

Rio de Janeiro at night

The Way Ahead for Brazil*

*connectedthinking

PRICEWATERHOUSECOOPERS 

Preface

The economies of Brazil, Russia, India and China, commonly referred to as the BRICs, have a high growth potential, and significantly influence the flows of international trade, capital, and geo-politics. Together, they concentrate over half of the world population. Recent studies have continued to forecast optimistic future projections for the performance of these nations vis-à-vis the developed world.

Previously associated with crises and high risk, these emerging economies are now regarded as important markets for a number of products and services. They are now showing a steady annual growth and are in the process of implementing reforms aimed mostly at attracting new levels of foreign investment. In addition, they are regarded as serious contenders in the international arena together with a number of emerging global players.

Brazil itself has seen a steady improvement in its economic health over the course of the last few years, prompted by a substantial increase in foreign exchange reserves (it is now a net international creditor), and by its virtual crude oil self sufficiency, low inflation rates over the last decade, a strong currency and climbing economic growth, hand in hand with lower real interest rates. Moreover, the country has strong democratic institutions, cultural integration with little or no racial or religious tensions, and no terrorism or border conflicts.

This environment, together with the country's enormous size and its influence as a business expansion platform in South America, has greatly enhanced Brazil's risk evaluation and the attractiveness of its business prospects. Moreover, the mere size of the Brazilian consumer market and its projected growth rate make it increasingly attractive to foreign investors.

Recently, Brazil received the so-called "investment grade" classification from the Standard & Poor's credit rating agency. This classification sends a signal to international investors that it is less risky to invest in Brazil, and makes the country more attractive to foreign capital, primarily in terms of funds earmarked for long-term projects that are important to keeping Brazil on the road to growth. It also makes it more feasible to invest in certain investment or pension funds that have been tagged with investment restrictions in countries not considered investment grade material.

Over the course of the last ninety years, PricewaterhouseCoopers in Brazil has played an important role in identifying and addressing business trends and needs and has made a firm commitment to developing the country. It has been the leading professional services organization in Brazil since 1915, and currently has some 3,600 professional staff members working in the 16 offices located in the country's major economic centers.

The Way Ahead for Brazil is a publication designed to map out some of the business potentials and challenges facing the development of this country vis-à-vis other major emerging markets. To us, leadership is not enough. We must also lead the way to building a fairer and more dignified future for future generations.

Fernando Alves
Territory Senior Partner
PricewaterhouseCoopers - Brazil.

The Way Ahead for Brazil

...But because there was blood-colored,
amber-colored wood in abundance,
and because the wild morning fire
was a heap of embers in the coal night landscape
and because the Land had red trees
and because it was very kind,
they gave it the name **Brazil**.

Brazil full of grace

Brazil full of birds

Brazil full of light

Excerpt from the poem:
The Names Given to the Land Discovered
By Cassiano Ricardo



Sugar Loaf, Rio de Janeiro

1.	Introduction	6
2.	Brazil: A Country in Transformation	9
3.	Brazil Compared with the “RICs”	27
4.	Conclusion	39



1. Introduction

In an article called “Dreaming With BRICs: The Path to 2050,” published in October 2003, Dominic Wilson and Roopa Purushothaman of Goldman Sachs made a vigorous intellectual effort to outline the economic prospects for Brazil, Russia, India and China (BRICs) up to 2050.

The article concluded that the GDP of the BRICs by 2050 could be greater than that of the G6, and that their GDP by 2025 could climb to half that of the G6 countries. In March 2006, John Hawksworth, head of macroeconomic research at PricewaterhouseCoopers, published a more wide-ranging article which estimated the relative sizes of the 17 largest world economies in terms of PPP (Purchasing Power Parity) in 2050. He concluded that the E7, formed by China, India, Brazil, Russia, Indonesia, Mexico and Turkey, today representing 20% of the GDP of the G7 in current dollar terms and 75% in PPP terms, would be 25% higher in 2050 than the G7 in dollar terms and 75% larger in PPP terms. He also made some recommendations on how the OECD countries should conduct their economic policies to deal with this reshaping of the world economy.

These studies are based on economic growth models founded on the traditional role of production involving capital, labor and technology. The authors of both studies used assumptions to explain the growth in these variables and the performance of the exchange rate, and produced estimates for the size of the GDP of these countries, which are comparable in terms of both currency and PPP.

This focus on the BRICs aroused the curiosity and interest of investors, researchers, companies and decision-makers in these countries, and sparked a series of discussions on the feasibility of the projections cited in the original document. Many questions were raised in these discussions over the presence of the “B” in the BRICs due to the enormous challenges Brazil faces in the scenario depicted by the article, such as achieving sustained growth.

The intent of this article is not to reproduce the methodology used by the previous authors, but rather to document the main transformations undergone by the Brazilian economy recently, particularly in the economic sphere. The aim is to bring Brazil into this discussion in terms of the potential strengths and weaknesses of the BRICs, and also to shed a little light on how Brazil's main economic variables are expected to develop in the future. The conclusion is that the Brazilian economy is experiencing substantial ongoing changes, particularly in terms of the foreign sector and growth, thus justifying the presence of the "B" in the BRICs, even though the challenges facing the country remain significant. One thing is clear: within the BRICs, Brazil is the country with the most highly developed capitalist system, in terms of its institutions, its market economy, the flexibility of its economic policy and its democracy. This point will certainly not be overlooked by investors in the BRICs.

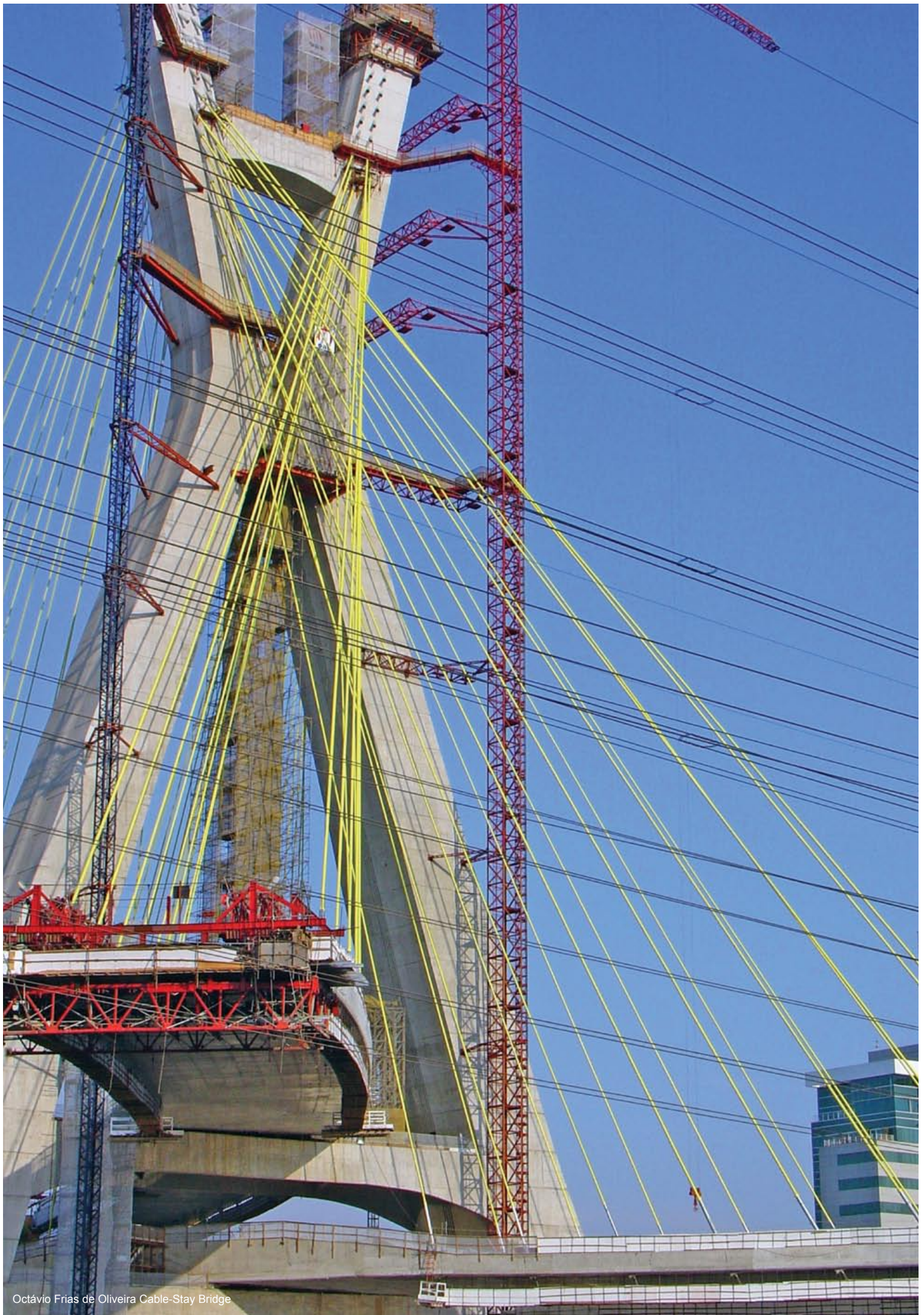
This article is divided into four sections, including this introduction. Section two will address the main recent macroeconomic changes in Brazil and outline the expectations for the near future, section three will compare Brazil within the context of the BRICs, based on the main factors influencing its growth, and section four will draw some brief conclusions.

By the year 2050, the "E7" economies (China, India, Brazil, Russia, Indonesia, Mexico and Turkey) will have outstripped the current G7 countries (United States, Japan, Germany, UK, France, Italy and Canada) by 25%, if comparing Gross Domestic Product indexes and 75%, if using purchasing power parity.

PricewaterhouseCoopers'
Macroeconomic Forecast

78%
of CEOs in developed economies say their companies are going global to find new customers, compared with 48% who are looking to reduce costs.

PricewaterhouseCoopers' 9th Annual
CEO Survey, January 2006



Octávio Frias de Oliveira Cable-Stay Bridge

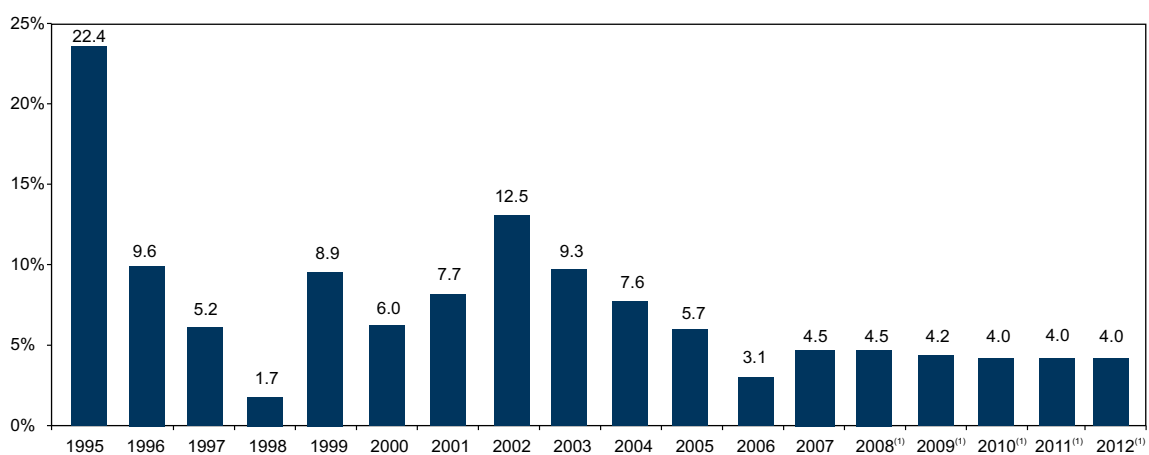
2. Brazil: A Country in Transformation

2.1. The challenges brought about by economic stability (1994 - 1998)

After several decades of galloping inflation, which surpassed 2,400% a year¹, Brazil defeated inflation with a severe stability plan introduced in the second half of 1994, based on the super-indexation of its economy, a change in its currency and a rise in interest rates. This combination of economic policy resulted in a sharp appreciation of the Brazilian currency in the second half of the year, and

when confronted with the Mexican crisis of 1994, the country adopted a system in which the exchange rate was managed as of March 1995. This spelt the end of rampant inflation, insofar as management of the exchange rate led to a strong real rise in the currency, whereby the competition from imported goods was enough to overturn inflation.

Graph 1: Brazilian Annual Consumer Inflation - IPCA index (%)



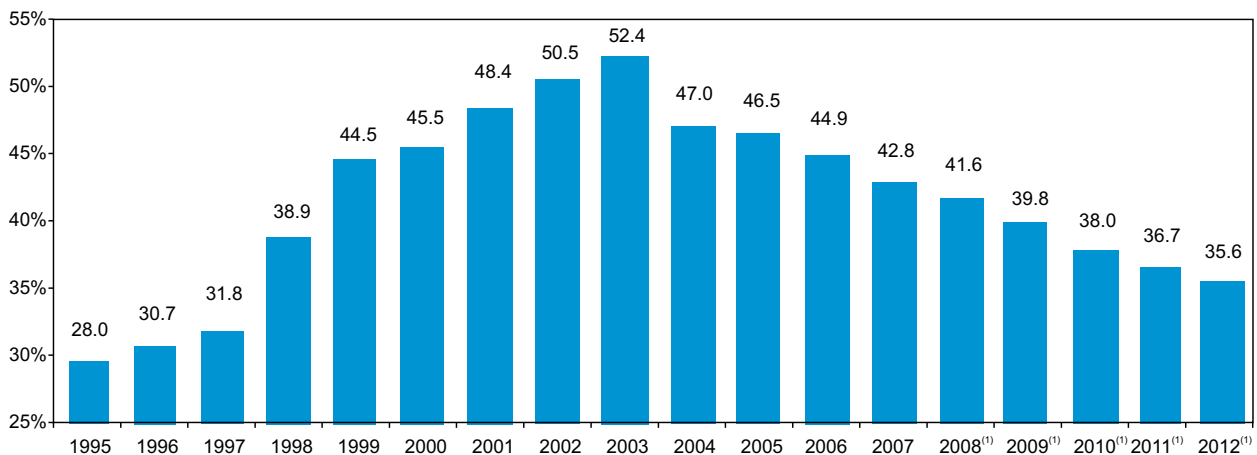
Source: Brazilian Institute of Geography and Statistics
 (1) Projection: Brazilian Central Bank Focus Bulletin

¹ Inflation measured by the IPCA (Amplified Consumer Price Index), which includes families with an income of up to 40 minimum wages currently equivalent to R\$ 15,200 or US\$ 8,500, totaled 2,477% in 1993, shrinking back to 916.5% in 1994.

The war against inflation was the greatest victory of the second half of the last decade and allowed the country to start using traditional instruments of economic policy and aligning relative prices correctly, particularly, salary levels. A new era was inaugurated for the Brazilian economy, where market mechanisms began operating more efficiently and prices reflected the relative shortage of goods and no longer the inflationary inertia or exchange rate correction. At that time, the horizons and planning of companies became much more far-reaching, and companies could get an accurate picture of their prices, their breakeven points, the costs of opportunities provided by the real rate of interest and by the competitive edge of the country, etc. In short, this marked the end of a decade-long period in which inflation had exerted a significant distorting influence on the efficient allocation of resources in the economy, and had severely penalized families with the lowest income levels.

Nonetheless, controlling inflation came at a price. The upshot triggered an escalation of domestic debt and a deficit in the balance of payments. The big mistake in the post-stabilization period was the failure to make urgent and strong fiscal adjustments. On the contrary, the first primary deficit continued for some years. As a result, the reduction in inflation ended the period in which the government had financed itself through inflation and, in so doing, had to use the traditional mechanism of raising taxes to pay for its spending. The escalation in public spending was sustained by a mounting tax burden, so that the fall in the inflationary tax was offset by the rise in traditional taxes per se. However, the increase in spending was greater than the amount collected. This, combined with the payment of interest on the domestic debt (kept at a high level to combat the inflationary inertia and attract foreign capital in order to maintain the managed exchange rate system), resulted in a dramatic increase in the public debt.

Graph 2: Brazilian Public Sector Net Debt (Domestic and Foreign) % GDP



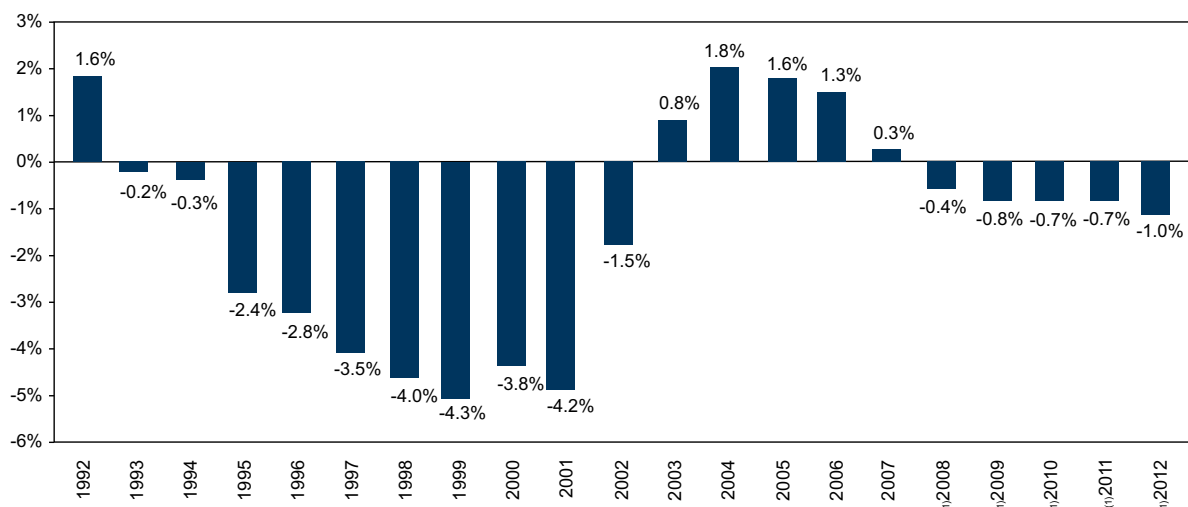
Source: Brazilian Central Bank
 (1) Projection: Brazilian Central Bank Focus Bulletin

As can be seen in the graph above, the public sector net debt rose from 28% of GDP in 1995 to 52.4% in 2003, by which time it had taken on unsustainable dimensions. On several occasions, the country was on the verge of defaulting on its foreign or even domestic debt. However, changes were underway that would greatly deflect the trend of this debt. This point will be dealt with later.

The second highest cost to the Brazilian economy, arising from the stabilization process, was the external imbalance. Part of the strategy of any country with a managed exchange rate is to anchor its domestic prices. The internal logic of the model was to allow the gains in competitiveness to make the real exchange rate competitive, even in a country using a band system and, apparently, out of balance in the long-term. In practice, the exchange rate system did in fact allow the country to anchor its domestic prices, but the combination of high real interest rates, along with an appreciated currency, widened the deficit and fueled foreign debt. The Brazilian economy boosted its internationalization but ended 1998 with a current account deficit of roughly 4.0% of GDP. This worsened in 1999 to 4.3% of GDP due to higher interest payments.

Within the BRICs, Brazil is the country with the most developed capitalist system, in terms of its institutions, market economy, flexibility of economic policy and democracy.

Graph 3: Brazilian Current Account Balance (% GDP)



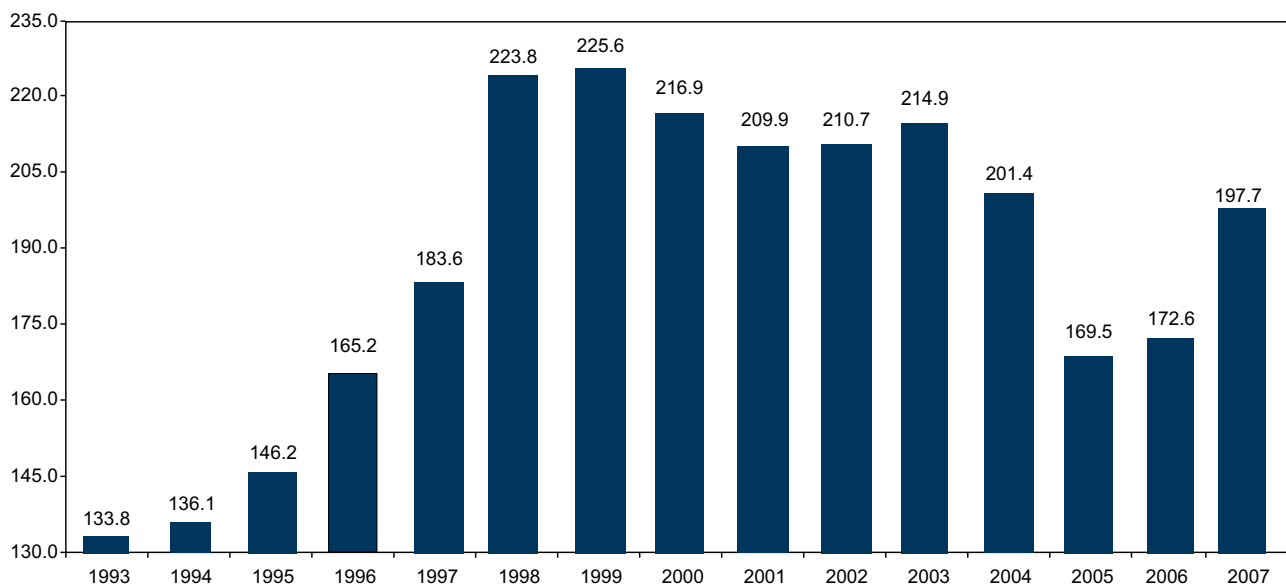
Source: Brazilian Institute of Geography and Statistics, Brazilian Central Bank, Applied Economic Research Institute
(1) Projection: Brazilian Central Bank Focus Bulletin



Luiz Carlos Berrini Avenue, São Paulo

Brazil's foreign debt rose dramatically during this period, climbing from US\$ 134.0 billion in 1993 to US\$ 224.0 billion in 1998. This development made the country extremely vulnerable to external crises, even more so when considering the speculative attack on the Brazilian currency in late 1998, early 1999, which led to the loss of a substantial amount of foreign reserves. As a result, the country introduced a floating exchange rate system in January 1999, and, thereafter, Brazil's monetary policy began to change in order to cope with the challenges imposed by economic stability.

Graph 4: Brazilian Foreign Debt (US\$ billion)



Source: Brazilian Central Bank

2.2. The new combination of economic policy and advances in the Brazilian economy (1999 - 2008)

All economic policy implemented since 1999 has aimed at addressing the costs associated with the monetary stability process initiated in 1994, i.e., the external imbalance, and the fiscal and high real interest rates. This policy combines a floating exchange rate system, inflation targeting and a primary fiscal adjustment², together with a wide-ranging reform of the tax law covering the states and municipalities, which renegotiated their debts with the federal government and allowed regional finances to be put in order. Limits were also imposed on states and municipalities to assuming additional debt commitments³. The floating exchange rate aimed to resolve the external imbalances and allow the real exchange rate to adjust to its own long-term level, thereby reversing the trend of successive current account deficits. However, the floating system put at risk the price stability achieved by the pass-through effect of the exchange rate on prices and the size of the nominal devaluation which began⁴ in 1999.

In January 1999, the country introduced a floating exchange rate system.

Likewise, the fiscal adjustment was imperative to containing the growing public debt and preventing the inflationary financing of the public debt, which would also threaten the price stability. The public sector also had to reduce the crowding-out effect⁵ on the private sector, allowing it to broaden its investments. Furthermore, the outlook for the external adjustment meant that there would be a reduction in an important source of investment financing, namely, the current account deficit. Therefore, efforts to expand domestic savings were indispensable to replacing the reduced amount of foreign savings, though this came at the expense of reducing private consumption.

² The Brazilian government has always used targets for the primary result, i.e., revenues minus costs excluding interest payments. There was no goal for the nominal deficit such as that laid down in the Maastricht treaty for a country to enter the European Union.

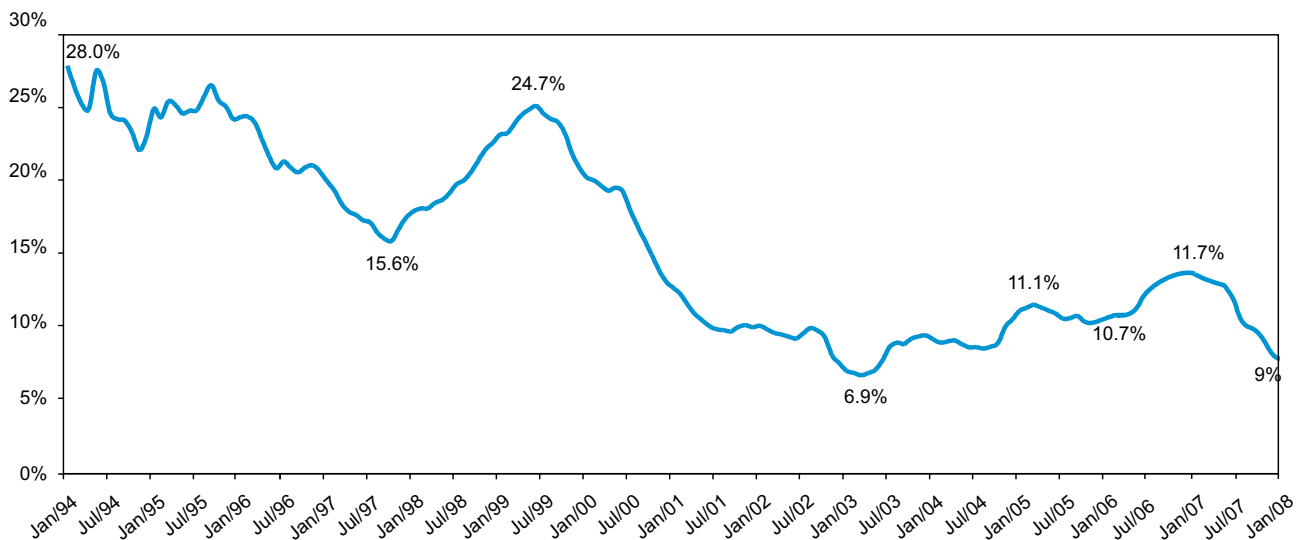
³ This grouping of laws became known as the Fiscal Responsibility Law and establishes, among other things, limits on current spending by state and municipal governments as a proportion of their revenues, and restricts them from acquiring new loans from banks and other bodies, and from undertaking primary debt issues.

⁴ Since the exchange rate was overvalued and the country had serious economic imbalances before the floating system was introduced, there was a high risk of strong currency depreciation - which eventually occurred - and consequent increase in inflation.

⁵ The crowding-out effect occurs when the public sector "expels" the private sector from making investments by competing for loans.

The high real interest rates are much more a result than a cause of Brazil's problems. This is because the interest rates were originally set very high to underpin the price-stabilization process and could not be reduced because there was no suitable fiscal adjustment. As a result, the interest rates during the 1994-1999 period included the premium charged by the market to finance an economy with a rising public debt. Furthermore, under the managed exchange rate system, interest rates play the additional role of attracting capital to the country to preserve the exchange rate anchor. As said earlier, the market demanded a high premium for this financing due to external and internal imbalances.

Graph 5: Real Interest Rates in Brazil - Average of 24 months



Source: Brazilian Central Bank, Brazilian Institute of Geography and Statistics

During a floating exchange rate period, the logic determining interest rates is reversed. The inflation targeting system is the new instrument which the monetary authority uses to define the base interest rate and, as can be seen, interest rates fell substantially after the system was changed, even though they are still high by international standards. This new combination of an economic policy based on a tripod, formed by the floating exchange rate system, inflation targeting and fiscal adjustment, allowed the country not only to reduce real interest rates to below 10 percentage points, but also to end its external vulnerability and contain the explosive growth of the public debt. In fact, in the last 12 months, Brazil's effective real interest rates have held at 6.8%, while market rates have been about 7.6%, currently estimating that real rates are below neutral or the term premium is at least 0.8 percentage points higher than current rates.

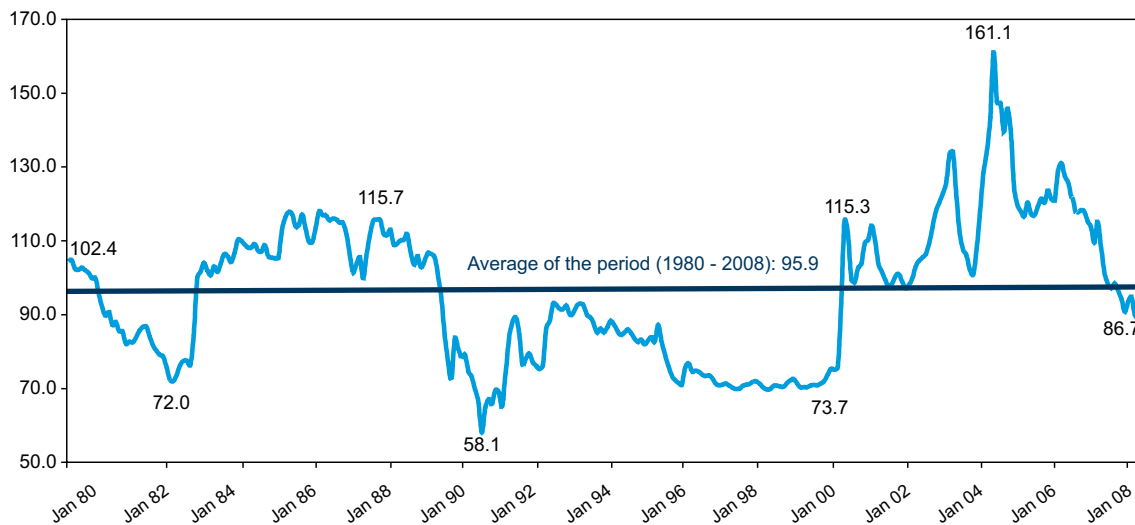
As a result, we can say that the 2004-2007 period was the best in terms of Brazil's macroeconomic performance in the last 30 years. One can feel extremely optimistic about the country, while still recognizing its challenges and imbalances. Once again, it was the foreign sector which was largely responsible for this adjustment. As can be seen in Graph 3 (page 11), the five-year period of 2003-2007 recorded consecutive surpluses in current account transactions, a result which had never been seen in the history of this indicator since it was instituted in 1947. Furthermore, the surpluses in 2004 and 2005 were record figures. The market projections for this indicator through to 2012 point to a rising deficit but one that can be comfortably financed, since it does not even amount to 1% of GDP, which is 4 times below the recorded deficit of the late 90s. Only in terms of foreign direct investments, the Brazilian economy receives about 1.7% of GDP yearly. It should be noted that foreign financing conditions of the Brazilian economy are highly favorable, with Brazil appearing among the main countries receiving foreign direct investments. These currently amount to roughly US\$ 35.0 billion. According to Unctad, Brazil was among the world's top three destinations for foreign direct investments⁶ during the 1999-2002 period, due to its privatization program, the vast and diversified nature of its industry and its level of domestic market development. Today's levels are very similar to those attained during the privatization program, and it should be borne in mind that almost no public asset has been sold to meet these levels. It is worth mentioning that a reversal of the current account surplus is desirable in the midterm for a country like Brazil, which has a low growth rate and needs to increase its savings to finance investments and sustain permanently higher growth rates. The current account surpluses were responsible for reducing the foreign debt, as can be seen in Graph 4 (page 12), but they are not expected to hold in the long term; actually, a deficit is already expected for the current year of 2008. The current account surplus was reversed by the appreciation of the currency and by higher domestic growth, exactly what has happened in the last three years. The recent surge in the foreign debt, from 2005 to 2007, is partly due to the internationalization of some Brazilian companies and also to short-term debt. But all the increase was held by private sector agents, while the public foreign debt is still diminishing and, given the high level of international reserves, practically all our foreign debt could be paid with our US\$ 185 billion international reserves. The government is currently in a net asset position in terms of foreign debt.

It is also worth highlighting that Brazil has been gaining international market share in its exports since 1999, with its participation in world trade increasing from 0.83% in 1999 to 1.12% in 2007. Furthermore, about 55% of Brazilian exports are manufactured goods and not raw materials (25%), as many people believe. The current balance of trade has also expanded substantially, rising to US\$ 281 billion in 2007 from US\$ 97.3 billion in 1999. This is another factor contributing to reducing the country's vulnerability to external shocks.

⁶ Brazil followed only behind China.

The main results of this post-99 external adjustment were the reduction in the country risk and the appreciation of the currency. The country risk, which reached 2,400 points above the US Treasury bill in 2002 is now no more than some 200 points higher. This means that Brazil has a country risk almost the same as the average for the other emerging countries. In 2002, for example, the country risk was 1,400 points above the average for the other emerging countries⁷. With the improvement in the risk and intensity of the external adjustment, marked by the reversal of the current account deficit from 4.3% of GDP to a surplus of 1.8% of GDP (a variation of 6.1% of GDP), the exchange rate underwent an appreciation rarely seen in the country⁸. This adjustment in external savings - a reduction of 6.1% of GDP - was made by applying the classic mechanism of adjusting the balance of payments, done by reducing household consumption and forcing higher domestic savings. As a result, whereas household consumption in 1997 represented 65.4% of GDP, it dropped to 59.8% of GDP by 2004.

Graph 6: Effective Real Interest Rates - (Average 2000 = 100)



Source: Applied Economic Research Institute

⁷ Measured by the J.P. Morgan EMBI+. The year 2002 was marked by the worsening of the situation brought about by expectations of the victory of Luiz Inacio Lula da Silva in the presidential elections. At that time, there was uncertainty over his commitment to the existing macroeconomic policy. However, since the macroeconomic tripod was maintained, the markets reduced their premiums in relation to the Lula government. The transition he made from a social democratic to a left-wing government that maintained a rational economic policy was another important determinant for the country at the time. Freed from any populist risk to democracy, Brazil's economic institutions emerged much stronger from this episode. In 2006, for example, even though the country faced a serious crisis involving corruption that affected important members of the government, the country risk did not worsen, because of the general view that there would be no substantial changes to the economic policy, whether from the government or the Finance Ministry. This institutional success gained by the more favorable pricing of the Brazil risk by foreign and domestic markets, even though it was achieved by an informal institution, should not be underestimated.

⁸ It should be borne in mind that a large part of the currency appreciation was due to the buoyant world liquidity, although Brazil would not have been able to benefit had the conditions of its domestic and international solvency not been suitable.

Another important point associated to the exchange rate appreciation is the lower rate of expected volatility and the lesser likelihood of an exchange rate depreciation. This is because foreign accounts have provided some breathing room enabled by the great accumulation of foreign reserves and the reduction in the net foreign debt. With this mind, there is no reason for a large depreciation caused by balance of payment flows. The expectations for the exchange rate, in turn, also do not point to any large depreciation, since sustainability and even a reduction in the debt/GDP ratio is ensured by maintaining the current economic policy⁹. Today, all maturing public debt (principal plus interest) does not reduce the international reserves, because the government purchases the needed dollars directly from market players.

Lower expectations for currency depreciation and volatility are important signposts for potential investors in Brazil.

In terms of exchange rate volatility, the great increase in the trade flow means that any eventual deficits in the balance of payments would require a smaller rate of devaluation of the currency – given the elasticity of foreign accounts – if it is to entail a given adjustment in the trade balance, for example. Therefore, less exchange rate volatility is expected in the coming years. In fact, during the recent turmoil of the US subprime crisis, the Brazilian currency depreciated very little in the worst days of the crisis, operating in the range of 1.70 – 1.85 R\$/US\$, which is proof of the reduced volatility achieved by the country.

These two components - lower expectations for depreciation and volatility - are important signposts for potential investors in Brazil. This is because the lower expectation of depreciation for the exchange rate means that the current value of assets will be maintained, while less volatility means lower risk for both the investor who invests in financial assets and the investor who invests in the production side of the Brazilian economy.

⁹ Another important factor indicating unexpected depreciation occurred in 2006 when the Brazilian Treasury acquired the entire foreign debt maturing between 2007 and 2010. With this buyback program (leaving only a part still to be acquired) carried out mainly in the first half of 2006, the market saw that Brazil would not have to use any funds in the coming four years to make foreign debt principal payments, only current debt interest payments.

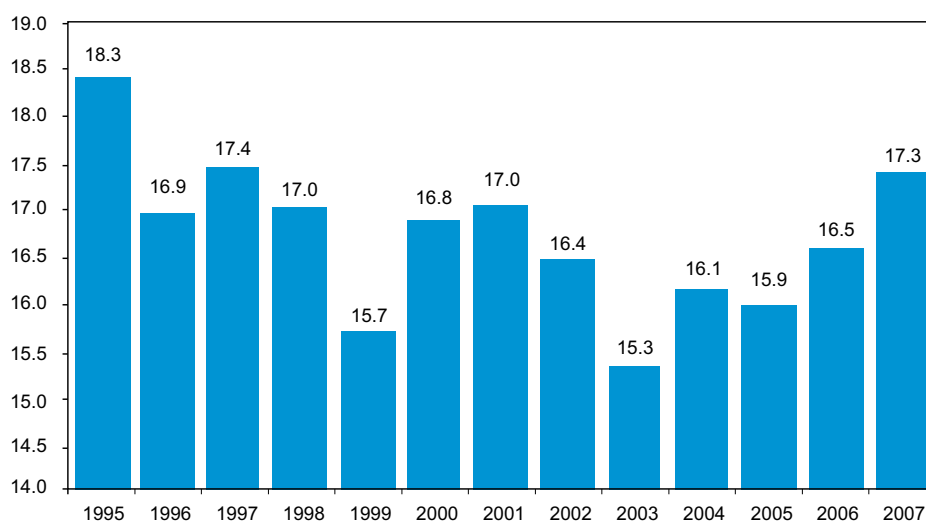
We must emphasize two other aspects of the Brazilian economy in the pre-floating exchange rate stage. The first is that the cycles of economic growth were restricted mainly by external imbalances at every turn. Restrictions in the balance of payments always require adjustments in to be made in domestic absorption to allow the country to make its demand suitable to the level of savings and aggregate supply. The second aspect is that Brazilian inflation has always been an expression of the imbalances in the balance of payments, given the devaluations needed to adjust the external accounts and the subsequent pass-through effects. In the period before the Real Plan, this inflation, which was touched off by the external accounts, spread even more easily through the Brazilian economy, fueled by the high inflation inertia abetted by the automatic price indexation mechanisms (including the exchange rate and wages), which virtually ceased to exist as of 1994.

As a result, if the Brazilian external adjustment was seen as long-lasting, a reasonable assumption in our view – given the gain in market share, the higher trade balance, the diversity of exports and destination countries and, lastly, the very expectation that the floating exchange rate system will be maintained – is that Brazilian inflation will tend to be systematically lower and less volatile from now on. If not, it should at least move closer to the target set by the government, currently fixed at 4.5%. As we stated earlier, under an inflation targeting system, maintaining the inflation close to the target is the signal required by monetary policymakers to keep depressing interest rates, providing there are signs of an increase in supply conditions. Graph 1 (page 9) shows that the Brazilian Central Bank is currently enjoying great credibility and has been highly successful in its task of making expectations converge to the inflation target. The market does not expect the current target of 4.5% to be surpassed at any time between 2008 and 2012. In fact, market participants expect inflation to be below target from 2009 on.

In terms of supply conditions, the reduction in the country risk indicator points to a lower foreign financing cost. At the same time, low inflation extends the horizon for planning and investment, since it allows the investor to calculate its relative price correctly. Together with this outlook, we have the prospect of a ongoing macroeconomic adjustment, which means that expectations are very favorable for increased investments in the economy¹⁰. The natural result of this process is a reduction in real domestic interest rates. It is important to note that lower real rates will be the trend in the Brazilian economy in the next few years, even if the Brazilian Central Bank needs to increase rates for a short period of time to contain inflationary pressures and keep expectations around the targeted inflation, which might be the case in the next few quarters.

¹⁰ Graph 7 shows a small downward trend in the rate of investment in the Brazilian economy between 1995 and 2003 and a strong recovery as of 2004, enabled by offsetting the external imbalances and reducing the concern over the solvency of public debt, which started to show a stable trend. At the same time, the exchange rate appreciation lowered the cost of capital goods, boosting investments. The expansion of credit – which rose by about 6.5 percentage points of GDP in two years, from 28.1% in 2005 to 34.7% in 2007 - boosted the civil construction sector that, alone, is responsible for roughly 55% of investments in the economy.

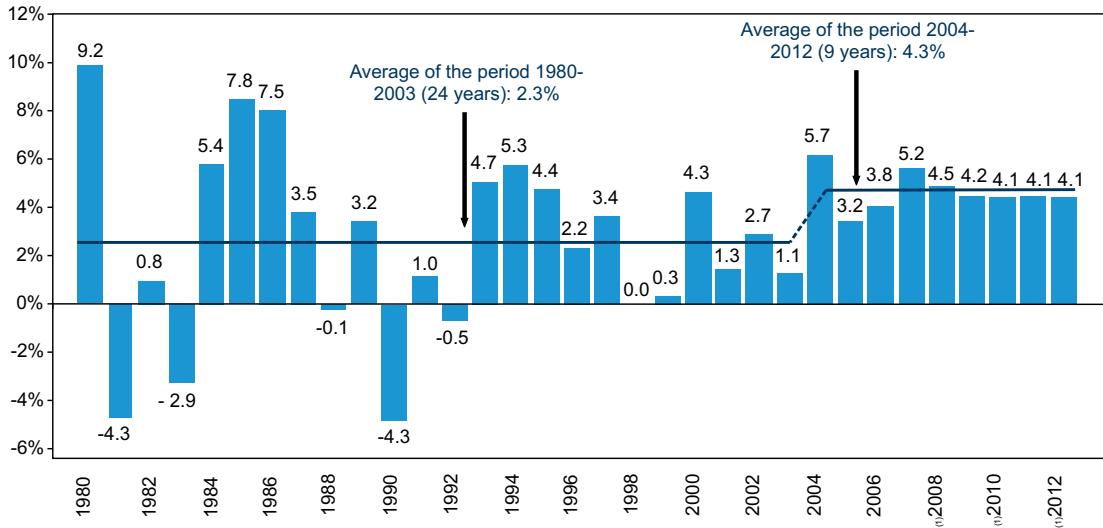
Graph 7: Rate of Investment in the Brazilian Economy (% GDP)



Source: Brazilian Institute of Geography and Statistics

The fundamental issue in the conduct of economic policy is related to economic growth. Brazil has a much lower growth rate than practically any country in the world and particularly in relation to the BRICs. As we have said before, part of the reason for the stop-and-go cycle of Brazilian economic growth can be attributed to external imbalances, which have been responsible for higher inflation and, in turn, higher interest rates. Once external imbalances have been resolved and the prospect is for lower real interest rates in the near future, the conditions will be in place for higher Brazilian growth and less volatility. The last methodological revision of Brazilian GDP statistics shows that the Brazilian economy is still growing at a slower pace, but the country is closer to what is expected from a developed economy with a minor rural population and a well developed real economy. We believe that in the coming years the country could grow by roughly 2.0 percentage points above the average for the last 24 years (2.3%) without any great additional structural reforms. The country could also grow in a sustained manner in the coming years, given the increase seen in the rate of investment in the economy. As the next section will show, one of the key determinants for growth is the increase in total factory productivity in conjunction with investments in technology, education, infrastructure, and a greater trade liberalization, among other factors. However, there are still challenges to be surmounted if Brazil is to grow by more than 2.0 percentage points above the average for the last 24 years. These will be addressed in the next section.

Graph 8: Real Rate of Growth of the Brazilian Economy (%)



Source: Brazilian Institute of Geography and Statistics
 (1) Projection: Brazilian Central Bank Focus Bulletin

The recent period can, therefore, be regarded as the best in the modern Brazilian economy, considering the external adjustment, the lowest inflation rate in a floating exchange rate system and the lowest nominal interest rates in history, combined with controlled inflation, the lowest country risk, economic maturity and higher GDP growth expectancy. This favorable combination of factors supports improved investment prospects that led to an upgrade in Brazil’s long-term foreign currency sovereign debt to investment-grade by Standard & Poor’s¹¹.



Pateo do Colégio, São Paulo

¹¹ On April 30, 2008, the Standard & Poor’s Ratings Services raised Brazil’s long-term sovereign foreign currency credit to ‘BBB-’ from ‘BB+’, and its long-term local currency sovereign credit to ‘BBB+’ from ‘BBB’.

2.3. Mid- and long-term challenges

In this context, some of the challenges facing the Brazilian economy in the coming years are worth mentioning. The main macroeconomic challenge is fiscal. Should the current level of the primary surplus remain at 3.8% of GDP, the country will have a zero fiscal deficit around 2010, depending on the real interest rates prevailing in this period, and on the rate of economic growth. However, reasonable assumptions of interest rates and growth suggest that this scenario will materialize. There should be no great concern that solvency will affect this path. However, the fiscal adjustment of recent years was a consequence mainly of the increase in the tax burden, which distorts relative prices and allocations in the economy, creating inefficiency and reducing the net assets of consumers and/or producers. The heavy tax burden and/or high labor costs are leading companies and employees to choose more flexible working conditions (making the economy more formal to a certain extent). Several studies indicate that productivity in the informal sector of the economy is much lower than in the formal sector due to the lower rate of training, legal guarantees, and restrictions on increasing physical and human capital, among other factors.

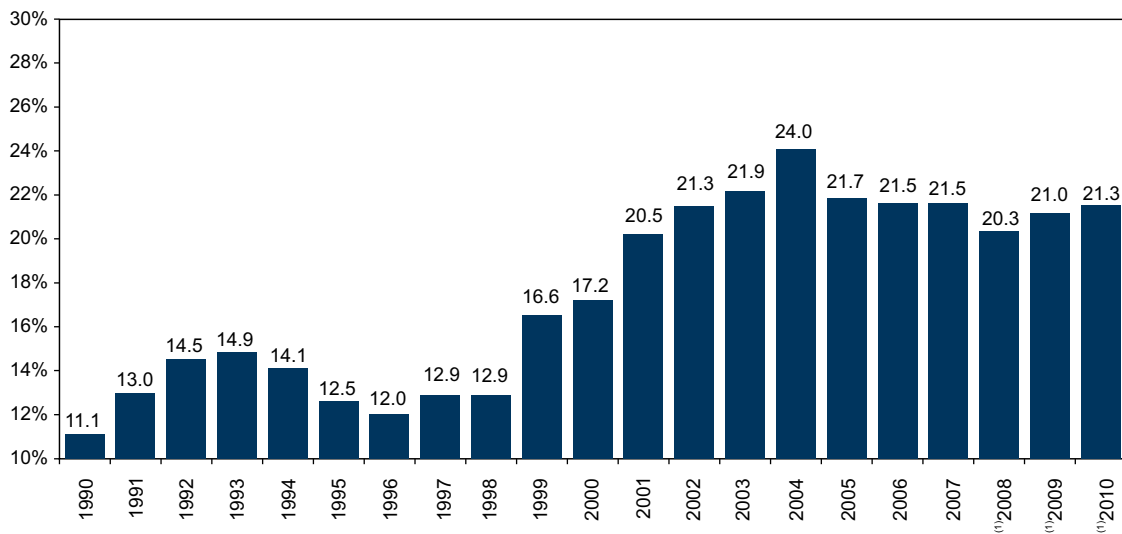
Although the tax burden, like interest rates, has increased Brazil's economic problems, its format is much more the result than the cause of these problems. This is because the big question involving the tax burden is the continuing rise in public spending, particularly in pensions and current expenditures¹². A wide-ranging reform of the pension system is essential to ensure the sustainability of the fiscal system in the long term and to depress the tax burden, thereby paving the road for greater private investment. Furthermore, a fiscal reform that reduces the size of public spending in the composition of the federal budget will allow the government to resume playing the role of an investor in areas where the return does not always compensate private investment, like education, health and large-scale infrastructure, among other factors.

Achieving a permanent, long-lasting fiscal adjustment is the great macroeconomic challenge facing Brazil at the moment. It is on this adjustment that the substantial reductions in interest rates and the tax burden depend, as well as sustained economic growth at a higher rate, made possible by the overturning of external imbalances.

¹² For a wide-ranging analysis of public spending in the country, see Giambiagi (2006).

Another macroeconomic challenge facing Brazil is that of opening itself commercially to more trade. Brazil is one of the most closed countries when measured by its trade flow and GDP. There have been advances in recent years, but they have not been enough to make Brazil comparable to high growth countries. It is very likely that the currency appreciation experienced by the country as a result of the balance of payment adjustment will pave the way for a broader commercial opening. This is generally more politically feasible when there is a large trade surplus. Furthermore, only a greater commercial opening can contain the currency appreciation in the midterm, thereby stopping the recent exchange rate appreciation from reducing the gains in market share of Brazilian exports.

Graph 9: Brazilian trade flow (% GDP)



Source: Brazilian Institute of Geography and Statistics
 (1) Projection: Brazilian Central Bank Focus Bulletin

The other main items on the reform agenda in Brazil are in the microeconomic area: reforms of the Judiciary and the Legislature are essential to improving the efficiency and augmenting the predictability of the business environment of the country. There also has to be greater stability in terms of regulations, achieved by strengthening the regulatory agencies for utilities such as water and sewage, electric power, telephone service, etc. Granting the Brazilian Central Bank formal independence would be an important step in ensuring a formal commitment to long-standing, low inflation¹³. Only when there is confidence that inflation will remain steady at a permanently low rate will the Treasury be able to extend the due dates of the public debt definitively in the midterm and make it mainly pre-fixed, thereby reducing the uncertainty of the flow of domestic debt financing¹⁴. The main microeconomic reform in relation to the balance of payments is related to the exchange rate legislation that is outdated and inadequate in terms of foreign trade and capital flows within the context of globalized economies.

A wide-ranging reform of the pension system is essential to ensure the sustainability of the fiscal system in the long term and relieve the tax burden.

The capital markets need to be developed more intensively to improve domestic financing investment conditions. This will only come about if inflation is low, interest rates are down and investors have confidence in the regulations governing contracts. The increase in the credit/GDP ratio described above should be hailed, but it is likewise admittedly true that credit in Brazil is very scarce and expensive by international standards. Once again, a reduction in interest rates and inflation will allow credit mechanisms to expand. As a result, products, together with an improved labor market, will tend to reduce default levels, favoring lower rates for loans. Greater economic stability and a reduction in the crowding-out effect of the public sector will inevitably create a larger appetite within the financial system to expand credit lines to the private sector, leading to greater competitiveness in the sector and lower costs to final consumers. Indeed, last year was a very successful one for capital market operations, mainly IPOs, proving that stability and economic growth are the substance for the improvement in capital markets. However, there is still much to do in terms of developments in secondary markets, mainly increasing liquidity and establishing price-setting mechanisms, and also in terms of securitizing and of spreading risks to enhance the potential of the capital and the derivatives markets.

¹³ Although the Brazilian Central Bank is not formally independent, it is independent in practice.

¹⁴ Roughly 35% of Brazil's current debt in domestic securities is post-fixed (indexed to floating interest rates) and the other 65% is indexed to price indexes and pre-fixed rates. The domestic debt indexed to the exchange rate, which amounted to about 40% of the total debt in 2002, was completely redeemed from the inflow of currency resulting from the adjustment in the balance of payments, and there is no expected devaluation of the currency. As result, Brazil has a positive position today in terms of assets, if we consider the foreign public debt and subtract the foreign reserves and the currency swaps in which the government is a creditor in dollar terms.



Museum of Contemporary Art, Niterói

Brazil also needs to raise the quality of its primary and secondary education to enhance the skills of future generations. Significant amounts are actually spent on education and health as a proportion of GDP, compared with other countries having similar income levels. The focus should therefore be on improving the quality of expenditures made on education. According to Soares (2006a), the Brazilian government spends 14 times more on higher education than on basic education. Discounting the greater costs of maintaining higher education spending, this inequality in allocating resources leads to inequality of income among the different levels of schooling. Educational reform, therefore, does not depend on more resources alone, but also on greater spending efficiency.

Much progress has been made in tackling poverty and inequality between 2001 and 2007. In 2004 alone, there was a reduction of 8% in extreme poverty and in inequality, as measured by the Gini index. This improvement continued through the 2005-2007 period, although at a more modest rate. Soares (2006b) describes the transformation in Brazilian inequality as follows:

“Brazil is known internationally for having won the World Cup five times, having most of the largest tropical forest in the world and being a country of extreme inequality. There is an extensive bibliography on this inequality through events such as the economic miracle, the return to democracy, hyperinflation and the various stability plans, opening of the economy, economic stability and a number of currency appreciations and devaluations. However, anyone who examines the figures and does not make any math errors can see clearly that there was a continuous and unequivocal fall in inequality between 2001 and 2004 (p. 25).”

It is worth stating that part of this reduction was due to programs aimed at transferring income. Whether these advances will continue depends on whether these benefits are maintained for a prolonged period of time (which will create new undesirable rigidity in public spending), or, preferably, on whether these programs can offer the conditions needed to help the current beneficiaries and their families reach a position in which they can earn their own income and become less dependent on the benefits in the future. The developments in the labor market, underpinned by the lowest unemployment rates in the last 14 years, combined with the historical rates of labor-force formalization, are steering in the right direction, but still have a long way to go.

Although advances must continue to be made in this area, progress will depend on whether the country will grow in a sustained manner through sustained macroeconomic and social policies. Some of these policies will be directed at removing people from poverty and relieving poverty, while others will address training human capital, and creating jobs and income.

I have in me **all the dreams in the world.**

Fernando Pessoa



We are good when we make the others better.

Russian Proverb

People are difficult to govern because they have too much **knowledge**.

Lao-tzu, China

Victory attained by violence is tantamount to defeat, for it is momentary.

Mahatma Gandhi, India

3. Brazil Compared with the “RICs”

The issue of the emergence of the BRICs is based on the proposition that emerging countries, which are large in terms of land and population but small in terms of average income, can converge to per capita levels of income comparable to those of developed countries, within decades.

The theory of economic growth presented by Harrod-Domar, followed-up in the theoretical work of Solow (1956), raised the possibility of a convergence of global income in the long term among nations, if laws were respected governing the mobility of production factors (simplified, for theoretical reasons, as capital and labor) around the world.

However, a series of restrictions still exists, such as the migration of labor between countries, as well as the exchange of capital goods and, more broadly, differences in technological expertise between countries.

This is a theoretical point, since current international trade regulations and restrictions on migration flows indicate that the convergence of nations will not occur naturally. This raises the question of under what conditions will nations turn from being developing countries to countries with the same standards as developed economies?

It is important to note that despite the restrictions that hold back the “natural” convergence of income among these nations, there are cases of countries that have made the transition from an “emerging” to a “developed” nation in a relatively short space of time. The rise of post-war Japan and the revolution in South Korea are only two examples of economic policies which spurred a rapid growth in the income of these countries and substantially reduced the gap between their income rates and those of the developed countries.

As a result, the following questions arise:

<ul style="list-style-type: none"> • What are the conditions required for these countries (Brazil, Russia, India and China) to effect the proposition of becoming part of the group of developed countries within a few decades? 	<ul style="list-style-type: none"> • Which of these conditions already exist in each of these countries? 	<ul style="list-style-type: none"> • What are the comparative advantages of each of these countries in the race to become developed ahead of the others?
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The first question can be answered by using the theory of economic growth as a base. It simplifies the GDP of an economy starting from a production function of the Cobb-Douglas equation:

$$Y = AK^\alpha L^{(1-\alpha)} \quad (1)$$

where **Y** is defined as the total product of the economy (GDP), **K** is the capital stock of this economy, **L** is the stock of employed labor, and **A** is the technological level, whose rate of growth is called Total Factor Productivity (TFP), and α a term that defines the participation of capital in the country's income. Hereafter, it will be taken as a constant to simplify our analysis.

With this in mind, an economy can only experience growth in its gross national product if there is growth in the stock of its production factors (in capital employed or labor employed) and/or if there is a rise in the productivity of these factors (increasing work productivity and/or the productivity of the capital, which will become greater, as represented in term **A** described in the equation (1)).

Factors which have a negative or positive effect on these variables will, therefore, allow a country to experience a higher or lower growth rate and a faster or slower convergence toward the income of the developed countries. Barro (2004) describes a series of determinants which influence production and productivity factors. These are:

- | |
|---|
| <ol style="list-style-type: none"> 1. Level of schooling of the population • 2. Life expectancy of the population • 3. Lower government spending • 4. Maintenance of political and legal regulations which directly or indirectly affect business • 5. Low inflation (inflation under control) • 6. Greater trade liberalization |
|---|



Paulista Avenue, São Paulo

Each of these factors affects the speed at which the income of BRIC countries will converge with the average income of the developed countries. Each BRIC is also at a different stage of development in relation to each of these indicators. Looking at the importance of each of these factors in driving higher economic growth rates, we can consider the following points:

1. Greater schooling is very closely related to an increase in labor productivity and, therefore, has a positive effect on a country's growth.
2. An increase in life expectancy means that people have a greater incentive to make investments in human capital, since the opportunity cost of studying for one more year to someone who expects to live longer is greater than the opportunity cost of someone who expects to live for a shorter period, for example. As a result, greater life expectancy leads to an average increase in the schooling of the population and, subsequently, to greater productivity at work.
3. Lower government spending means that prices are less distorted within the economy. Any additional public spending has to be financed over a long period by more taxes to avoid being inflationary. Since taxes are not levied uniformly on all contributors and on all production sectors of the economy, they create distortions in relative prices between sectors. Even where the tax is reasonable, its application reduces the surplus of consumers and/or producers. These distortions lead to the allocation of fewer monetary resources in the economy, which in turn creates a reduction in the total productivity of the production factors, and results in a lower GDP. Several studies show that greater government spending creates a potentially lower GDP in the economy over the long term, unless this spending is used to increase production investment by the government.
4. The instability of regulations which govern business creates market uncertainty. These uncertainties are incorporated to an extent in the readiness of investors to apply their resources and even in the price charged for their products. As a result, in an unstable regulatory environment, the economic system will generate a lower product quantity for the same price, leading the economy to strike a new balance with a smaller GDP than in an environment where there is no or at least less uncertainty over legal matters.

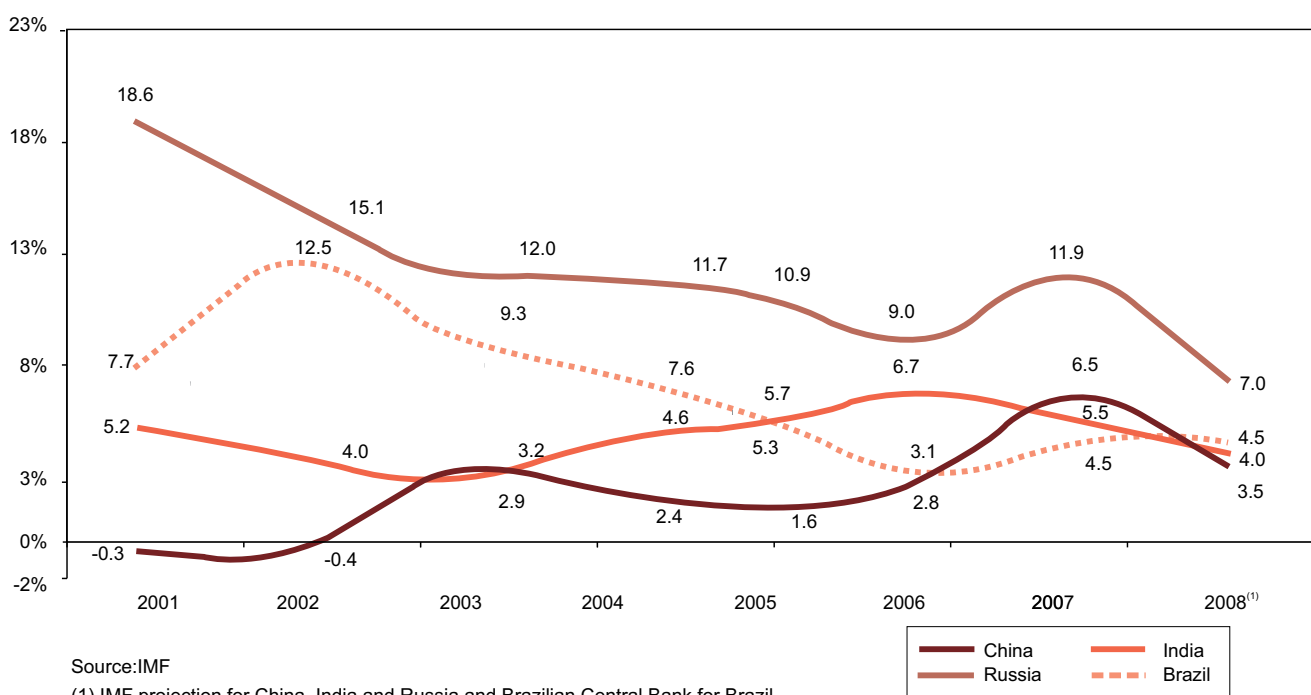
5. High inflation distorts the market view of relative prices. One loses the notion, for example, of whether the nominal gain from a company's revenues is a real gain or whether other costs have risen to such an extent that they ultimately offset the revenue gain. Against this backdrop, decisions on investments by companies or on household consumption are greatly distorted, since there is limited information on the combination of prices. This eventually creates an undue allocation of monetary resources and lower economic production.

6. Greater trade liberalization brings greater competitiveness to the business sector and makes the economy more open to competition in the various sectors (creating the Pareto efficiency results). This reduces occurrences of oligopoly and/or monopoly, which are inefficient and which lead to the manufacture of products of inferior quality. The final result is a level of production that is higher, and that has potential productivity gains made possible by the importing of capital goods with the most advanced technological components previously banned due to foreign trade restrictions. The outcome is a boost in production opportunities within a country.

Any analysis of the current stage of development of the BRICs in each of these areas must begin with these core variables, such as inflation, trade liberalization and the size of public spending.

Consumer inflation - a good indicator of monetary stability - is shown in the following graph.

Graph 10: Development of consumer prices in the BRICs (%)



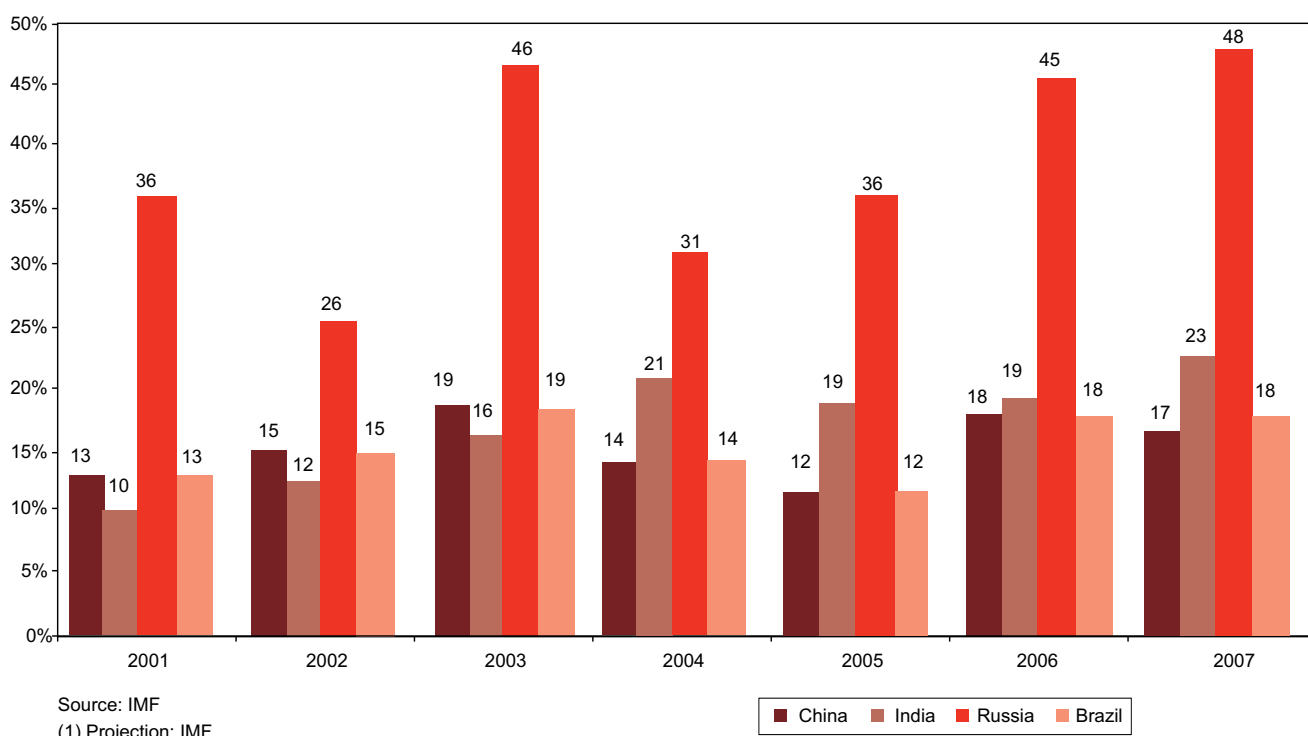
Any analysis of the current stage of development of the BRICs in each of these areas must begin with these core variables, such as inflation, trade liberalization and the size of public spending.

As can be seen, the country with the greatest difficulty in curbing inflation is Russia, whose inflation levels are still high and whose monetary policy risks spinning out of control.

It should be noted that Russia's currency has undergone a substantial appreciation in recent years. Notwithstanding, there has been no convergence to inflation rates comparable with those of developed countries. The main problem Russia faces in controlling inflation is the complete non-sterilization of the buyback of foreign reserves. This lack of control is evidenced by Russia's monetary base expansion rate that has been over 30% a year, compared with 10% and 15% in India and China, which have experienced higher economic growth than Russia¹⁵. To a great extent, Brazil and China face similar problems of excess liquidity and a need to control the expansion of the monetary base due to the buyback of foreign reserves. However, Brazil is better positioned than China, because of Brazil's floating exchange rate versus China's currency management constraints, which exert enormous pressure to let the Yuan appreciate.

The following graph shows this relaxed control over the monetary base in Russia and the risk this implies to inflation. Note that, in this respect, Brazil has tight control over its monetary expansion. This is because the determination of the monetary base is endogenous in an inflation targeting system, since the Brazilian Central Bank actually controls interest rates.

Graph 11: Variation of the monetary base of the BRICs (%)



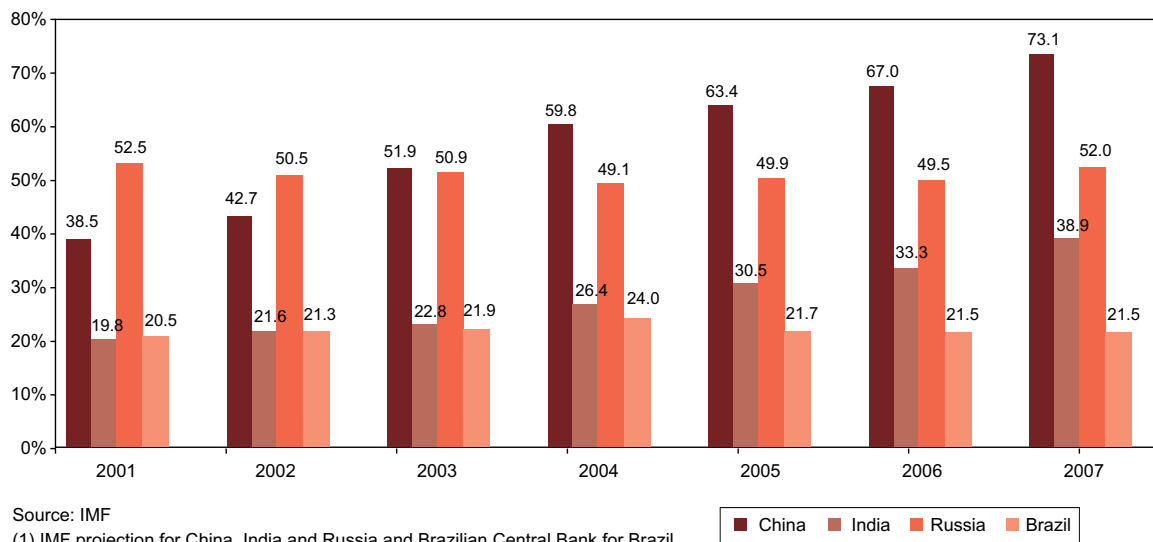
¹⁵ Higher economic growth, with other factors remaining constant, means greater demand for money, which should lead to the monetary expansion of the Asian countries (China and India) over Russia.

It is worth pointing out that none of these countries operates within the framework of an inflation targeting system as does Brazil. There is an additional problem in Russia, where the monetary policy is guided by a double objective: controlling both the inflation and the exchange rates. Russia further faces pressure to reduce government spending. This could also contribute to worsening inflation.

China’s problem is the opposite. Its investment rates are very high and the clear trend toward currency appreciation (despite the fixed exchange rate system), in earlier years, was associated with the risk of a widespread deflationary situation. But last year, inflationary pressures began to change the role of China from a nation of deflationary prices to one of inflationary prices, due to swelling commodity prices and the overheating of global and Chinese economies, even though it exports this higher inflation to the world. Despite the official estimate of a 3.5% inflation for 2008, the Chinese economy risks seeing a much higher inflation - some analysts even say that it might reach the two-digit inflation figure of 10%. The local authorities have already adopted liquidity-restricting, investment-curbing measures in certain sectors in order to quell this risk.

In any case, the most developed and most stable system of controlling inflation among the BRICs is Brazil’s, which uses just one instrument (interest rates) to control one single objective - inflation. In developed countries, this system has been more efficient to ensure price stability in the long term, required for higher rates of economic growth. Therefore, in terms of how monetary policy is conducted and how prices are kept under control, Brazil is ahead of the RICs.

Graph 12: Development of the trade flow of the BRICs (% GDP)



The BRICs have made great strides in terms of opening trade in recent years. The country with the most restrictions in this area is Brazil, followed by India. Although India still has one of the lowest trade balance/GDP ratios in the world, it has made an effort to reduce its import tariffs sharply. It has numerous trade agreements and is discussing others to offset this restriction to growth. The previous graph illustrates this trend toward broader trade.

It should be noted in the case of Russia that, although the volume of foreign trade has grown substantially, the simultaneous rise in the exchange rate means that GDP has also grown in dollar terms, restricting the perception of greater trade flows. This was also the case of Brazil between 2003 and 2006.

China and Russia are ahead of India and Brazil in terms of opening trade, but India has already given clear signs that it will counter this restriction forcefully. Nonetheless, Brazil continues to open its market gradually through restricted trade agreements, and shows no signs of broadening this opening. This holds back its potential to seek gains in productivity and augment its potential GDP in the midterm.

In terms of the role and the “size” of the public sector in the economy, there are two countries with distinct problems which are comparable to Brazil’s. India, for example, has a high debt/GDP ratio of 85%, which means that the cost of financing this debt restricts greater spending in investments and social programs. India’s situation is even more precarious, since it has great difficulty in expanding its tax base, due to the high degree of informality in the domestic economy.

Russia, on the other hand, has an enormous number of government-owned companies and the government has a participative role in corporate business, inherited from the centralized socialist state. There are also demands from the population for new government expenditures out of an increased level of tax income obtained from oil exports. As a result, there seems to be a structural and cultural restriction on reducing the state’s participation in the Russian economy. This is extremely negative in terms of the future growth potential of the country.

The remaining factors which influence long-term growth, such as schooling, life expectancy and institutional issues like the quality and stability of regulations, do not present a uniform front. However, there are signs that the issue of schooling, which is still generally very precarious in India and in rural areas of China, has been tackled more strongly in these countries. Although universal schooling has been in existence in Brazil throughout the last decade, the Asian countries have concentrated on investing in human capital at a higher education level. There has also been an enormous flow of Chinese and Indian students to the best American universities, and these have returned home with the benefits of having internationalized part of this acquired knowledge. There is a growing development of state-of-the-art technologies, and India has created a growing information technology market and is exporting software and hardware all over the world¹⁶.

Table: New technology production indicators in India
(Number of registered patents)

	Hardware	Software	Total IT	Share of GDP
2000	281	244	525	
2001	311	378	689	
2002	328	474	802	
2003	375	590	965	4.30%
2004	438	745	1,183	4.83%
2005	498	978	1,476	5.40%

Source: Indian Information Technology Department

The above table shows how India has expanded in the technology sector. These state-of-the-art sectors have important multiplying effects on the total productivity of the economy and will, therefore, generate a greater GDP in the future. In this respect, Brazil is behind the RICs since it invests in low quality education, produces few patents and has a low average schooling level of the population.

Lastly, institutional conditions, such as the quality of laws, and regulatory as well as political and social stability must be analyzed qualitatively. Many aspects must be considered.

¹⁶ The risk of this strategy favoring the higher education sector lies in growing income inequality, as is the case in Brazil, for example.

One of the first issues, for example, relates to how robust the financial systems of these countries is and whether investors have the comfort of knowing that there are no risks of a financial crisis provoking economic instability. In this respect, Brazil is the country with the soundest financial system, thanks to the healthy restructuring that occurred in the mid-90s. The other countries have their risks, such as potential liabilities from creditors in China, excessive participation by government banks with rules that are not clear, and financial statements that are not transparent. At the same time, the failure to use interest rates as a tool to control inflation could lead these countries to making direct interventions in the financial system in order to contain the expansion of the monetary base, thus creating instability throughout the economic system.



Praça XV, Rio de Janeiro

Another area where Brazil seems to have an outstanding position is in the operation of the exchange rate system. The system works under market rules in Brazil, thereby giving investors the security of knowing that the market will establish the forces rather than any specific agent¹⁷. In China, for example, the exchange rate is controlled within strict floating bands. These keep the currency depreciated and create perverse midterm incentives, such as investments in export sectors that are actually only competitive in the foreign market in the midterm, at which time the currency appreciates artificially. In Russia, there is a multiple exchange rate system which allows the government to make arbitrary choices to influence the exchange rate. This distorts the conditions of the free market.

Therefore, despite the costs incurred in the greater degree of volatility ascribed to an important price within the economy, the exchange rate in Brazil reflects market conditions. As a result, it gives the right signals for investments and for relative price adjustment between the tradable and non-tradable sectors. This compares with the currency “control” mechanisms in China and Russia, which create economic distortions that will be extremely expensive to adjust when there is a discreet adjustment of the exchange rate to market conditions. The occasions on which the Brazilian government has intervened in the exchange rate have all been associated with the intentions of the Brazilian Central Bank and Treasury to improve the management of the country’s foreign liabilities (buying back foreign public debt) and to reduce exchange rate volatility, rather than defining the value of the currency.

¹⁷ As we have already stated, Brazil has an archaic currency law which needs to be reformed to increase the freedom of capital accounts, but the Brazilian floating system among the BRICs is highly transparent.

Brazil has a democratic system and unrestricted social mobility. These factors make Brazil's institutional structure relatively superior to that of the RICs in certain aspects.

Finally, some issues about political systems have to be addressed, like China's, and about arbitrary government decisions where companies have been expropriated and politically persecuted, like in Russia. The caste system in India engenders social rigidity, whereas the rural population in China is restricted in migrational terms. These are examples which constrain more efficient allocation of financial and human resources in these economies. In turn, these constraints reduce their appeal to foreign investors in the long term, since the mobility of capital and work is not free. In this case, Brazil has a democratic system and unrestricted social mobility. While its business regulations may not be the best, its rules are not thrown off skew by great shocks and changes. These factors make Brazil's institutional structure relatively superior to that of the RICs in certain aspects.

Questions such as excessive bureaucracy and the slowness of the legal system, for example, are negative points in the institutional structure of Brazil, particularly in comparison to Asian countries.

The main points which particularize the BRICs have been pointed out in previous paragraphs. None of the BRICs has all the preconditions to become a developed country in the short term. However, it's possible that, after they surmount their own particular hurdles, they could boost growth and economic sustainability in the coming years to ultimately realize the predictions foreseen for these countries in 2050.

In relation to the RICs, Brazil has performed best in addressing aspects such as curbing inflation, thanks to its mature inflation-targeting system, and also in offering good conditions to institutions, with democracy and social mobility. It has also implemented more suitable price incentives, such as the flexible exchange rate system, it honors business contracts better, and has a sounder financial system in place than the other countries.

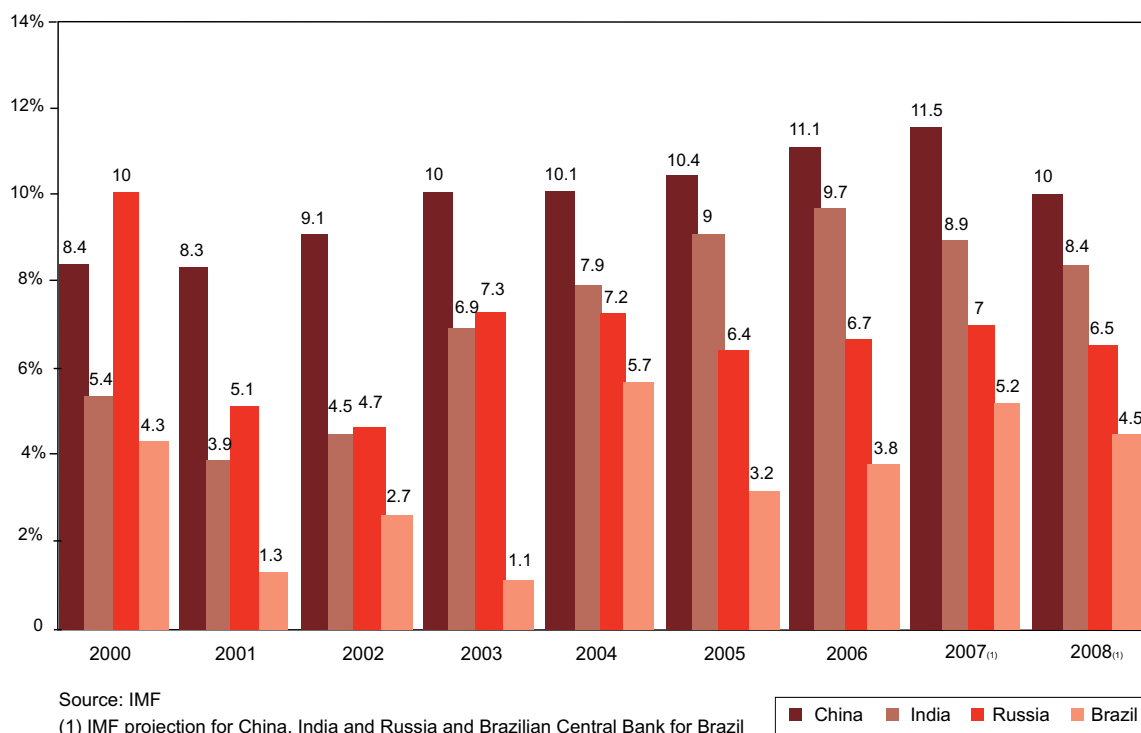
On the other hand, Brazil's openness to trade is still thwarted. As a result, local companies have little incentive to compete abroad. This holds back the country's productivity. The level of education is still precarious, both in terms of middle-grade education and investments geared to more technological areas. The public sector is also very large and absorbs funds that would be better invested by the private sector under free market conditions.

In conclusion, the recent rates of growth of the BRICs could indicate which countries are ahead in the race to converge with the levels of income of developed countries. Obvious improvements seem to have been made in the short-term conditions fostering the growth of Asian countries, which have been more proactive in making the additional reforms needed to maintain this trajectory of convergence.

Russia has benefited in the short term from high crude oil prices but seems to be less disposed to undertake the necessary institutional reforms to expand its potential GDP. Despite all its macroeconomic improvements in recent decades, Brazil still needs to open itself more to trade, to curb public spending and make sure it is spent more efficiently, to provide incentives for education, to introduce reforms that improve business conditions and predictability, to reduce bureaucracy, to ensure a quicker judicial system and to improve infrastructure, among other measures.

Finally, an issue of concern to the world in the next few years will be the non-stop surge in commodity prices. The huge domestic demand from the BRICs, today amounting to almost 1/3 of US consumption, exerts serious pressure on natural resources, resulting in price hikes. Another unaddressed issue is the intense worldwide use of biofuels. This question has certainly not yet been resolved and will continue at issue in the next most relevant economic discussions.

Graph 13: Annual GDP Growth of the BRICs (%)



The basic conclusion is that **Brazil is currently experiencing its best** macroeconomic moment in the last 30 years and even in its entire history, in terms of some variables, such as balance of payments and inflation.



Ibirapuera Park, São Paulo

4. Conclusion

The BRICs are undoubtedly a group of countries with a high growth potential and a great influence on the world economy in terms of flows of trade, capital, migration and even geopolitics. Various studies have produced estimates of the comparative growth of the BRICs to other countries, whether G-3, G-7 or even OECD countries. However, long-term success – 2050 in the estimate of some writers – depends on certain short-term moves, particularly in relation to the implementation, soundness, maturity and consistency of economic policy.

The aim of this article was to discuss these economic policies in Brazil and, wherever possible, make market projections for the main variables in the coming years. The basic conclusion is that Brazil is currently experiencing its best macroeconomic moment in the last 30 years, and even in its entire history, in terms of some variables, such as balance of payments and inflation. There are ample conditions for Brazil to grow in the coming years without requiring major reforms, although it is believed that reforms will enable the country to achieve a more sustained and consistent growth. Brazil has managed to overcome the restrictions in its balance of payments, reduce inflation rates to international levels and keep them low, and also contain the expansion of the debt/GDP ratio. Strictly speaking, improvements have occurred.

The challenges to achieving more robust growth and reducing inequality and poverty are immense. The core of the future macroeconomic adjustment lies in the public sector. The social security system must be reformed and public spending retrenched. This will relieve the tax burden and help reduce real interest rates. Advances in education are urgent but what is required is better coordination and qualification rather than funds. The improvement of the public debt profile and higher public investment are other endeavors to be pursued, but both require fiscal reform committed to a permanent and long-lasting adjustment of public spending. Nonetheless, Brazil is on the road to fiscal adjustment. If the current primary surplus is maintained at 3.8% of GDP and there are plausible rates of growth and interest, the country will record a nominal zero around 2010. This should cause the debt/GDP ratio to fall rapidly.

The second great macroeconomic challenge facing Brazil is to expand and open its economy in order to boost the growth rate of productivity and technological innovation. The most propitious time to do this is when the currency is appreciated, although there may not be too much political will to do so.

The other challenges, generally speaking, are of a microeconomic nature, such as ensuring the proper functioning of the regulatory agencies, making the legal system more efficient, implementing political and labor reforms to reduce the burden on employment and income, lending support to the capital market, and the broad liberalizing of the exchange rate, among others.

Therefore, what is under discussion is not the road per se but rather the speed at which Brazil intends to go. If everything remains constant, considering the current tripod of economic policy based on inflation-driven targets, a floating exchange rate system and a primary surplus, Brazil will gradually build a better structure for growth, and reduce both the tax burden and real interest rates. However, if there were visible signs of a deeper reform of the Brazilian public sector and there was some credible commitment to making other reforms, the country could significantly speed up this rate of transformation and could quickly join those countries which will certainly become the most powerful in the world by 2050.

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