, and sustain the recovery of the world economy. This restrictive macroeconomic policy was implemented in an uncertain international scenario that suddenly turned negative. In 2011, the problem was the budget ceiling in the U.S., the recovery problems of Greece in Europe, and China's deceleration. This

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international scenario amplified the effects of the Brazilian restrictive policy. And, for domestic reasons, there was also a generalized fall in private and public investments.

So these three features actually explain most of the growth deceleration in Brazil. To put things in perspective in terms of GDP, we had a deceleration from 7.5 to 2.7. A deceleration in growth in Brazil in 2011 was predicted and expected for statistical reasons. There was a quick recovery in 2010, and then growth decelerated in 2011. However, it decelerated much more than expected, reaching something close to 1 percent in 2012. The market expectation is 2.4 for this year and 2.3 for next year. I believe this year's prediction is right on the mark, but next year's prediction is too pessimistic, it is probably going to be something closer to 3 percent or at least higher than 2.3 (Figure 1).

Now I will discuss fiscal policy. This graph will show you how restrictive fiscal policy was implemented. These are the primary surpluses of the federal government, the budget balances without interest rate payments, since 1997. I used this long period to place the recent years in historical perspective. You have a very sharp fiscal contraction in 1998-99, ultimately increasing the budget's surpluses. This happened after the East Asian crisis, the Russian crisis, and the Brazilian crisis. Then you see another increase in the primary surplus at the beginning of Lula da Silva's administration. Volatility is present during the 2008 crisis, and then fiscal contraction happens in 2011, showing an increase in the primary surplus of 1.1 percent of GDP (Figure 2 on next page).

These are the recurring primary surpluses for those familiar with Brazilian statistics. It excludes non-recurring operations such as those with

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Figure 1

Petrobras and the Sovereign Wealth Fund -- it is a primary surplus based on expenditures and taxes.

This is a major change. This process happened in waves, you have the first consolidation, then some fluctuation, then you have another reduction

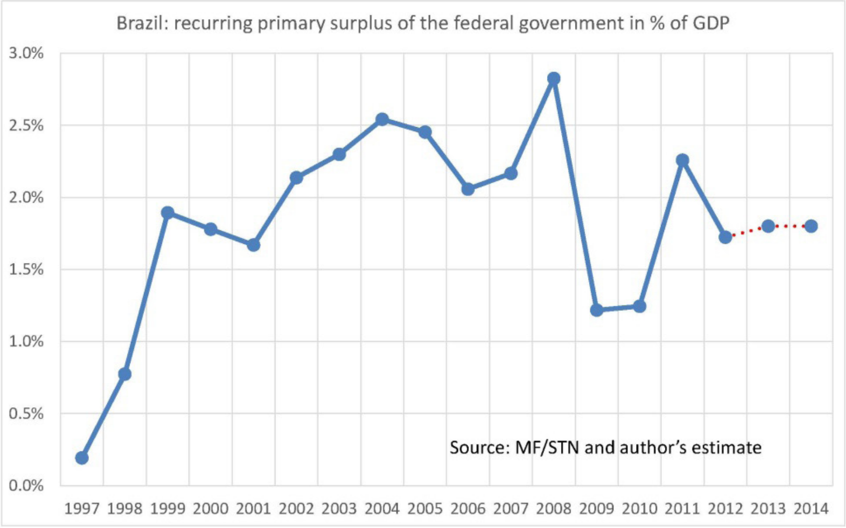

Figure 2

after 2006, which was aided by the exchange rate appreciation associated with the commodity cycle, and then, you have the recent trend. The deceleration in growth and the restrictive macroeconomic policy allowed the real interest rate to fall very sharply, very quickly. It fell from something close to 6 percent per year, to 2 percent per year. Now it is around 3.5.

So, in 2011, we had an increase in the primary surplus of more than 1 percent of GDP. The expectation now is that the federal government will maintain its primary surplus stable for this year and next year.

On the one hand, the restrictive macroeconomic policy was one of the factors that caused slow growth. However, it also allowed a very quick and sharp reduction in the real interest rate in Brazil.

This graph (Figure 3 on next page) shows the real base interest rate in Brazil (our Fed funds rate discounted by expected inflation). In the beginning of the 21st century, Brazil had a real interest rate of something between 14 and 20 percent. Ten years later, it is between 2 and 4.

Market expectation is that this will fluctuate between 2 and 4 even with the recent hikes of the Brazilian Central Bank. So despite this recent increase, when you analyze the long-term perspective, it is a major advance in the Brazilian economy. It undoubtedly depends on domestic issues, but, if there is a window of opportunity, it can also benefit from the world economy due to low interest rates, allowing a quick conversion of Brazilian real interest rates to international lev-

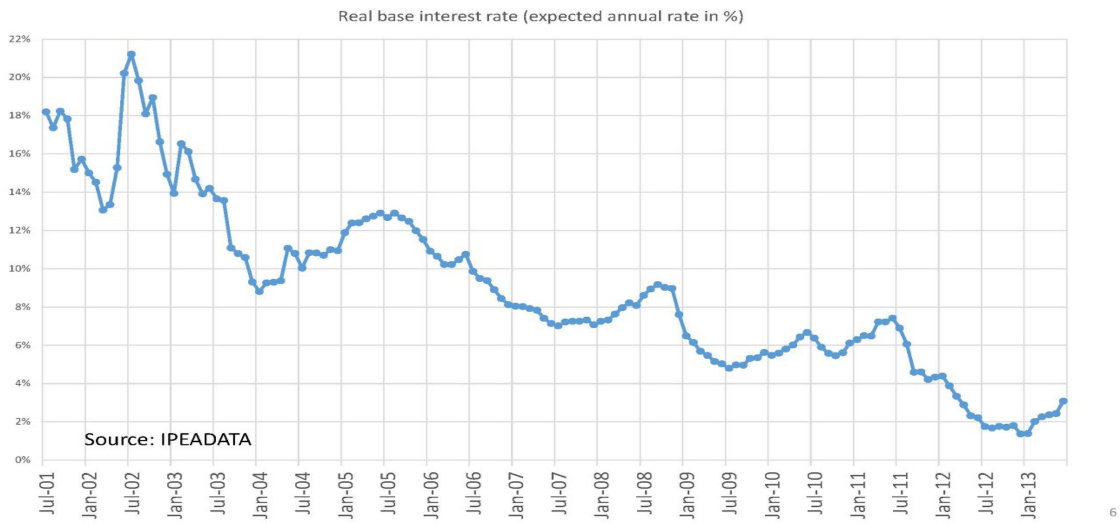

Figure 3

els. Interest rates are still very high, but, again, they fell from something between 14 and 20 percent to something between 2 and 4.

On the international scenario, this is the Brazilian terms of trade, representing how much every unit of exports Brazil buys of imports (Figure 4 on next page). There are two major expansions, first from 2005-2008, pulled by China, the crisis, and then you have a much faster and higher expansion. This is due to, again, the recovery of China and quantitative easing, which pulled the international commodity prices, peaking in 2011. When the international scenario turned negative in 2012, they actually fell by 10-12 percent, and this had an immediate impact on the Brazilian economy, which is historically restrictive.

More and Better Public Services

The decrease in inflation and reduced disposable income of firms and households all led to deceleration. So this demonstrates that fiscal contraction and the changing international scenario explain most of the deceleration in recent years.

However, it was not only the factors mentioned above. There was also a reduction in investment which has to do both with domestic and international issues. If you divide Brazilian investments in four components, you first have investments by commodity producers, which took a very huge hit in 2011-12. In fact, Petrobras is undergoing a comprehensive re-evaluation of its investment plan since the international oil market is not booming as it was in the past. And the mining sector worldwide is in the midst of major restructuring. In recent years, the CEOs of the four largest mining companies were replaced.

There was an important change in the world cycle of mining prices and mining production. In Brazil, Petrobras and Vale alone answer for something between 10 to 15 percent of total investments. Of every USD$10 invested in Brazil, USD$1 is done by Petrobras directly. Petrobras is as important for the Brazilian economy as the military budget is important for the U.S. economy. Petrobras' investment follows its own logic, and when it changes it affects the rest of the country.

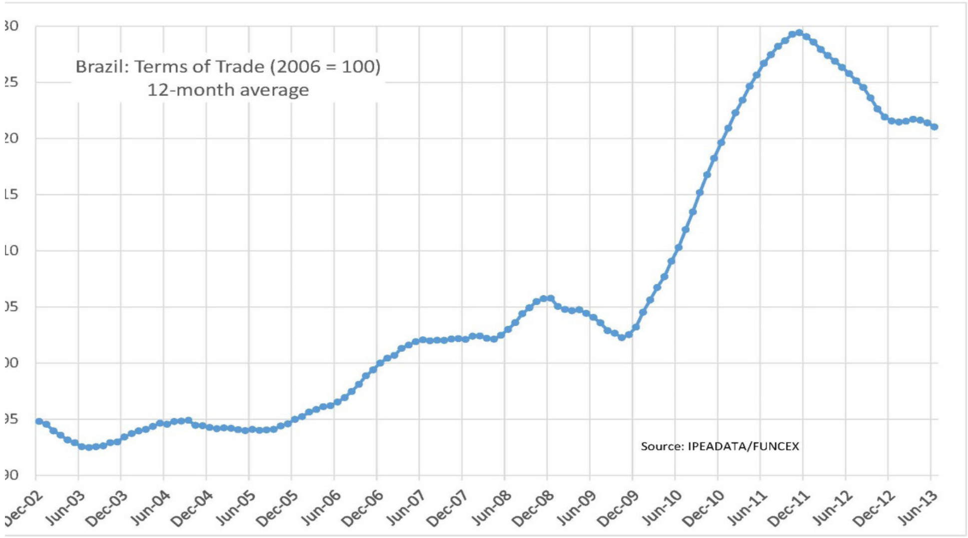

Figure 4

There was also a major fall in investment in capital goods in 2012. A change in the product cycle of trucks and buses due to regulatory changes meant that buses and trucks could no longer be produced with old technology. The consequence was anticipated production in 2011, meaning that firms produced as much as they could and then had to cut production in 2012. This led to a major fall in 2012 but is now rebounding. So, this also provides the statistical explanation for the reduction in investment.

Residential construction slowed down in the transition between the Lula and Rousseff administrations, when the government was actually changing gears, ending its first phase of the housing program, and starting the second phase. As common with many government programs, when you are ending one phase and starting another, the pace of construction, of new contracts, decelerates. So, these factors explain the deceleration in residential investments in 2011-2012.

In terms of infrastructure, Brazil decided to re-evaluate its investment model, both public and private. The government chose to make investments through the private market, through concessions, and it has been taking a long time to put those concessions in place. This transition also led to a temporary reduction in investment in infrastructure. Brazil should take sole responsibility for this; no one else should be blamed. The inner functioning of the government, congress, the regulating agencies in Brazil, legislation and debts, have so far caused too many delays in investments in infrastructure. They are now rebounding, but it is important to note that the previous decrease was a major determinant of the reduction in overall investment in 2011 and 2012.

Despite this, the Brazilian investment rate, investment in terms of GDP (Figure 5 on next page), has been increasing in the last 10 years. This is the Brazilian investment ratio. The blue line represents current prices. It went from 16 percent to something between 18.5 percent. But that tends to underestimate the increasing investment in Brazil. Why? Because in addition to increasing investment, there was also a reduction in the relative price of investment in Brazil.

Ten years ago, investments in Brazil paid for, for example, an indirect federal tax similar to the sales tax you pay in the U.S. when you purchase an item at a store. When you bought a capital good, such as construction material, you had to pay an indirect federal tax around 20 percent. This was cut to zero in recent years, reducing the price of investment. What I am showing in this graph is that if you consider constant prices, the increase in investment was actually much higher. The investments went from 16 percent to something close to 20.5 percent.

There were two compensating moves. The government took some measures to increase the quantity of investments and reduce the price of investments, so that one thing compensates the other. When you consider it at constant prices, there was a major increase in the Brazilian investment ratio. This is still low by international standards but not in terms of Brazilian history. The highest value that this has reached in Brazilian history is 25 percent, during the military period in the 1970s. So, an investment rate between 20 to 22 percent is usually adequate to sustain a growth rate of 3 to 4 percent in Brazil.

Moving along to the second question: Why did inflation accelerate? There has been a sequence of adverse exogenous shocks, both domestic and international, in the last two years. This occurred during a domestic period of very low unemployment rates that kept services' inflation high. In the past, with low unemployment rates, inflation of services was usually high, but this was compensated by favorable shocks in other prices.

What happened in recent years is that you had a series of adverse shocks that compounded with

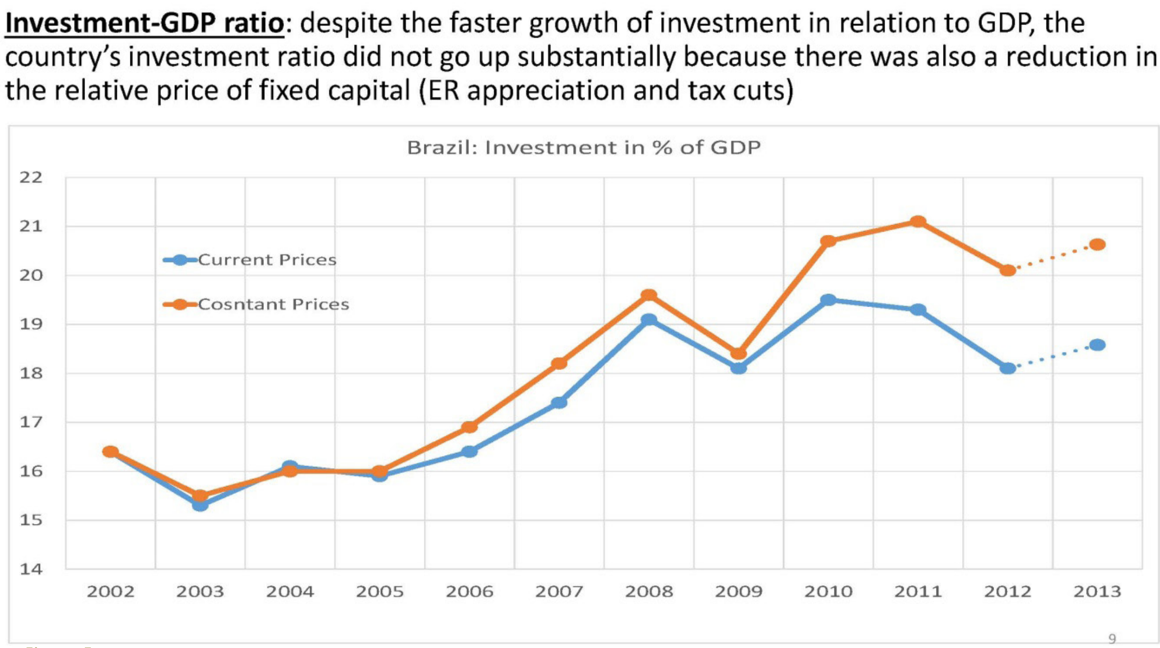

Figure 5

the inflation services to push the general price levels up (Figure 6 on next page). The recent depreciation of BRL also raised inflation in 2012. Now we have this monetary volatility and it is not clear yet how significant the impact will be. On top of that, we had, at some points, mixed signals from the government that were interpreted by the market as a change in our macroeconomic policy. Some people decided to interpret statements by public officials as if the system had changed, concluding that the government no longer targeted inflation and that it had adopted an exchange rate target.

This is obviously wrong and has been denied strongly by the government in recent months. But at that time, 2011-2012, speculations led to expectations of increasing inflation. People started to believe that inflation went up and that it would not go down. What ended up happening is that inflation did indeed go up because of these adverse shocks in 2011, and inflation expectations remained very high, still at 6 percent, despite government efforts.

It will take some time until the government is capable of pulling inflation expectations down again. This will happen only when people start seeing the results. Expectations for this year are actually of a small reduction in inflation.

Just this morning I was reading that people actually expect inflation to decelerate faster than expected. There are two reasons for this. First, prices are falling faster than expected even amidst the growth recovery. And second, with the continuance of quantitative easing, the Brazilian real is appreciating again. The two factors will likely contribute to decreasing inflation.

However, at the end of the day, inflation expectations are still stuck at 6 percent, and it may take some time until the macroeconomic policy, especially monetary policy, brings that

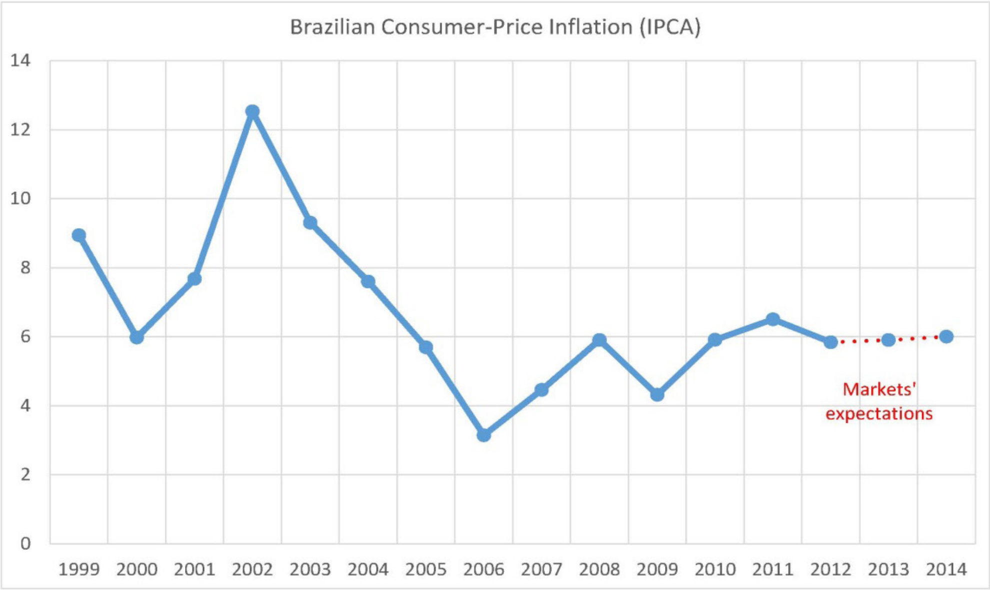

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Figure 6

back to the target of 4.5 percent. We do not expect this to happen rapidly through 2013-14.

Let us put the adverse shocks into perspective: these are the changes in commodity prices in Brazilian currency (Figure 7). They usually follow a change in the exchange rate and the commodity prices. We went through a shock in the beginning of the Lula administration, with an annual commodity inflation of almost 50 percent. After which high volatility emerged, and recently, we had another adverse shocks.

In mid to end- 2011 there was a shock that pushed commodity inflation to something close to 30 percent in Brazilian currency. The price of food, the price of mining and the price of oil increased. That explains the acceleration of inflation. It became incorporated in market expectations because markets did not perceive that the government would be capable of producing a quick convergence of inflation.

Third point: What happened to fiscal policy? Excessive fiscal restraint in 2011 actually ended up eroding the sustainability of high primary surpluses in 2012 and 2013. As the economy decelerated, the government revenues fell, so they ended up with the same expenditures, having a lower budget balance. In order to fight the recession, the government had to adopt a series of tax cuts that pushed the revenues further down, reducing the primary surpluses. This is acceptable in a situation of low growth. But in order not to decrease the primary surplus too much, the government started to resort to quasi-fiscal financial operations.

Part of this initiative was done through financial loans to government banks in order to stimulate the economy through financial operations.

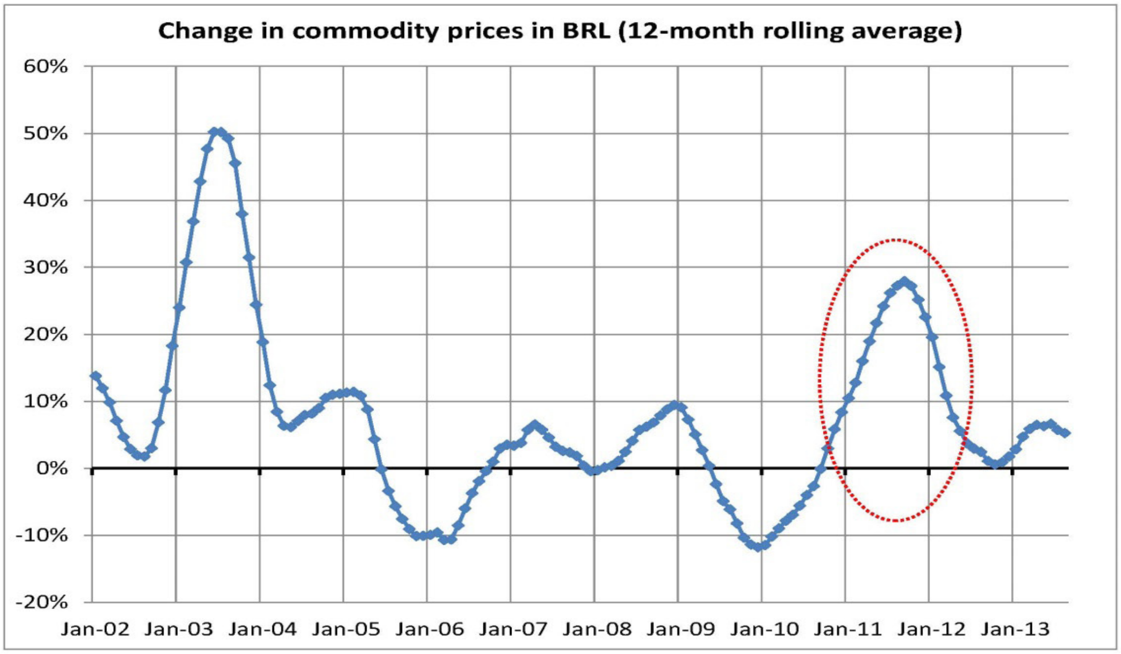

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Figure 7

Brazilian primary budget in % of GDP: the increase in the federal primary expenditures was concentrated in income transfers to families, through social-security benefits (indexed to the minimum wage) and cash transfers to the poor (Bolsa Familia).

Numbers in % of GDP	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Change 2002-12
Net primary revenue	17,9	17,4	18,1	18,8	19,0	19,3	19,2	18,9	18,7	19,7	20,0	2,1
Net primary expenditure	15,7	15,1	15,6	16,4	17,0	17,1	16,4	17,7	17,4	17,5	18,3	2,6
Government payroll and pensions	4,8	4,5	4,3	4,3	4,5	4,4	4,3	4,7	4,4	4,3	4,2	-0,6
Income transfers to families	**6,6**	**7,2**	**7,6**	**8,1**	**8,4**	**8,5**	**8,1**	**8,7**	**8,5**	**8,6**	**9,2**	**2,6**
Investment	0,8	0,3	0,5	0,5	0,6	0,7	0,9	1,0	1,2	1,2	1,3	0,5
Other primary expenditures	3,5	3,2	3,2	3,5	3,4	3,5	3,1	3,2	3,3	3,4	3,5	0,0
Primary balance*	2,1	2,3	2,5	2,5	2,1	2,2	2,8	1,2	1,2	2,3	1,7	-0,4

* The number does not include non-recurrent revenues and expenditures, Source: Brazilian MoF and author's calculation

Figure 8

It is a kind of fiscal expansion, but not a typical fiscal expansion. It is a fiscal expansion through the official system of credit.

The result of this was a reduction in net public debt, but with a very high interest rate. This is because the government issued bonds at 10 percent, and lent to the government banks at 5 percent. So this deal actually represents a huge financial cost for the government. It was an important measure to fight recession in 2009-10, but it now puts some pressures on public financing in the long run.

This table (Figure 8) is the primary side of fiscal policy. It shows the composition of the primary balance in terms of its main components. The main item to stress in the chart is where the gain in revenue went over the last 10 years. The net primary revenue of the federal government went from 17.9 percent of GDP in 2002, to 20 percent of GDP last year - an increase of 2.1 percent of GDP. Primary expenditures went from 15.7 percent of GDP to 18.2 percent of GDP - an increase of 2.6 percent of GDP. When you take the main components of expenditures, government payroll, income transfers, investment, and other expenditures, what increased most was income transfers –from 6.6 percent, to 9.2 percent of GDP; that is: an increase of 2.6 percent of GDP.

So all the increase in primary expenditures was channeled to income transfers, to increase the minimum wage, to reduce poverty, and to increase unemployment insurance. So there was a fiscal policy in which the government gave back all its gains in revenue to the private sector through income transfers. This is what ultimately pulled domestic demand up in the last 10 years.

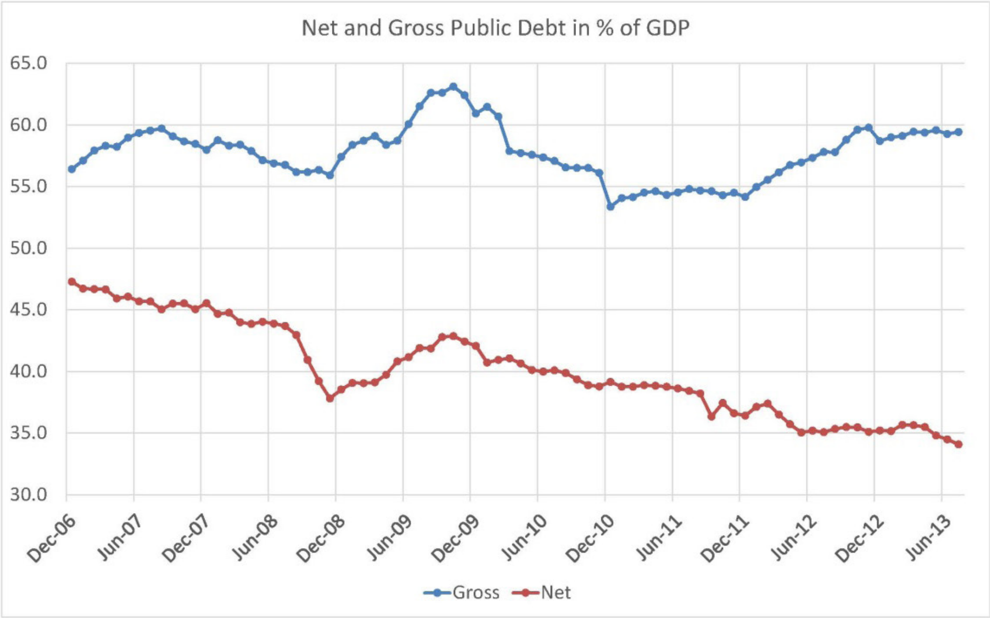

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Figure 9

On the financial side, this policy was consistent with the reduction in the net public debt, at something close to 60 percent of GDP at the beginning of the Lula administration, to something just below 35 percent of GDP now (Figure 9, next page). But in recent years the gross debt has been growing because the government used loans through its banks to stimulate economic activity. This was a form of quantitative easing in Brazil. Here in the U.S., the Federal Reserve itself bought private bonds and expand credit. In Brazil, that was done by the Treasury with the state banks. The Treasury issued bonds, took the resources, placed them mainly in our national development bank, and the national development bank used it to expanded credit. Again, this was useful to fight the crisis but obviously, at some point, it has to end, otherwise it would increase the cost of debt too much. The government is already phasing out, reducing gradually its loans to BNDES.

The side effect of this was that Brazil was able to recover quickly from the crisis and to maintain a low unemployment rate. However, the cost of public debt is still very high. This is the net interest rate on public debt. To calculate net interest rates you must take the interest that you receive on government assets and subtract the interest that you pay on government liabilities. I want to use this to emphasize one thing: in 2008 and 2009, even when we had a very high real interest rate, the cost of government debt was something between 14 and 15 percent. This was the time when the real interest rate in Brazil was at 8 percent.

Now the real interest rate (Figure 10 next page) in Brazil is 2 percent and the cost of debts is 15 percent. So now it is higher than when the real interest was lower. This is because of the cost of our quantitative easing. Because we had to organize this huge action by our national development bank, we now have a high short-term financial cost, and so far this has been appearing in the financial side of the government budget.

What are the challenges for the near future? Recently there were a lot of demonstrations on the streets of Brazil. People's expectation can probably be discussed for a long time, but one thing we know for sure is that there is an opposition between the market's demand and the people's demand.

The people's demands in general terms are for more and better public services. It is a kind of hierarchy of needs applied to public policies. Since poverty was reduced and unemployment was reduced, the people's demands moved to other aspects of public policy. So there is now a huge demand to improve public education, public health, and public transportation. These issues require more resources and more expenditure. Even if you reduce corruption and increase public efficiency, it is still going to require more resources. On the other side, the market is demanding more fiscal restraint from Brazil. Again, the market still believes in the expansionary fiscal contraction hypothesis, that is, that with more fiscal restraint interest rates will be lower, and that, coupled with confidence, will pull the economy up.

How can you solve this contradiction? Perhaps it cannot be resolved, but the political powers will ultimately determine this. As it is common in Brazil, there is always a bright side to everything. The bright side of this is that to improve public services you have to work with a lower primary surplus (we have already been doing this in the last two years), and you can compensate that with lower financial costs of public debt. By scaling down the government subsidized loans through the state banks the net cost of public debt will be reduced, so one thing compensates the other, and you keep financial stability and financial solvency while attending to the people's social demands at the pace that your budget allows it. That is what the government has been doing. It is not clear so far what the consequences will be, but the recent government actions point in that direction.

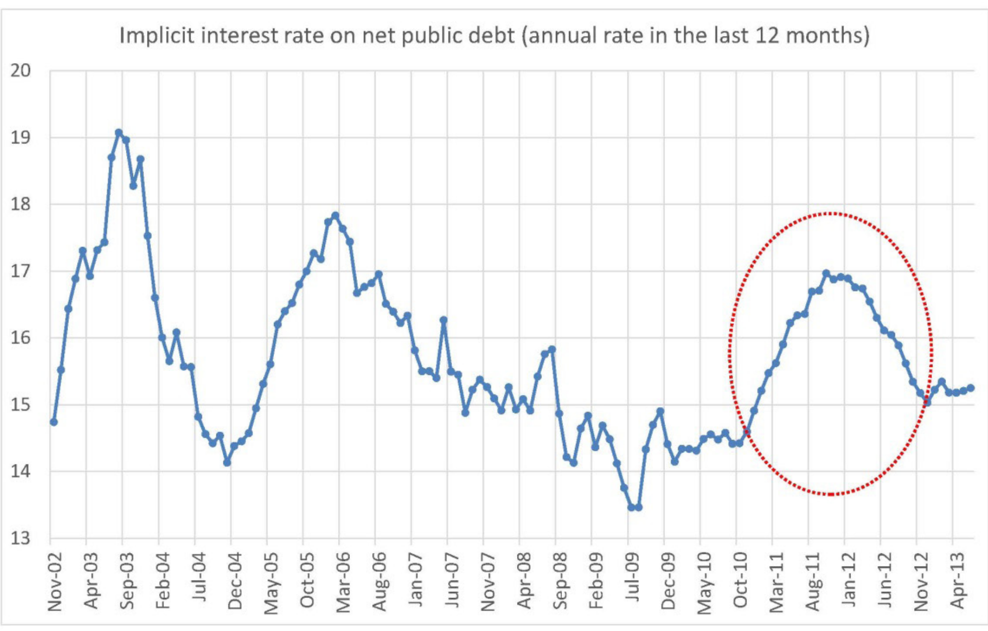

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Figure 10

What can we expect next? What's next for the economy? Despite all this volatile macroeconomic performance, I believe Brazil still has a very favorable growth potential. Brazil is still very competitive in commodity production: food, mining and oil. There is a huge repressed demand for more investment in infrastructure that allows for accelerated growth. The expansion of the middle class in Brazil is reaching the housing sector. It started mostly with people eating better, buying better clothes, and buying households appliances and cars.

Now, it is reaching the housing market. It actually started in 2009, and despite all of these years of macroeconomic volatility, we had a gradual and steady increase in residential investment in Brazil. This trend tends to continue. This poses another possibility for a long run of expansion in Brazil from the demand side. As I mentioned, public demands for better public services will also increase investments in urban development in Brazil. These are what I call the growth avenues from the demand side: looking at growth from the demand side.

How can you make that compatible with your supply constraints? You have to do this through product diversification, not relying so much on commodities to finance our balance of payment. This is especially true in the current context in which we can no longer count on exchange rate appreciation in the same amount that we had in the past. From 2003 to 2009, the exchange rate in Brazil appreciated something close to 40 percent. That will not happen again. So, you have to accelerate growth but in the context of a stable real exchange rate. This means that monetary policy itself will have to control inflation more through interest rates rather than through exchange rate appreciation.

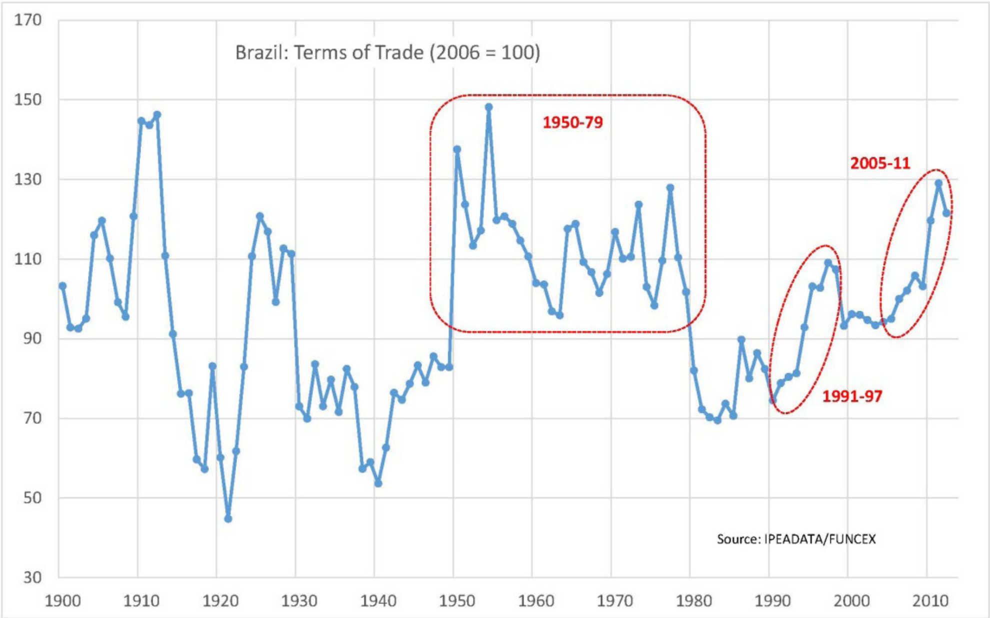

Figure 11

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Is this situation too adverse given the changing international scenario? To put the current situation into perspective, here is a graph (Figure 11) showing the terms of trade in Brazil over the last 110 years. These are the terms of trade in Brazil since 1900. In economic terms, this is the amount of goods that every unit of Brazilian exports can buy in the world economy– it is a measure of the purchasing power of Brazilian exports.

The change in the international scenario caused this fall shown in the graph. If you put that into consideration, you can see first that there were two periods of increasing terms of trade in Brazil recently. One in the mid-1990s, from 1992 through 1997, and one more recent in 2005-2011. Brazil usually takes advantage of a very favorable scenario to do something positive with its economy. In 1994, the Brazilian government launched a stabilization plan, the well known Real Plan, which reduced inflation through an exchange-rate anchor. From 2006-10, the Brazilian government accelerated economic growth and reduced income inequality, through its investment and income transfers.

Now, the situation changed, we are probably not going to see another increase in the terms of trade in the near future. The expectations of the market and the government is that the terms of trade will fluctuate around its current level in the next years. This is not bad, since the current level of terms of trade is still at a very high level by historical standards. The last time Brazil had fluctuations around such a level was between 1950 and 1980, during the three decades of very fast growth in Brazil.

Those were the decades when Brazil became an industrial and urban economy. In a sense, this was the period when Brazil took advantage of favorable terms of trade to industrialize and urbanize. What people are predicting is for the next decade is something close

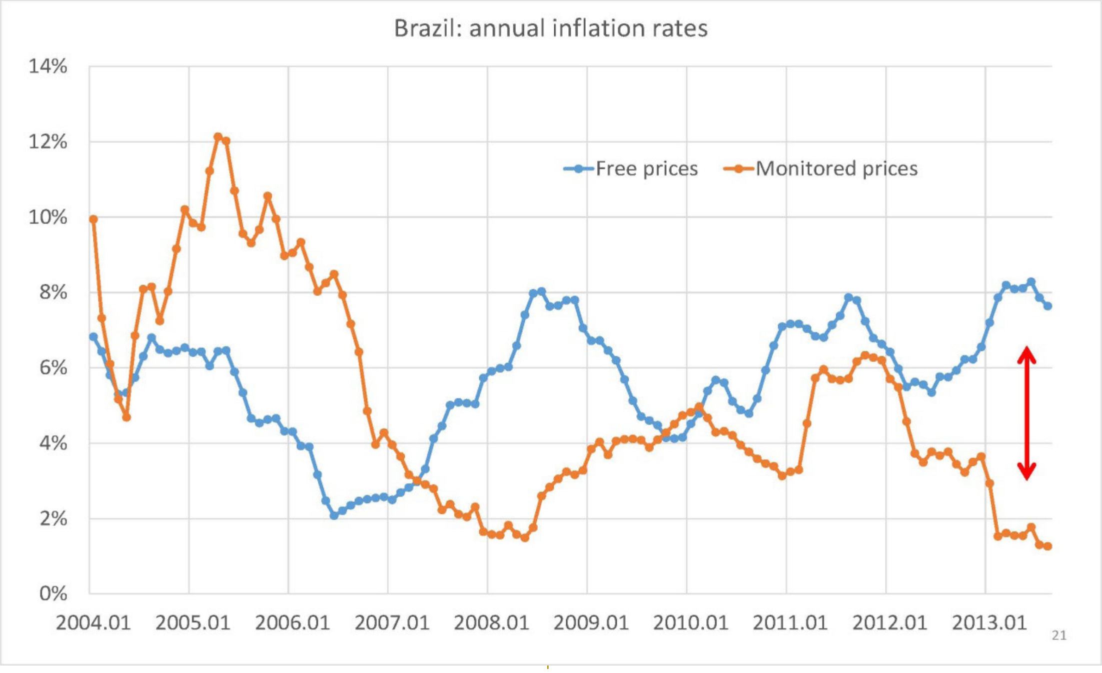

Figure 12

to a fluctuation around a very high level of terms of trade, a still positive economic scenario. What is going to be done with that opportunity is a main challenge for the Brazilian economy, it is more a political challenge than an economic one. It is a political challenge in the sense that the government must try to build a national consensus around a development strategy that is economically and financially sustainable and, at the same time, responds to people's demands.

But there are some immediate problems. One is repressed inflation. The inflation of some monitored prices is too low for specific reasons and they will eventually have to be corrected. If and when they are corrected inflation will temporarily be pushed up, having a restrictive impact on the economy.

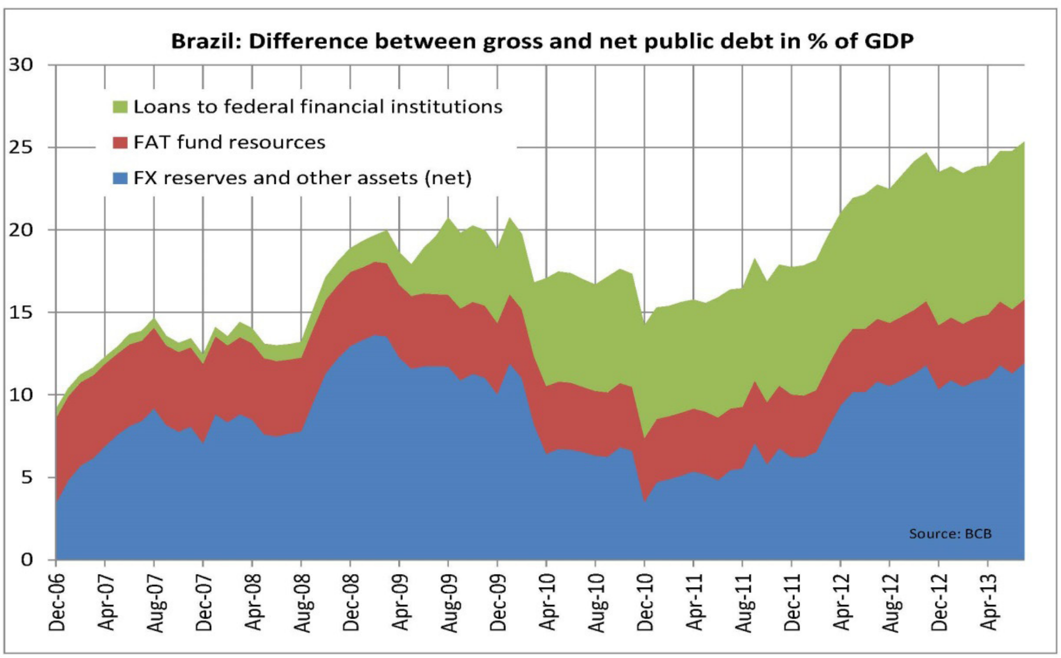

Figure 13

Reaching the Debt Limit

As I already mentioned, the gross debt of Brazil grew very quickly in recent years. That cannot go on forever. If something is unsustainable, it will eventually stop. The government is already phasing out its loans to state banks, but it will take some time to reverse this cycle. Despite the recent volatility, the numbers also show that there may be more exchange rate realignment in the near future. Not an exchange rate crisis per se, but a gradual increase in the exchange rate.

This graph (Figure 12 on previous page) illustrates this with numbers. This is inflation; the blue line is the inflation of free prices; market prices, the red line is the inflation of monitored prices, the prices that are in some way or another regulated by the government. You see a clear disparity there. Monitored[22] prices grew 1.5 percent recently, and in an annual basis, while free prices grew 7.5 percent. So, eventually, these two inflation rates will converge. The two price indexes tend to have the same rate of inflation in the long run. If and when that happens, inflation will accelerate, requiring more restrictive macro-economic policy, which will slow down growth a little, but nothing that takes the economy out of its long term path.

Debt (Figure 13): this is the difference between the gross and the net debt of the government. The government issues debt either to finance its budget deficit or to buy assets. This is the part of that that was issued to buy assets. To show you where the money went: the blue section represents mostly international reserves, Brazil's accumulated foreign currency, mainly US dollars, something around 13 percent of its current GDP. This is why Brazil does not have the financial fragility that it had in the past. Now, when there is a shock in the international economy, the Brazilian exchange rate fluctuates but there is no financial crisis in the economy because Brazil has very high international reserves.

The red section is a government fund, the so known FAT fund as it is called in Brazil, which is used to finance unemployment insurance and other expenditures. It has been stable at around 5 percent of GDP.

The green section is the government loans to the state banks, mostly BNDES and more recently Caixa Economica. This has reached 9.5 percent of GDP in recent years. As I said, this is the quantitative easing of Brazil. It went from something close to 0.5 percent, in 2006, to 9.5 percent of GDP, today. Right now these loans are getting close to the value of the government's international reserves. So, one of the challenges for the next years is to scale this down, to gradually return the economy to the usual operations of state banks, so that you do not have such a high gross public debt as a source of indirect funding of the private sector.

The exchange rate (Figure 14): this is the Brazilian unit-labor cost, it is how much of the price of goods are paid to workers in U.S. dollars. So it is a unit-labor cost in foreign currency. Since 1989 what you see is that this pretty much follows the exchange rate. With the implementation of the Real Plan, the real appreciated and the unit labor cost in Brazil went up. Then there was the crisis of the late 1990's and early 2000's, which pushed it down. Then appreciation occurred again during the Lula administration, with a temporary pause during the 2008 crisis.

Brazilian unit-labor cost: the impact of high TOT on the exchange rate increased the country's ULC in USD, which in its turn reduced the competitiveness of the tradable sector and resulted in a two-velocity economy in recent years.

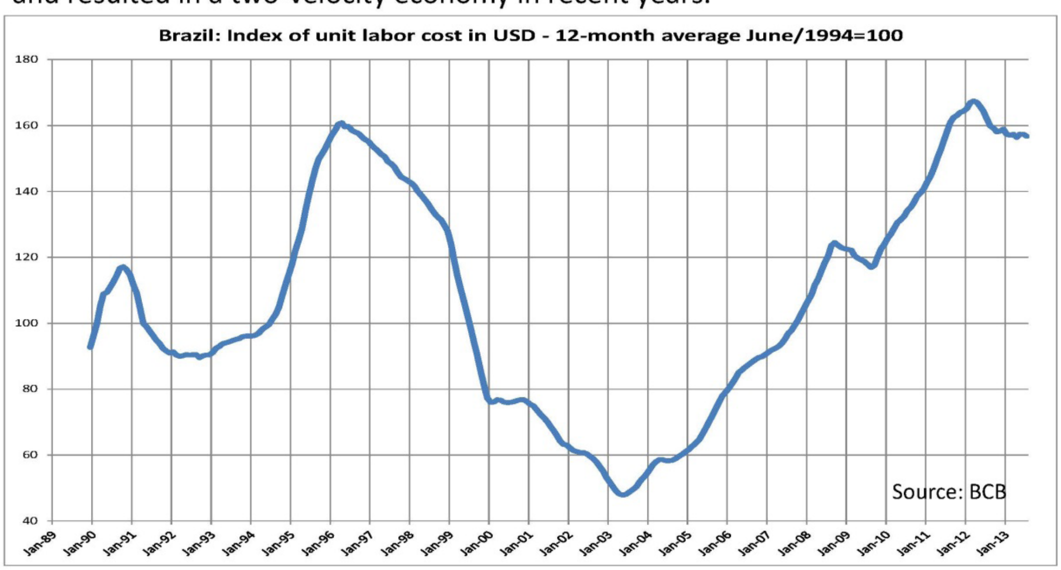

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Figure 14

Now, this is the impact of the recent depreciation of the Brazilian real.

It reduced unit-labor costs but they are still very high by historical standards. So one of the challenges in Brazil is to regain competitiveness in the tradable sector in terms of labor costs without doing it in a regressive way. You can achieve this by devaluing, which reduces real wages, by recession, which also reduced real wages, or you can do it by increasing productivity.

What the Brazilian government has been trying to do in recent years is to solve this problem through higher productivity -through more advancements in education, infrastructure, through changes in the tax law and changes in some regulations of markets. However, these gains are usually slow. So, the question is, what is going to make it happen faster? Exchange rate realignment or productivity gains as a result of this increasing investment in recent years?

So far the government response has been an improvement in the communication of economic policy. The government very strongly came out and stated that its interventions in the foreign exchange market have no commitment to a specific value of the exchange rate, so Brazil has a floating exchange rate. The government will intervene in the market but it has no commitment with a specific value of the exchange rate. It intervenes to reduce volatility.

You also have lower but more realistic public targets now in Brazil. Most inflation targeting is done by the management of the SELIC rate. As I said, in the beginning 2011, the official target was pursued through a mix of quantitative measures and changes in interest rates. Now, it has been done mostly through changes in the interest rate.

Reduced intervention regulated markets. For those who follow Brazilian news, from now until the end of this year, there will be a public concession almost every week. The government is adjusting the process, reducing its intervention and improving the context to a market friendly environment to attract foreign investors.

There has been a reduction in financial loans to state banks. Brazil's finance minister, Guido Mantega, has already stated that loans this year will be lower than last year, which were lower than previous years, showing a gradual reduction.

The big "if" is the adjustment in fuel prices. Depending on the week, sometimes people say there will be an adjustment in fuel prices, sometimes people say it will be adjusted but not this year. This is something that is on the government agenda and may happen in the near future.

Despite all of this macroeconomic volatility, there has been a standing improvement in some long-run issues in Brazil. As I said, Brazil is a modern democracy, so some reform initiatives take time. They have to pass through Congress and sometimes through the judiciary system, making it a slow process. So, throughout this whole macroeconomic economic instability, there are some recent improvements that go unnoticed when you focus too much on high frequency fluctuations in the economy.

In 2009, when Brazil launched its housing program, the government also took the opportunity to reform its regulations of housing finance. Just to give you one example, in Brazil it was forbidden to use the price table in housing finance. Your mortgage payments used to be higher at the beginning of the contract and lower at the end. You could not have constant mortgage payments in Brazil by law. This was changed in 2009 and this is one of the reasons why the housing sector has boomed in recent years.

There were new private instruments created for banks (Letra Financeira) and for infrastructure (Debênture de Infraestrtura). So far these projects have not become important because BNDES entered the market and financed almost everything. If and when BNDES retreats, those bonds will become more and more important.

In 2011, the new education plan of the Dilma administration was established (PRONATEC), which includes more student loans. Now, in Brazil, if you go to a good university, you will undoubtedly have a loan from the government, with an interest rate of 3.5 percent, which is high for U.S. standards, but in Brazil it is a negative real interest rate. In the first half of this year, 500,000 students got these loans. So, it will take some time until these people complete their studies and join the market, but eventually this will create some gains.

In 2012 Brazil eliminated its lower bound interest rates. People talk a lot about the zero lower bound here in the US, where interest rates cannot go below zero. In Brazil, we used to have a 6 percent lower bound, meaning that interest rates could not go below 6 percent. This was changed in 2012. In 2012 the creation of the pension fund for government employees was also approved, establishing a defined benefit system.

In 2013 we experienced concessions in infrastructure and the creation of what we call the ABGF, which is a government agency to give guarantees and insurance to exports and infrastructure. This was a way of increasing the efficiency of the government funds that are allocated to insurance and especially to export financing.

What to expect? In monetary policy, even if we have price liberalization of monitored prices, there will be a temporary increase in inflation, which blocks the reduction in real interest rates. The real base interest rate will probably fluctuate between two and four percent, per year, in the near future.

In terms of infrastructure, despite some difficulties here and there, the movement for concessions will go through and this will increase investment in Brazil in the next four to five years.

Fiscal reform. The low primary balance will be compensated by a reduction in loans to state banks. This is already happening but is still in its early stages. It is going to take some time for this to appear in the numbers.

A continuation of structural reforms in the tax system is very likely. We call these taxes PIS/COFINS and ICMS. As BNDES becomes less and less important, private sources will become more important in long-term finance. This is what I think will probably happen. What we do not know for sure is what path social security and labor regulation and re-industrialization will take – this has been an important debate in Congress and in society. There are many initiatives being discussed in congress in terms of social security that go in opposite directions – some increase the transfers, other reform the system, etc. This is something that the next administration will eventually have to deal with.

Everyone in Brazil agrees that labor regulations should change. The unions, the judges, the firms, and the government all agree, but not necessarily on the same changes. The debate is similar to immigrant reform here in the U.S. - everybody knows that something has to be done, but no one agrees on the direction it should take.

In terms of the positive side of labor reform, there are a lot of new initiatives being discussed between firms and unions. They are trying to make a bargain where you get more labor flexibility in exchange for more union participation. This is a kind of adaptation of the German model to Brazil.

Reindustrialization is a permanent debate in Brazil. It happened in the 40s, the 50s, since Brazil became an industrialized economy. How a commodity-producing economy can also be an industrial economy is one of the main questions. Some people think changes should be made to the exchange rate; others think a reduction in wages is necessary. I believe it has more to do with innovation, especially in investments in information communication technology. Brazil is very far away from the frontier and the general use of information and communication technology, both in the private sector and in the government sector. Here you have the potential for huge gains in productivity.

TERESA TER-MINASSIAN*

Teresa Ter-Minassian

I do not want to dwell much on the past. I would like to focus more on the future, but I would first like to explain my difference in views with Nelson about the causes for the deceleration of the economy during the last three years. I think Nelson put a bit too much emphasis on what was a very short-lived tightening of fiscal and monetary policies in 2011, and not enough on the more supply-related constraints on growth which emerged in 2010.

Among these constraints, I would note in particular the loss of competitiveness of the economy, demonstrated by the large increase in the real exchange rate as measured both by relative consumer prices and especially relative unit-labor costs; the fact that there were significant infrastructure bottlenecks, particularly in the more dynamic sectors, affecting export performance and the agricultural and commodity sectors. Another factor was the overheated state of the labor market, which, especially given the problem of skill mismatches between demand and supply, also had an impact.

I believe we can say that it was not mainly a demand management issue in 2011 and 2012. In fact, in 2012 the economy did not recover, despite a substantial easing of macroeconomic policies. Nelson has pointed out correctly some of the specific factors that affected that.

In summary, I think that the slow growth of the Brazilian economy in recent years has mostly to do with a lack of adequate progress in restoring the competitiveness of the economy and in eliminating some of the constraints on higher potential growth of GDP.

Now I would like to focus more on the challenges during the next year or so, which of course will be dominated by the political tensions related to the October 2014 elections. Then I will

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**Former director of the Fiscal Affairs Department at the IMF, and holds degrees in Law from the University of Rome and Economics from Harvard University* say a few things about what, in my view, should be the main features of a reform agenda for the next government.

I would agree with most observers of the Brazilian economy that barring major exogenous, either domestic or external, shocks, little progress can be expected in structural reforms next year. Both the executive and the congress will be focused on the reelection agenda and will not be inclined to move forward on policy initiatives that may carry political costs.

Realistically, I think the most that can be expected on the structural front, is that both the president and the main opposition candidates will use this period to develop an agenda of structural reforms that could be quickly put in place at the beginning of a new administration.

However, even in the absence of major structural reforms, the short-term economic policy agenda is going to be a challenging one. The government will need to pursue a mix of macro-economic policies that will have to balance two difficult-to-reconcile objectives: on the one hand, keeping inflation clearly within the target band (but not through further repression, i.e. not by postponing needed adjustments in administered prices); and on the other hand, avoiding a significant increase in unemployment, within an international context that is likely to be a not very benign one.

I would like to say a few things about the risks on the international front. These are changing, and we probably do not know today all those that will emerge in the next 12 months. In any case, even today one can see that they remain substantial. The moderate ongoing recovery in the U.S. economy could be negatively affected by a protracted political showdown on the 2014 budget and the debt ceiling. The exit from QE will start at some point within the next 12 months. We do not know at what speed, and what its effects are going to be on financial markets. There are experts who say, "Well, this has already been priced in." But the volatility in these markets during the last few months does not bode well for emerging markets, especially those with rising external current account deficits such as Brazil.

The Eurozone crisis is receding, but there are still political vulnerabilities, especially in my own country, Italy, which could make it flare up again. Of course tension in the Middle East, which currently seems to be a little bit more under control after recent developments on the Syria front, could increase again and lead to new escalation of oil prices. Additionally, the (so far soft) landing of China could accelerate, putting further downward pressures on commodities and on external demand.

Moreover, economic conditions could deteriorate more rapidly than currently expected in some Latin American countries, like Venezuela and Argentina, further dampening growth prospects in the region and perhaps inducing some financial contagion. Obviously, not all of these risks are likely to materialize at the same time. However my expectation is that the external environment will continue to constrain domestic policy-making in Brazil next year, particularly in terms of its monetary and fiscal policies.

Monetary policy will need to be geared towards stabilizing and anchoring inflation expectations firmly within the band. That is very important for credibility and for future progress of inflation, particularly when the current repression is eventually unwound.

Also, monetary policy will need to avoid a rapid and sustained depreciation of the exchange rate. I know the exchange rate is not the target of monetary policy, but it is important to avoid a renewed pick-up of inflation that would be very damaging not only to the credibility of the monetary authorities, but also to the prospect for reelection of the current government.

In regards to fiscal policy, my sense is that the degrees of freedom are perhaps more limited than implied by Nelson's presentation. I have looked quite a bit at market signals, at what rating agencies say about Brazil, what motivated the downgrade of the outlook in the case of S&P, I have looked at the very lukewarm language with which other rating agencies have described the current outlook, and I have looked at the analysis of investment banks. I think all this points to significant market concerns over Brazilian prospects, and particularly to the perceived weakening of fiscal discipline. Market analyses frequently refer not only to the decline in the primary surplus but also to the growing gap between the gross and net public debt – which imply a growing resort to quasi-fiscal operation that include, but are not limited to the treasury loans to public banks.

I would like to stress that in the last few years the primary surplus in Brazil has lost value, both as an indicator of the current fiscal stance and also of the longer term fiscal sustainability. I said in a recent article that Brazil is at risk of losing its fiscal compass. Why? Because of a number of factors: first, the reduction of the coverage of the public sector with the exclusion of public enterprises - first Petrobras, then Eletrobras—and of the public investment under an initially small program which then became the large PAC program. More recently, the government has also excluded from the fiscal target the revenue effects of the tax cuts. So, the primary refers to a smaller and smaller universe. There have been significant resorts to exceptional revenues, to the anticipation of revenues from the public banks or public enterprises, and the big increase in the loans of the treasury to the public banks, as noted by Nelson.

These trends have negatively affected the credibility of fiscal policy which had been hard-gained between 1999 and 2007. I fully agree with Nelson that clearly and consistently avoiding this type of operation should be a policy priority, both for this administration and the succeeding one. Now, if the credibility of fiscal policies is firmly restored, the shift to a structural fiscal balance as a target for fiscal policy could help avoid pro-cyclical fiscal policies without damaging market confidence.

Looking beyond next year, I think the focus of policies should be firmly on raising Brazil's potential growth rate to at least 4 percent a year. This would permit a sustained growth of GDP per capita, and continued growth of formal employment, which has been very beneficial also from a social point of view. Brazil must also ensure that inflation remains in the low single digit range, and the current account deficit remains within a level that can be covered by FDI.

Raising potential growth requires a clear improvement in productivity trends, which has not been featured very much in Nelson's presentation, but clearly has been subpar in most sectors except agriculture in recent years. Increasing productivity is no easy task as we know from many countries' experiences. In the case of Brazil, this requires a really wide-range of structural reforms. Fiscal reforms are necessary to make the tax system, especially the federal and subnational indirect taxes, less distorted and easier to administer and comply with.

Spending reforms. Brazil must create room within a declining structural deficit for increased spending on sound public investment projects, and for the looming costs of an aging population. Brazil is one of the countries where the population is aging fastest. It is still relatively young, but the demographic dynamics are very negative in the sense that they are leading to a rapidly aging population, and this will put pressure on the social security finances (already in deficit), and the health system.

A reform of the social security system is of particular importance. This includes both pension and family allowances. The reforms of the education and health spending programs are also important. Although additional resources would help, it is also necessary to improve the quality and the cost-efficiency of these programs.

The economy should be further opened, to promote competition in domestic markets and the financial sector, which in Brazil remains relatively closed. Reducing red tape and more generally the cost of doing business in Brazil is very important. Clearly, Brazil is among the countries that have the highest cost of doing business.

Jose Roberto Afonso

Continuing regulatory reforms will strengthen competition and promote efficiency gains in the monopolistic or highly concentrated sectors. Promoting innovation costs money, and therefore should be done smartly, which is not easy. Brazil must accelerate the programs of concessions and PPPs, but with a caveat. It is important to ensure an appropriate sharing of risks between the private and the public partners, because the gains of PPP's are not from additional financing since that financing could be obtained more cheaply directly by the government. The involvement of private partners can promote efficiency gains, but this only happens if the private partner is sufficiently sharing risks, which also helps avoid large increases of contingent liabilities for future budgets.

And finally, increasing flexibility in the formal legal market is necessary. I am personally very fond of the German system. I am a bit concerned whether the unions and the firms in Brazil have the maturity that is necessary to import this model of cooperation.

All these needed reforms require substantial political capital. Therefore, I think it is important that a clear and sufficiently specific reform agenda be presented and vigorously pursued early on in the administration. This will promote not only a renewed confidence in the financial markets, which would be justified by Brazil's fundamentals, but also, more importantly, in domestic economic agents, both households and enterprises. Only so can the growth of both consumption and investment be boosted and expected to be sustained over the medium-term. As a long-time friend of Brazil, I surely hope that this will be the case.

JOSE ROBERTO AFONSO*

Presenting after Nelson and Teresa, given their extensive experience, there is not much left to say. I would like to make a side note to begin with. In the past, in Brazil, we would hear the expression, "for Gringos to see," but given the panel we are participating in today, we should say the opposite, "come meet the Gringos to learn about Brazil." In my experience, I have learned things in the U.S. that are not being discussed in Brazil. These conversations are very important.

I would like to add to some of the main points Nelson already presented on. It is fundamental for any debate to have overarching questions. Nelson already introduced these, answered them, and Teresa delved into them further. What I will do is, in addition to the three challenges Nelson

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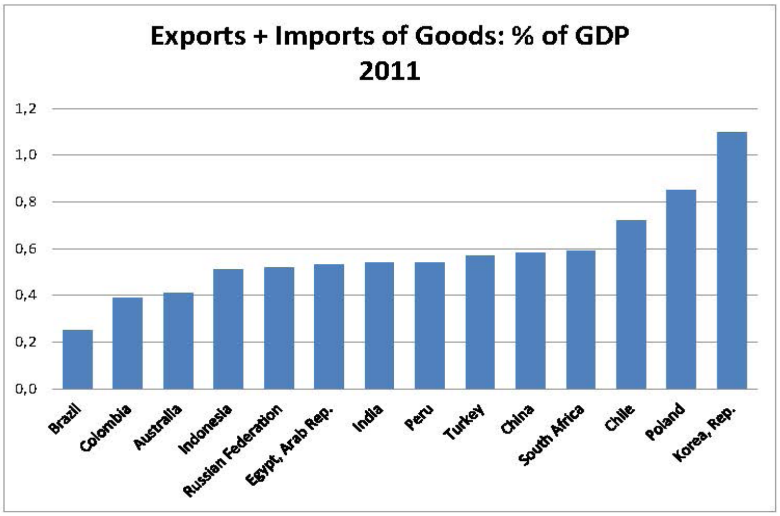
Macroeconomics:
Opening economy under commodities producers and emerging



Exports+Imports % of GDP 2011	
Brazil	0,25
Colombia	0,39
Australia	0,41
Indonesia	0,51
Russian	0,52
Egypt, Arab	0,53
India	0,54
Peru	0,54
Turkey	0,57
China	0,58
South Africa	0,59
Chile	0,72
Poland	0,85
Korea, Rep.	1,10

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Figure 15

ended his presentation with, add another four that I find important.

First, in terms of macroeconomics (Figure 15 on next page), I would like to point out that although much is said about the effects of commodities on global trade, Brazil still has a very closed economy compared to other Latin American and emerging countries. Exports plus imports in Brazil account for 25 percent of GDP compared to 40 percent in Colombia and 70 percent in Chile. It is important to take this into account when thinking about Brazil's economy and putting into perspective that it is still very closed.

I often wonder how we will ever achieve a more open economy with a tax system that is completely shaped to fit a closed economic model. This has various aspects and explanations. The external bonanza (Figure 16 on next page) of the past few years might not continue on the same path. An issue that we should be concerned about is the investment to GDP ratio. From the year 2000 on, it evolved in several short cycles, since the minimum of 15% in 2002 to a maximum of near 21% in 2008. In the current year, the ratio is at 18%. But, besides the low investment to GDP average ratio in the period, the main point is that over the past few years we have become increasingly dependent on foreign savings.

On inflation, I do not have much more to add. I would note, however, that when we observe emerging markets on the international scale, we have two different groups. On the left we have those countries that were able to reconcile economic growth with decreasing inflation in the past years, and on the right we have countries that have experienced deceleration in economic growth and acceleration in inflation. Brazil's challenge is obvious, to move towards the group on the left.

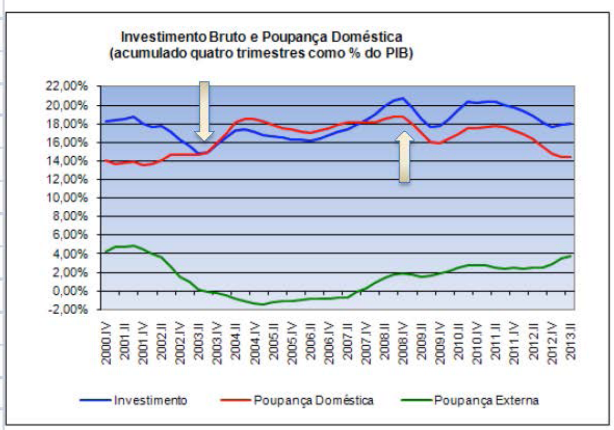
In terms of fiscal policy, since the 2008 crisis, we have struggled to comply with the annual target, even when relying on very atypical policies. In my opinion, the big debate in terms of fiscal policy should concentrate on public investment. Direct government investment has been declining since 2010. Even investments in all other sectors of the economy, supported mainly with public funds transferred through BNDES, seem to have failed to increase the gross fixed capital formation. Agents, public and private, took less government credit to increase the total to invest more and to change the composition of the funding of the projects - the decreased contribution of own resources in exchange for using more state loans and become, and preferred to stay each increasingly liquid, amid a world still marked by uncertainty and an economy still one of the largest real prime rate. Unfortunately, the increase in public debt and credit offered by the public sector has failed to increase the rate of investment.

Most of the resources passed onto state banks had two previous destinations. First, they were used to promote equity restructuring. BNDES has been working in the Brazilian economy in a similar way the Fed works in the U.S. Many argue that if we were to compare the support from the financial sector in the U.S. to those contributions made by the Brazilian National Treasury to BNDES and Caixa Economica Federal, we would find out that more resources have been spent in Brazil than in the U.S.

Macroeconomics:
External bonanza …. Or …. investment *versus* savings

Decomposition of External Bonanza, 2005-10 (in 2005 prices)			
Year	Terms of Trade Effect/GDP	Foreign Transfers Effect/GDP	Excess Dom. Spending over GDP
2005	0,0%	-3,6%	-3,6%
2006	0,7%	-2,9%	-2,2%
2007	0,9%	-1,5%	-0,6%
2008	1,7%	-0,2%	1,5%
2009	1,8%	0,2%	2,0%
2010	3,4%	1,1%	4,4%
2011	4,4%	0,8%	5,2%
2012	3,4%	1,5%	4,9%

Source: Edmar Bacha



Source: Fernando Montero

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Figure 16

Second, the resources that were not used for equity restructuring went back to the Treasury through a series of measures spanning from dividends to purchases of financial assets. A point to add is that our fiscal policy has always been linked to monetary policy and now to credit policy, as well. Nevertheless, the exchange rate still has a strong impact as net liquid debt responds directly to it, due to the weight of the reserves.

One issue we should become more aware of is the volume of our gross debt. The Central Bank has two ways of measuring it. In the measure compatible with international standards, our debt is very high, surpassing that of India. A high gross debt, by itself, should not be of great concern. However, its growth dynamic is important. When compared to other countries, Brazil shows two peculiarities. No other country has such a large disparity between gross and net debt, and that can be explained by the fact that in Brazil we consider the Central Bank as part of the public sector, which is not the case in other countries. While the Central Bank should be listed among those institutions that finance the public sector, in Brazil, the Bank is labeled as part of the government, and, as such, it should receive the same kind of economic treatment than state governments or public universities.

Notwithstanding its legality, this way is not economical, and so, our monetary and foreign exchange accounts are mixed with fiscal accounts. Fiscal policy and monetary policy become incredibly interlinked.

The second and last point to be made is that despite the fact that our debt is high compared to other emerging countries; a low proportion of it is held by foreign hands, as it is in India, by the way. I believe this is why those who are not in Brazil do not worry much about this issue.

I will present my conclusions pointing out four significant challenges for the Brazilian economy. The first challenge is how to successfully open the economy and establish a more appropriate macroeconomic arrangement.

Second, in terms of inflation, we must be aware of the divergence between fixed/administered prices and free prices. The low levels of administered prices have an invisible but significant impact on the Brazilian public sector. State companies, in charge of the energy and oil sectors, suffered a significant devaluation in the stock market. Normally when thinking of the market, we tend to forget that the owner, in this case, is the government. The Treasury and BNDES, the two largest shareholders of Petrobras and Eletrobras, underwent significant losses. Just to give you an idea, in March of 2011 BNDES's liquid assets were worth 75 billion reais. In June of 2013, they were worth 46 billion. The challenge is how to restrain inflation not needing to keep administered prices so low and not devaluating public assets to that level.

The third challenge has to do with fiscal policy. Restoring credibility in the indicators is essential to achieve credible results. A contractionist fiscal policy is not necessarily bad once you know exactly what your fiscal policy is. We need to establish a fiscal policy that is consistent with the rest of the country's economic policy. We also need credible numbers, no matter if they are lower than previously defined targets. To regain credibility, new fiscal indicators must be incorporated.

The fourth and final challenge is that we need a more sustainable economy in terms of public and private investments. As to private investment, it should not be financed through higher participation of public banks. What we need is more credit at lower interest rates, because we can no longer reconcile more investment with more public debt. Our challenge is to put together the public and private sectors in order to raising funds and channeling them into more investment, so that growth could be less dependent on consumption.

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